MARKET DEFINITION

OVERVIEW

1.1 This Chapter discusses the treatment of market definition in the merger guidelines of twelve countries (the “Guidelines”). The first section briefly summarizes the role of market definition in the analysis of the competitive effects of mergers and references a brief historical overview. The remaining sections review the main features of the Guidelines.

I. MARKET DEFINITION AS AN ANALYTICAL AND DISCIPLINARY TOOL

a) Why Market Definition?

1.2 The principal, if not exclusive, goal of merger control in these twelve countries is the identification and prevention of transactions that create or enhance market power. Market power is variously defined in the relevant jurisdictions but a definition that might be viewed as common to all of them would be the ability of the merged firm or of the firms remaining in the market after the merger to raise prices above (or reduce output below) competitive levels or otherwise to reduce rivalry. The objective (and challenge) of merger control is to prevent those mergers that do pose a threat of market power while not impeding those that do not.

1.3 Market power might best be reflected by the elasticities of demand (the percentage change in quantity demanded of the product or service concerned in response to a 1 percent change in its price) and of supply (the percentage change in quantity supplied in response to a 1 percent change in price) faced by sellers of the product in question or of the residual demand curve of the merged firm. In other terms, the question of whether a transaction creates or enhances market power could be resolved if one could actually calculate whether post-closing the merged firm could raise prices without suffering such a loss in demand as to make the price increase unprofitable. But this calculation requires a wide range of reliable market data that is frequently unavailable and the complex measurement of variables that affect demand and supply.

1.4 There are other ways to evaluate whether a transaction may lead to market power. One can examine the internal documents and interview knowledgeable personnel at the
merging firms and at customers, suppliers, competitors, etc.\textsuperscript{5} It now seems widely recognized that the input of the affected economic actors should be obtained where there is a need for a serious inquiry into the market power issue. On the other hand, without an analytical framework guiding both the inquiry and the evaluation of the material obtained, the inquiry can be easily frustrated. In short, there is frequently not enough reliable data to calculate elasticities and insufficient documentary or other evidence standing alone to determine with confidence whether a transaction will result in market power.

1.5 The most widely used proxy for the determination of the possible existence of market power is market share, i.e., the percentage of total sales of the product to be held by the merged firm and the distribution of the remaining share among its rivals. To calculate market shares presupposes the definition of a market and the identification of the firms participating in it. It is the goal of the market definition process to ensure that these calculations and thus the possible existence (or not) of market power corresponds as closely as possible to market realities.

1.6 In many cases, then, market definition is a first step in the process of evaluating whether a transaction creates market power as it allows the calculation of market shares and of concentration indices. These calculations in turn give at least an indication, however imperfect or rebuttable, of whether a post-transaction dominant firm or oligopoly can raise prices above the competitive level or otherwise reduce competition.

1.7 Most of the Guidelines recognize, explicitly (e.g., U.K.) or implicitly (e.g., Finland, New Zealand, the EC, and the U.S.), that market definition is not an end in itself but a useful discipline in many cases. It is important not only to recognize its value as a flexible analytical tool but also its limitations both in capturing market dynamics and in answering the ultimate market power issue.

\textbf{b) Evolution of the Concept}

1.8 The use of market definition as an analytical tool in merger cases was introduced in 1948 in the U.S. While the Clayton Act had since 1914 prohibited any transaction the effect of which "may be substantially to lessen competition," there is little in the
legislative history that interprets this term and, as with the Sherman Act, the courts and the enforcement agencies were left to give meaning to vague statutory language. Case law interpreting the statute was sparse until the 1950’s. In any event, by the late 1950’s and early 1960’s, product and geographic market definition played a central role in U.S. merger analysis, yet there were no standards guiding the process.

1.9 In 1968, in the first set of merger guidelines issued by the U.S. Department of Justice, market definition was included as a formal first step in the evaluation of the competitive effects of a merger. But the guidance that was provided on how to define a market was at a minimum confusing and was severely criticized by a presidential task force. Even in the early 1980’s, there was no consensus on a sensible way to define markets and there was frequent criticism of the way in which the agencies and the courts defined markets, e.g., their findings were often thought to be designed to achieve a pre-ordained result of prohibition. In 1980, a Harvard professor and former Assistant Attorney General in charge of the DOJ’s Antitrust Division said that the case law on market definition was “a bloody mess.”

1.10 The 1982 DOJ Merger Guidelines formalized a methodological approach to market definition that had evolved through the preceding decade. The then-head of the Antitrust Division, Stanford Professor William H. Baxter, was committed to bringing economic rigor to the process. The effort was successful and over time, the “smallest market principle” and the “small but significant non-transitory increase in price” (SSNIP) test (see below) have become, with revision and refinement in subsequent guidelines of other countries, the predominant analytical tool in merger analysis.

1.11 The twelve Guidelines under discussion were adopted between 1991 (Canada) and 2003 (U.K.) and in all of these market definition plays a central role in the assessment of mergers – in some jurisdictions it has been sanctioned by the highest judicial authorities. Most have adopted some form of the SSNIP test or its equivalent.

