

CRA Competition Memo



Sponsored Entry

Some mergers materially reduce the choice of suppliers available to customers. When this happens, how much weight should competition authorities give to the potential for customers to sponsor new entry? Two recent cases investigated by the UK Competition Commission (CC) give an insight into the circumstances in which sponsored entry arguments are likely to be successful. In one case, it was concluded that the threat of customers sponsoring a new entrant was so potent that the merged firm would have no incentive to raise prices. In the other, customers were found to have shifted significant volumes to alternative suppliers following a completed transaction which raised substantial competition concerns. The CC cleared both deals without conditions.¹

Defining sponsored entry

When is entry “sponsored”? A precise definition is hard to pin down but it can be viewed as a variant of standard buyer power arguments. The implication is that a customer would be prepared to guarantee some level of business to either a new entrant or a currently small incumbent in order to expand its choice of supplier.² The option of sponsoring entry is therefore limited to a certain type of customer: it needs to be sufficiently large such that the offer of a proportion of its business would justify the supplier undertaking the required financial investment.

This guarantee may be implicit or explicit, but the customer would need to have some aspiration that a sponsored entrant would be able to meet certain price and service quality criteria once it became operational. In some cases, the customer may be prepared to make a short-term financial sacrifice in return for a longer-term benefit. This might be the case, for example, if a new entrant or a small supplier needs time to increase capacity and reduce average cost through scale economies; the customer may be willing to pay higher prices in the short term if it facilitates the expansion of an efficient low cost producer in the longer term.

¹ The author worked for the merging parties on both cases. The views expressed are those of the author alone and do not represent those either of the clients involved or other CRA staff.

² In practice, offering substantial business to a previously small supplier can be considered as “sponsoring expansion”. In this memo I consider the term “sponsored entry” to include the sponsoring of expansion as well as entry (and the second case study cited falls into the category of expansion sponsorship).

However, when considering sponsored entry as a potential response to a merger that materially reduces customer choice, it should be noted that any financial sacrifice of this sort would have to be transitory and of a relatively small magnitude for a sponsored entry argument to be a convincing countervailing factor. It is not sufficient that a customer could sponsor entry; it is also important that the new supplier be able to offer prices comparable to those available pre-transaction. The significance of the viability of the sponsored entrant or enlarged small supplier was a common theme in both cases investigated by the CC. The two cases are examined in turn below.

The BATS/Chi-X transaction

Pre-transaction, BATS’s European operations and Chi-X both operated multilateral trading facilities (MTFs) which facilitated the trading of equities across a large number of indices in 15 European states. When considering the proposed acquisition by BATS of Chi-X, the Office of Fair Trading (OFT) was primarily concerned with the potential impact of the transaction on the trading of UK FTSE 100 equities. The OFT accepted that the transaction had raised few customer complaints – with many respondents being in favour – but decided to refer the transaction to the CC, partly on the basis that the transaction would reduce the number of independent equity trading platforms with a material market share from three to two (an alternative MTF, Turquoise, had been previously independent but was now majority owned by the incumbent UK exchange, the London Stock Exchange (LSE)).

The CC examined the proposed transaction in detail. It found that the parties had both won business from the LSE but also had customer bases with a high degree of overlap. The parties were also found to have similar business models and fee structures. It reached the view that BATS and Chi-X were competing with each other pre-transaction and would continue to do so if the merger did not proceed. It shared the OFT’s finding that the only other exchange with a significant trading share was LSE/Turquoise (with Turquoise comparable to BATS and Chi-X in terms of service levels and trading fees). These findings meant that the CC’s view on buyer power and the potential for entry would be pivotal to its final decision.

On buyer power, the CC noted that the customers of both parties were well resourced and sophisticated financial

intermediaries with strong incentives to maintain high service levels and low trading fees. Switching costs were very low and influence could be exerted over the merged enterprise given that it would be substantially owned by consortia of major customers. The CC concluded it was “relevant” that major customers had not expressed significant concerns about the proposed transaction.