1.12 It is important to understand, however, that as critical a step as market definition may be in most cases, it must not be confused with the overall objective – the evaluation of the likely competitive effects of a merger. Several Guidelines explicitly recognize the subsidiarity of market definition to the assessment of the competitive effects of a
merger. For example, the Irish Guidelines make clear that because market definition is an indirect way of assessing market power, it is not a required step in all instances.

[T]he approach to market definition...is not mechanical, but rather a conceptual framework within which relevant information can be organised. In particular, it will not always be necessary for the Authority to reach a firm conclusion on market definition. This will be the case, for example, where it is clear that the merger does not raise competition concerns on any reasonable definition of the market. Alternatively, the Authority may not define a market if the transaction clearly gives rise to adverse competitive effects.

Nonetheless, the recognition that market definition is only a means to an end does not negate the need for the adoption of sensible and transparent guidelines on this issue in all jurisdictions enforcing merger control. Also, to the extent that a jurisdiction’s market definition methodology introduces analytical rigor and discipline into the evaluation of the market power issue, it can add enormous value to the process. The conceptual breakthrough represented by the SSNIP test, for example, contributed not only to the market definition process but also to the fuller understanding of what constitutes market power and what does not.

c) The Relationship of Market Definition to the Respective Applicable Substantive Standard

1.13 At the risk of some overgeneralization, it seems fair to say that seven of the Guidelines in issue use the substantial lessening of competition (“SLC”) test as their substantive standard for assessing a transaction’s lawfulness and five use the dominant firm standard. There is a broad consensus on the value of sound market definition as a framework for the application of either standard, and a majority of the Guidelines use similar concepts and tools (with varying degrees of detail and explanation) to define markets irrespective of the substantive test employed.

1.14 The question arises whether market definition is more important in applying one or the other substantive standard. Under an SLC standard, market definition in a coordinated interaction case is likely to be highly useful to the analysis because the likelihood of
coordinated effects turns on the number of rivals, the availability of substitutes, the
distribution of share, and the existence of excess capacity and of detection and
punishment mechanisms, etc. On the other hand, market delineation in a unilateral
effects case would seem less important: evidence that the firm has or will have
significant market power, e.g., margin data, together with a finding that a substantial
proportion of the merged firm’s customers would be forced to pay higher prices (due to a
lack of available substitutes), provides significant evidence regarding competitive effects
without the need to define the market. It might seem, therefore, that market definition
would be less critical under a single firm dominance standard. But, if anything, the
opposite seems to be true. This may have occurred because some authorities under the
dominance standard operate under legal standards that are perceived to require a
finding of a certain minimum market share before dominance can be established, and
because these authorities have underemphasized evidence of the firms’ residual
demand elasticity, e.g., margin data, while trying to infer that elasticity from market
share.

1.15 In any event, regardless of the applicable substantive standards, market definition is a
key component of merger analysis and its underlying premise of marginal substitutability
plays a valuable role in focusing the parties on the market power question.

II. PRODUCT MARKET DEFINITION

a) Demand-side substitutability

1.16 In virtually all of the Guidelines, the process of defining the product market begins with
the identification of the goods or services supplied by the merging firms. The next step
is to identify the goods or services that may be considered substitutable or
interchangeable with these goods or services by customers (demand side
substitutability). Some of the Guidelines state explicitly that these products must be
economic or “close” substitutes. The overall goal is to identify and include in the market
only those substitutes whose prices and other characteristics constrain the ability of the
merging firms and their rivals from raising prices or reducing output.

1.17 Most of the Guidelines cite a mixture of qualitative and quantitative criteria to assist in
identifying products that are “in” or “out” of the demand side of the market. Some use
descriptive, largely static criteria such as “physical characteristics” and “end use.” Similarity in price is also used as an indication of whether products may be close substitutes. Industry’s perception of the role of the product is also included in some Guidelines. These criteria are useful in excluding many products from consideration but alone can not answer the dynamic question of economic substitutability, i.e., the extent to which a product or products currently and going forward will constrain the pricing of the product of the merged firm.

1.18 Only seven of the Guidelines seem to take account of qualitative factors that go beyond physical properties, end uses, and industry perceptions.\(^\text{15}\) For example, switching costs, e.g., the costs borne by a buyer switching from one product to another, are referenced in only six of the Guidelines.\(^\text{16}\) Only three of the Guidelines refer to the concept of a “chain of substitution” that may exist in certain consumer products (autos, furniture, clothing, etc., see below).\(^\text{17}\) Also, the idea of comparing the movement of prices of the products in issue over time to determine if there are similarities is also contained in only a minority of the Guidelines. The economic concept of price discrimination (see below) is referenced in only seven of the Guidelines despite the fact that it may be outcome-determinative in at least some cases.\(^\text{18}\) To be sure, these concepts are not affirmatively rejected in any of the Guidelines, and may well be used frequently in those jurisdictions. In any event, there is a distinct gap in the breadth and depth of the relevant factors cited in the twelve Guidelines.

b) **The SSNIP test**

1.19 As noted in the introduction, the SSNIP or “hypothetical monopolist” test has been widely accepted as an important tool for market definition purposes. The test is designed as a sometimes rough but often useful way to probe the boundaries of the product and geographic markets. The test may be easier to use in industrial input markets where the number of buyers is relatively small (i.e., most if not all can be interviewed) and where the buyers routinely consider substitution choices. It may be more difficult to use in highly differentiated products (especially consumer goods) because it is difficult to do reliable surveys and because customers have non-monetary reasons for their purchasing decisions.
1.20 The SSNIP test has become synonymous with market definition in many jurisdictions. Yet the Guidelines of some jurisdictions do not refer at all to the test or refer only broadly to the concept of including a product in the relevant market if customers would switch in response to a price increase. As noted above, the SSNIP test has introduced discipline into what otherwise can be an unwieldy and open-ended inquiry. The core concepts of demand and supply side elasticity that the SSNIP test represents must be a part of a sound merger control system, whether embedded in the market definition methodology or elsewhere in the analysis.

1.21 Eight of the Guidelines explicitly adopt the SSNIP test. The objective of the test, according to the Canadian Guidelines, is to identify

the smallest group of products and smallest geographic area in relation to which sellers, if acting as a single firm (a ‘hypothetical monopolist’) that was the only seller of those products in that area, could profitably impose and sustain a significant and non-transitory price increase above levels that would likely exist in the absence of the merger.

1.22 Two issues raised by the use of the SSNIP test are (i) the prices to be used as the basis for the hypothetical question (i.e., assuming the price of the product were X, if X rose by 5%, would you switch to another product?) and (ii) the appropriate price increase to be postulated. The treatment of these issues in the Guidelines is outlined below.

Base price under the SSNIP test

1.23 Using an appropriate base price for the SSNIP test is fundamental. The base price affects the demand and supply responses of those queried as to whether they would switch to alternative products and thus the delineation of the “smallest” market in which to measure share and evaluate the market power issue.

1.24 Seven of the Guidelines discuss the base price to be used for the SSNIP test. These Guidelines generally suggest that the “prevailing market price” be used as the base price. Five of them (i.e., EC, Ireland, New Zealand, the U.K. and the U.S.) state that where the prevailing price does not appear to be the competitive price, a competitive price should be substituted. The U.S. guidelines cite pre-existing “coordinated
interaction” as a circumstance that may have led to prices above the competitive level and thus is a reason to use a price in which a lower competitive price as a base price for the SSNIP test.24 The Guidelines of other jurisdictions (e.g., the EC and New Zealand) allude to possible reasons why the prevailing price is not the competitive price but, like the U.S. guidelines, do not advise how to determine the competitive price.25

1.25 The danger of using a price above the competitive level for defining markets is illustrated by a U.S. case from the 1950’s. (The case involved the issue of defining a market involving cellophane and the error made by the court has become known as the “cellophane fallacy”26 – the Australian and U.K. (OFT & CC) Guidelines refer to this case.) A base price above competitive levels will cause an overly broad market to be defined because more products will be viewed by customers as substitutes and a broader market defined by the process. The impact of defining a broader market than appropriate depends on the facts of an individual case. A broad product market may understate the actual competitive impact of a transaction involving firms offering closely substitutable products by including in the market products that are not in fact substitutes for those products at the (lower) competitive price. Alternatively, an overly broad market may overstate the actual competitive effect of a transaction where the merging parties offer products that are similar but not substitutable at the (lower) competitive price. In short, identifying and utilizing the “correct” base price for purposes of the SSNIP test is important to the process.

1.26 Four of the Guidelines discuss the possibility of using prices that would prevail in the future absent the merger when they can be predicted with reasonable reliability.27 The Australian Guidelines indicate that future prices absent the merger are the most appropriate base price for application of the SSNIP test because those prices most accurately reflect the prices customers would actually use in their switching decision absent the merger.28 No methodology is suggested for selecting the appropriate future price. The Irish, U.K. (OFT), and U.S. Guidelines all give the example of a change in regulation as an event that may predictably change prices.

1.27 Again, it is useful to consider whether the choice of a base price might depend somewhat on the relevant substantive standard and the statutory objective. If the dominance standard is understood as preventing any increase or strengthening of
existing dominance, then one might favor the competitive price as the base price because if it is below the “prevailing price,” customers would presumably respond that they would not shift to an alternative product in response to a 5% price increase. This would in turn result in a relatively narrow market definition, high shares, and likely prohibition even if the share of the acquired firm were very low.

1.28 On the other hand, if the standard is SLC and the statutory objective is to prevent a significant lessening of competition from current conditions, one might use the prevailing or likely future price (even if supracompetitive) to test substitutability and thereby define the market. If customers would switch to substitute products, then a relatively broad market would be defined, which would more likely result in approval of the transaction. This would be consistent with a regulatory regime whose goal was to prevent only a substantial lessening of competition from the prevailing competitive status quo.