Further, the CC also noted that in light of the strong incentive customers had to maintain competition, sponsored entry was feasible. Although network effects were present – with the attractiveness of an exchange a function of how many other traders were using it – a market share of around 5% was deemed to be sufficient to justify connecting to an exchange. The CC also noted that there were historical examples of customer consortia sponsoring the establishment of MTFs (suggesting network effects were not a material entry barrier). It concluded that if the merged entity’s competitive offering did deteriorate, the ability of large customers to sponsor entry and encourage expansion would be sufficient to overcome any detriment.

The Kerry/Headland transaction

Kerry Foods and Headland Foods were the UK’s two largest manufacturers of frozen ready meals (FRMs). Kerry’s acquisition of Headland was not notified and the OFT began its investigation after the transaction had completed. Kerry argued that Headland was not a viable long-term competitor in the market given that it was loss-making, that no other credible bidders were forthcoming for the business and that large supermarkets – the key purchasers of FRMs – could readily shift substantial business to alternative suppliers were prices to rise as a result of the transaction. The OFT, however, referred the merger to the CC, noting that a number of customers had complained about the transaction, that the merging parties were each other’s closest competitors and that it was not clear that price rises post-merger could be fully justified by increases in costs. The OFT also commented that the merged firm was “by far the largest” supplier of FRMs to UK customers and that customers were concerned about a lack of alternative suppliers, particularly those requiring either large volumes or a full-range FRM supplier.

The fact that the transaction had completed allowed the CC to review how the market had evolved over the approximate six month period after completion. Following the transaction, it found that Kerry had sought price rises from its customers. Some were accepted by customers, others were resisted. Overall, the CC concluded that the price rises achieved were greater than the increase in input costs over the preceding 12 months. However, the CC was also able to assess what customers did in response to those initial price increases. Its analysis showed that many customers had switched, or made arrangements to switch, significant volumes of their business away to alternative suppliers. Some of this

information about customers’ intentions to switch had yet to be made known to Kerry.

Crucially, not only were customers able to switch, the CC found that customers were able to negotiate prices at rates around the levels found pre-merger, or if they were higher, the increment could be explained by an increase in raw material costs. The key finding made by the CC was that the merger had provided customers “with an incentive to seek alternative suppliers which they had not had before the merger”. In other words, customers sought to sponsor the entry and expansion of smaller players (including some located outside the UK) and found they could do so at economically viable prices. The fact that the merger was completed allowed the CC to review a natural experiment in which it could test Kerry’s argument that customers could readily find alternative sources of supply for high volumes of FRM despite the fact that the transaction brought together the two largest manufacturers in the market. The CC concluded that Kerry’s ability to increase prices as a result of the merger was unlikely to persist beyond the short term and it cleared the transaction.

The application of sponsored entry arguments

These two cases show that competition authorities are willing to consider sponsored entry arguments provided the economic analysis demonstrates that the impact is likely, timely and sufficient to counter a potential substantial lessening of competition resulting from a merger. In one case, the potential entry remained hypothetical, but modelling work, the views of customers and market precedents were relied upon to show that if the merged entity’s offering did deteriorate, sponsored entry would be likely to produce a viable rival. In the other case, the fact that the transaction was completed allowed an assessment to be carried out of customers’ ability to shift volume to previously smaller market participants at prices consistent with pre-merger levels.

Sponsored entry differs from standard buyer power arguments in an important respect. It can be argued that countervailing buyer power arguments have a weakness in that large customers may be able to protect themselves from the potentially anti-competitive effects of a merger but the impact on smaller customers could still be significant. Sponsored entry, in contrast, leads to the emergence of a new market participant whose output is likely to be available to customers regardless of size. That said, sponsored entry – like buyer power arguments in general – is only likely to be convincing in a minority of cases. It requires a number of stringent conditions to be met in order for it to be deemed to be sufficient to prevent a substantial lessening of competition. However, these recent cases show that competition authorities are willing to consider sponsored entry as a credible defence when these conditions are met.

© Charles River Associates, January 2012