*Size of price increase under the SSNIP test*

1.29 A 5% price increase is the most popular benchmark for the SSNIP test. One jurisdiction, Australia, refers only to a “relatively small percentage increase.” The Canadian, U.K., and U.S. Guidelines indicate that a larger or smaller price increase may be used where the application of 5% increase would not reflect market realities, though none provide much guidance on how to determine when this is the case. Ireland uses a 5-10% increase as a base. The EC refers to a 5-10% range and Brazil to a 5, 10 or 15% price increase depending upon the circumstances. Most of the guidelines acknowledge that no single percentage is correct in every case. For example, the U.K. (OFT) Guidelines refer to the 5-10% test as a “rough guide.” Also, as a practical matter, enforcement agencies have from time to time used a price increase as low as 2% in assessing possible supply responses (especially in defining geographic markets – see below) in high-volume, low margin products such as petrol or groceries.

1.30 Several Guidelines (e.g., New Zealand and the U.K.) also acknowledge that there are markets in which the SSNIP test is not normally used because it can not produce useful information. For example, in so-called bid markets like building or highway construction contracts, there is generally no prevailing or competitive price on which to base the test. The relevant market is generally defined by reference to those firms capable of bidding.
and the issue is whether the transaction reduces the number of bidders, say, from 4 to 3. The same approach probably applies in most transactions in defense industries.

c) **Supply-side substitutability**

1.31 Firms not currently selling a product in competition with that of the merging firms but that could readily do so within a short period in reaction to a price increase can constrain the exercise of market power just as effectively as consumers switching to alternative products. On the other hand, for supply substitutes to be considered an effective competitive constraint, suppliers must be able to switch production to the relevant product in a short time period without incurring significant additional costs or risks. The SSNIP test is employed in many of the Guidelines in determining what supply substitutes to include in the market.

1.32 Most of the Guidelines in one form or another acknowledge the importance of the supply-side in determining the issue of whether a transaction would create market power. A majority of the Guidelines use supply-side substitution in defining the boundaries of relevant markets.29 (A notable exception is the U.S. – see below.) In addition, while the Brazilian, EC, Finnish, Irish, Japanese and Romanian Guidelines indicate a preference for demand-side substitutability factors, supply-side factors may also be considered if they are as effective a constraint on the hypothetical monopolist as demand-side substitutes.

1.33 Some Guidelines establish an express hierarchy between demand-side and supply-side factors: markets must be defined “primarily from the standpoint of consumers” (Ireland) because demand is considered “the most immediate and effective disciplinary force” (EU). Others simply mention demand-side and supply-side factors in turn.30 However, all the Guidelines that provide for the inclusion of supply substitutes in the relevant market put conditions on their inclusion. These conditions generally relate to the time within which the supplier can in fact respond with a product competitive with that of the merging firms and the cost (investment) needed to respond.

1.34 In order to be considered at the market definition stage, the Brazilian, Canadian, Irish, New Zealand, and the U.K. Guidelines state that the response should generally occur
within a year of the price rise. All of these Guidelines acknowledge that the exact time period will in each case depend on the nature of the market and specific circumstances of the case. The EC, Finnish, and Romanian Guidelines do not specify a time period but instead use the words “short term,” “quickly,” and “reasonable period,” respectively.

1.35 The U.K. and Irish Guidelines add a practical consideration: supply substitutes will be included in the relevant market if the units of output are sufficiently homogeneous to be meaningfully brought into market share calculations. The UK Authorities also include supply substitutes in the relevant market if there are similar products and/or operating in adjacent areas. Otherwise, supply responses will be considered elsewhere in the analysis.

1.36 In sum, while there is a broad consensus on the importance of supply substitutes to market definition, the Guidelines differ concerning at what stage in the market power analysis it is to be utilized: the market definition stage, as part of the entry analysis, or in the assessment of competitive effects.

1.37 For example, the U.S. Guidelines define relevant markets solely on the basis of demand-side factors. Consideration of supply-side factors is given only at subsequent stages of the process when additional market participants or credible entrants are identified. Several advantages (among others) are said to result from not including supply substitutability as part of market definition. In summary, it seems clear that the factual question of whether a firm or firms on the supply side will respond to a price increase depends upon a complex set of issues, i.e., production capability and flexibility, contractual commitments to (and customer relations with) current customers, margins on current products, etc. Also, because of these often complex issues, determining demand-side substitutability is normally less difficult than determining supply-side substitutability. It is thus arguably more sensible and efficient to complete the demand-side task and then take account of the more complex and time-consuming questions presented by the supply side.

1.38 On the other hand, the U.S. approach has been said to lead to possible complications in homogeneous product markets where capacity shifts can occur within a few hours. In those situations, defining a single comprehensive market may be as accurate as and
simpler than the U.S. process. It might be also argued that these alleged disadvantages to proper market definition including supply-side substitutes can be dealt with by proper and rigorous methodology – basically, a consideration of each case on its own merits.

1.39 In any event, there are probably very few cases in which the calculation of market share(s) under the U.S. approach will differ from the calculation under the approach that includes supply-side responses in market definition. This is because the U.S. guidelines provide for the inclusion in the market share calculation of all market “participants,” which includes firms not currently producing the product if they are “uncommitted entrants.” These are firms whose supply response to a price increase in the products of the merging firms would likely occur within one year “without the expenditure of significant sunk costs.”

1.40 Also, even those Guidelines that include supply responses in market definition exclude products of potential suppliers at the market definition stage if substantial time or investment impediments exist. Most of those Guidelines then consider these suppliers in the assessment of whether their entry into the relevant market would counter the creation or exercise of market power. The Australian, Brazilian, Canadian, EC, Finnish, and U.K. Guidelines take this view if switching to the production of the relevant product requires significant new investment or a significant amount of time (typically more than a year). Some of these Guidelines refer to the considerable investment required, for example, by the construction or adaptation of facilities, research and development, and significant impediments related to technology, marketing, and distribution.

1.41 In Ireland, producers of supply substitutes that exercise an immediate competitive constraint but whose units of output cannot meaningfully be added into market share calculations are considered at the competitive effects stage. Factors that exercise a longer-term competitive constraint are considered as entry effects.

1.42 In any event, the choice of which stage to consider supply-side substitutability should not change the outcome on the market power issue:
Some competition authorities prefer to define markets solely on the demand-side, leaving supply-side issues to the analysis of new entry. In practice both approaches should produce the same conclusions on the question of market power, provided that supply-side issues are examined at some point….Defining markets on the supply-side can allow early determination that an undertaking has no market power, thus avoiding the need for further analysis.⁴⁷

Perhaps the optimum guideline on supply-side substitutability would be early consideration of supply responses that would be immediate and with no or little investment. This would allow for early resolution of cases where supply side substitutability alone answers the market definition (and market power) question. In all other cases, the supply side would be considered later in the process, i.e., after the market is defined on a demand side basis only.

III. GEOGRAPHIC MARKET DEFINITION

1.43 The geographic market definition process starts with the identification of the geographic area where the merging parties offer the overlapping product and seeks to identify other areas where customers could purchase these products should the sellers post-transaction raise prices. The language of the Australian Guidelines is typical of most Guidelines:

Starting with the geographic area supplied by the merged firm, each geographic market is gradually expanded to incorporate sources of supply to which consumers would turn and firms which supply, or would supply, the relevant product into that area in the event of a significant price rise.

1.44 As with both the demand and supply dimensions of product market definition, the SSNIP test plays a key role in the demand and supply dimensions of geographic market definition. Customers are asked if they would look outside the hypothetical geographic market if prices within that market rose and suppliers outside of the market are asked if they would sell into it if prices rose. This iterative process is completed and the geographic market defined when the hypothetical monopolist in an area can raise prices profitably without too many customers looking beyond that area or without too many out-of-area suppliers entering in response. In practice, because of the availability of
shipment cost data, the SSNIP test may operate with less friction in the geographic
dimension than in the product market dimension.

1.45 Some of the Guidelines refer generally to the test of applying a hypothetical price
increase to define geographic boundaries:

The Commission will seek to define the geographical extent of a market to
include all of the relevant, spatially dispersed, sources of supply to which buyers
can turn should the prices of local sources of supply be raised.\(^{38}\)

Others are more specific in their reference to the SSNIP test:

The Authority delineates the geographic market for each relevant product, to be a
region where a hypothetical monopolist of the product in the region could
profitably impose a small but significant and non-transitory increase in price,
holding constant the conditions of sale for all products produced elsewhere.\(^{39}\)

1.46 Indeed, eight of the Guidelines (Finland, Germany, Japan and Romania excepted) refer
to the SSNIP test. One of the Guidelines notes at the outset a relationship between the
value of the product and the dimension of the geographic market:

Generally, the higher the value of the product to be purchased, in absolute terms
or relative to total buyer expenditure as appropriate, the more likely are buyers to
travel and shop around for the best buy, and the wider the geographic extent of
the market is likely to be.\(^{40}\)

1.47 While most Guidelines contemplate the possibility of local (i.e., “infra-national”) markets,
only five of the Guidelines expressly refer to the possibility of an international market.\(^{41}\)
Other Guidelines do not seem to exclude the consideration of foreign competition\(^{42}\) but
indicate that it will be taken into account as part of the competitive assessment rather
than at the market definition stage.\(^{43}\) This would seem unduly to complicate the
analysis, especially the calculation of market share.
1.48 Some Guidelines refer to qualitative factors to assist in defining the relevant geographic market. For example, the EC and Romanian Guidelines refer to an area where the conditions of competition are “sufficiently homogeneous.” The EC takes particular note of the process of market integration in the Union and the need to recognize artificial national barriers to trade that are in the process of being dismantled and thus may affect the scope of the geographic market going forward. 44

IV. VERTICAL INTEGRATION, THE TEMPORAL DIMENSION, AND OTHER ISSUES

1.49 The Australian Guidelines explicitly add a so-called functional dimension to market definition:

Delineation of the relevant functional market requires identification of the vertical stages of production and/or substitution which comprise the relevant arena of competition. This involves consideration of both the efficiencies of vertical integration, commercial reality and substitution possibilities at adjacent vertical stages. 45

The purpose of this unusual feature is apparently to consider whether products produced or sold at several levels by vertically integrated firms, or by firms at another level of distribution than the merging firms, should be included in the relevant market because the exercise of market power at one stage of distribution can be constrained by firms at an adjacent level of distribution. Several other Guidelines (Australia, New Zealand, U.K.) discuss the effect of vertical integration in market definition, but in more general terms, e.g., the U.K. (CC) Guidelines state that “conditions in downstream and upstream markets may affect the assessment of demand-and-supply-side substitution …” 46

1.50 Transactions involving vertically integrated firms raise the issue of whether production of a relevant product consumed internally by a market participant (“captive production”) should be considered in the product market or whether only production sold to the “merchant market” should be included. The Guidelines that refer to this issue generally follow the principle that captive capacity or production will be included in the market only if it can be demonstrated that it would be profitable for the supplier to forego captive use and sell into the merchant market in response to a SSNIP of the product in the merchant market. For example, the U.K. (OFT) Guidelines note that “The OFT may take into
account captive capacity or production where that capacity or production could be readily and profitably switched to the free market." Under the U.S. Guidelines, the products of vertically integrated firms are included in the relevant market “to the extent that such inclusion accurately reflects their competitive significance in the relevant market prior to the merger.” This standard would seem to leave the issue open to development on a case by case basis.

1.51 Several Guidelines consider the time period over which substitution possibilities should be considered in market definition. (This is in addition to the reference to a time period - usually less than one year - to determine whether supply-side substitutes will be included in the market.) The Australian Guidelines “consider substitution possibilities over the longer term but still in the foreseeable future, that will effectively constrain the exercise of significant market power by the merging firm.” Both the EC and U.K. (OFT) Guidelines indicate that regulatory changes over time (e.g., European market integration or deregulation in certain sectors) that may change the nature of competition will be taken into account, although no specific timeframe or methodology are mentioned. The New Zealand Guidelines refer to a broader range of future possible changes that may affect market definition:

*The Commission will take into account recent, and likely future, changes in products, relative prices and production technology in the process of market definition.*

Such an expansive approach provides significant flexibility in assessing the scope of the relevant market but also provides the possibility of an open-ended and legally uncertain process.

**Price Discrimination**

1.52 As noted previously, seven Guidelines reserve the possibility of defining markets of a subset of customers who are “captive” in the sense that, unlike others, they could not switch to another product or to a supplier outside of a geographic area in response to a price increase. Price discrimination can occur in both the product dimension (business travelers with a high value on certain departure and arrival times) and in a geographic dimension (customers without access to modes of transportation available to others).
This concept is variously treated in the Guidelines that do address it. For example, the Finnish Guidelines do not refer to the term “price discrimination” but do contemplate that “separate markets” may exist where certain customers must pay higher prices than others:

> The difference between various groups of customers and the differences between the prices of goods can have a bearing on the market definition. There can be separate markets, for example, if the goods are clearly sold at different prices and on different conditions to different groups of customers, even though the physical characteristics and the intended use of the goods would indicate that they belong to the same market.  

1.53 Other guidelines refer to “targeted” or “captive” customers to whom the relevant product is sold at higher prices because of the ability of sellers to price discriminate against them. Price discrimination would seem an important concept in some cases and its absence from some Guidelines, while not necessarily indicating it is not a feature of market analysis in those jurisdictions, is notable.

**Chains of Substitution**

1.54 Three of the Guidelines discuss “chains” or “links” of products or geographic areas that may in combination constitute a relevant market under certain conditions despite the fact that they are not direct substitutes. The U.K. Guidelines take as an example the automobile market where a relatively inexpensive car may not be viewed as a close substitute for a luxury car (at least not according to a SSNIP test) but where nonetheless both cars may be in the same relevant product market. This is because there are many models in between the two models and a rise in price of the small car might affect the demand and supply of cars adjacent to it in size and price, which will in turn affect conditions in cars adjacent to them, and so on until the “ripple” effect extends over the entire car market. This concept may also be helpful in service markets (e.g., ocean cruises where the cheapest room is not seen as a close substitute in a market definition sense for the most expensive stateroom but where they are linked in a continuous chain of price and quality). In any event, most Guidelines do not address this important concept.
V. HOW TRANSPARENT ARE THE GUIDELINES?

1.55 The Guidelines give valuable guidance to merging companies in defining markets. While some are quite general and others very detailed, they all describe generally the underlying principles and criteria for market definition and provide a list of factors and evidence that the authorities will rely on in defining the relevant market. Some Guidelines also summarize the process of defining markets. Some Guidelines do not provide guidance on the process and presumably defer to the agencies, courts, and practitioners to apply the principles on a case-by-case basis.

1.56 Case-law is cited in three of the Guidelines. The Australian and New Zealand Guidelines contain frequent citations and quotations from cases that support certain propositions. This reference to case law guides the reader to important cases concerning market definition and sometimes provides the language of courts used in deciding them. The Japanese Guidelines provide many illustrative examples of past cases involving market definition in a wide variety of industries. This approach can be useful as it offers the benefit of practical examples. Other Guidelines (e.g., the EC and the U.S.) seek to identify core issues and basic criteria in a shorter format without frequent examples or citations of case law. This approach has the advantage of emphasizing core legal and economic principles to be applied in all cases. The two most recent draft Guidelines (Ireland and the U.K.) focus on core principles and do not cite case-law.

1.57 A balance needs to be struck, it seems, between guidelines that are so detailed as to carry the potential to confuse the reader or to appear to reflect inflexibility in dealing with what are by definition enormously complex and varied circumstances, and guidelines that contain a limited number of well-defined but broadly applicable principles. For all cases, scope must remain for additional learning about how real-life markets operate and how they can be defined, measured, and understood by competition enforcement authorities.

VI. CHART

1.58 A chart describing the key elements of each jurisdiction’s approach to market definition is attached as Exhibit 1.
The authors of this Chapter are Mark Leddy, Stéphanie Hallouët, and Michael Kehoe (Cleary, Gottlieb, Steen & Hamilton), Mauro Grinberg and Priscila Benelli Walker (Araujo e Policastro), and Javier Ruiz Calzado and Annukka Ojala (Latham & Watkins).

Australia, Brazil, Canada, Finland, Ireland, Japan, New Zealand, the United Kingdom and the United States address market definition as part of general guidelines on merger control, whereas the European Commission and Romania have issued specific guidelines on the definition of the relevant market in both non-merger and merger cases. The ‘Principles of Interpretation’ issued by the German authorities do not include detailed discussion of market definition. For the U.K., three sets of Guidelines were considered: the 1998 Market Definition Guidelines issued by the OFT, the draft guidelines consultation paper issued by the OFT in October 2002, and the Competition Commission guidelines issued in March 2003. The OFT subsequently published final guidance on the substantive test in May 2003, and the references in this chapter have been updated to refer to this new text. The guidelines are referred to as the “U.K. (OFT) Guidelines 1998”, the “U.K. (OFT) Guidelines” and the “U.K. (CC) Guidelines”, respectively.

1. The residual demand curve measures the elasticity of demand faced by the merged firm after all of its competitors’ sales of the product in question have been taken into account, i.e., it demonstrates whether the merged firm can increase prices to its customers.

2. “It is only because we lack confidence in our ability to measure elasticities, or perhaps because we do not think of adopting so explicitly economic an approach, that we have to define markets instead.” Richard A. Posner, Antitrust Law: An Economic Perspective (1976), at 125.

3. See, e.g., FTC v. Staples, Inc. 970 F. Supp. 1066 (D.D.C. 1997), where the court concluded that the transaction would likely lead to higher prices in significant part because the internal pricing data of the parties demonstrated that prices were lower in cities in which Staples and Office Depot competed than in cities where they did not.

4. In 1950, an amendment to the statute, among other things, added the language “in any line of commerce in any section of the country.”

5. In 1974, the U.S. Supreme Court held in Marine Bancorporation that “determination of the relevant product and geographic markets is a ‘necessary predicate’” in merger cases. 418 U.S. at 618.


7. In the 1960s and 1970s, the federal antitrust agencies and the courts were criticized by, among others, proponents of the so-called Chicago School for “gerrymandering” markets to block transactions in an alleged campaign against corporate “bigness.” The term “gerrymandering” refers to efforts by politicians to configure election districts to ensure that their party continues to hold the legislative seats for those areas.


9. “[A] proper definition of the relevant market is a necessary precondition for any assessment of the effect of a concentration on competition.” European Court of Justice, Joined Cases C-68/94 and C-30/95, France and Others vs. Commission, 1988 ECR I-1375, para. 143.

10. “Market definition is a tool to identify and define the boundaries of competition between firms. It serves to establish the framework within which competition policy is applied by the Commission.” (I.2) (In addition, the EU Competition Commissioner stated in 2001 that market definition is “a cornerstone of competition policy, but not the entire building...a tool for the competitive assessment, not a substitute for it.”) The U.K. (OFT) Guidelines indicate that “market definition is not an end in itself. It is a framework for analysing the direct competitive pressures faced by the merged firm.” (3.11). The Australia Guidelines recognize that because
market definition is subordinate to the goal of evaluating competitive effects, it is not a rigid exercise: “[T]he linking together of the process of definition of the market and its object implies some flexibility in the former.” (5.36).

Irish Guidelines at 2.2.

Australia, Canada, Ireland, Japan, New Zealand, the U.K., and the U.S. use the SLC test and the EC, Finland, Germany, and Romania test for dominance. Brazilian competition law contains tests for both dominance and lessening or restriction of competition.

Australian, Brazilian, Canadian, the EC, Irish, U.K and U.S. Guidelines.

Brazilian, Canadian, the EC, Irish, U.K. and U.S. Guidelines.

Australian, the EC and U.K. Guidelines.


The Finnish, Japanese and Romanian Guidelines do not mention the SSNIP test as an analytical tool to measure substitution. As noted above, the German ‘Principles of Interpretation’ do not include detailed discussion of market definition.

3.1.

Australia, Canada, the EC, Ireland, New Zealand, the U.K. and the U.S.

For example, “[T]he price to take into account will be the prevailing market price.” EC Guidelines at II.19.

“[T]he Agency will use prevailing prices of the products of the merging firms and possible substitutes for such products, unless premerger circumstances are strongly suggestive of coordinated interaction, in which case the Agency will use a price more reflective of the competitive price.” U.S. Guidelines at 1.11.

Id.

The EC Guidelines state, for example, that the prevailing market price might not be appropriate “where the prevailing price has been determined in the absence of sufficient competition”’EC Guidelines at II.19. The New Zealand Guidelines state, “Where the Commission considers that prices in a given market are significantly different from competitive levels, it may be necessary for it to assess the effect of a ssnip imposed upon competitive price levels, rather than upon actual prices, in order to detect relevant substitutes.” New Zealand Guidelines at 3.6 fn. 23.

United States v. E.I. duPont de Nemours & Co. 351 U.S. 377 (1956). In this monopolization case the Supreme Court held that Du Pont did not have significant market power because, at prevailing prices, there were substitutes available for cellophane. The criticism of this decision has centered on the allegation that the prevailing prices were above competitive levels. At (lower) competitive prices for cellophane, there may have been no substitutes for cellophane, and thus Du Pont would have had market power.

Australia, Ireland, the U.K.(OFT), and the U.S.

“By using the likely future price absent the merger as the relevant base price, the market is defined in a way which is relevant to the conduct at issue, by identifying and including the closest substitutes to the merging firms product(s).” Australian Guidelines at 5.44 fn. 38.

The U.K. (and EC) uses the paper manufacturing industry as an example of the utility of supply-side substitutability in defining markets. While different types of paper are not demand side substitutes (bond paper vs. copier-grade paper), both are made on the same machines in the same process. The machine can fairly easily and without significant expense be switched from producing one to producing the other. Thus, bond paper and copier paper should be in the same product market.

The Japanese Guidelines do not distinguish between supply-side substitutability and market entry but merely list as criteria for market definition some factors that are generally used to identify supply substitution.


See, e.g., Philip E. Areeda and Herbert Hovenkamp, ANTITRUST LAW at 561d.

Firms that could respond but would require more time or significant sunk costs (“committed entrants”) are considered in the entry analysis, U.S. Guidelines at 1.32.

Irish Guidelines at 2.10.


New Zealand Guidelines at 3.3.

Irish Guidelines at 2.7.

New Zealand Guidelines at 3.3.

Australian, Canadian, EC, U.K. and U.S. Guidelines. The Romanian Guidelines also seem implicitly to consider this possibility, although it is not clear whether they are merely stating a hypothetical future development: “[T]he progress in the field of transports and communications and the tendencies of abolishing the barriers and of liberalising the international trade may alter, in time, the limits of the relevant geographic market, going beyond the borders of a country.”

Although this is not clear in the Japanese Guidelines: “Even if the business area of company extends to foreign countries, the competition to be maintained…is domestic competition in Japan. Therefore, the main focus of examination will be on the scope of business activities of domestic traders.”

New Zealand Guidelines: “the Commission, in order to comply with the wording of the Act, is likely to define a national market and then…to consider the extent to which overseas suppliers exercise a competitive constraint on the participants in the domestic market.” We understand that this is also the approach of the German authorities (“normative” market vs. “economic” market).

EC Guidelines at 32: “A situation where national markets have been artificially isolated from each other because of the existence of legislative barriers that have now been removed will generally lead to a cautious assessment of past evidence regarding prices, market shares or trade patterns.”

Australian Guidelines at 5.64. The Guidelines note that, for example, a single functional market for the distribution of groceries to the public was defined, reflecting the constraint imposed on the conduct of independent wholesalers by downstream competition between their independent retail customers and the vertically integrated chains. The New Zealand Guidelines also add a functional level (3.4). [?]

U.K. (CC) Guidelines at 2.35.


1.31.


Finnish Guidelines.


U.K. (OFT) Guidelines 1998 at 3.9; Australian Guidelines at 5.55; EC Guidelines at 57-58.
