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Counterintuitive? Counterfactual analysis in *Stagecoach/Preston Bus*

In the recent *Stagecoach/Preston Bus* case, the Competition Appeal Tribunal questioned the Competition Commission's choice of the counterfactual, in which the Commission considered the competitive situation in the market 18 months prior to the merger. The CAT's judgment in this case highlights the importance of the counterfactual in merger assessment

As part of a merger assessment, competition authorities typically compare the situation resulting from the merger to that which would have prevailed in the absence of the merger (ie, the counterfactual). If the competitive conditions are made substantially worse by the merger (compared with the counterfactual), the competition authorities might find that the merger leads to a substantial lessening of competition (SLC).

The counterfactual analysis is, by its nature, uncertain since there is usually little visibility of what would have happened in the absence of the merger. The assessment of the counterfactual is therefore not a precise science, and competition authorities often have to rely on their judgement.

The recent Competition Appeal Tribunal (CAT) finding in relation to the acquisition of Preston Bus by the UK local bus operator, Stagecoach, shows that the judgement call of the competition authorities is not always correct.[1] Stagecoach's appeal in relation to the UK Competition Commission's (CC) decision questioned whether the CC's choice of counterfactual was appropriate, an appeal which the CAT upheld.

This article examines the UK competition authorities' guidance on the use of counterfactual analysis in merger investigations, and discusses the central role of counterfactual analysis in *Stagecoach/Preston Bus*.

Use of the counterfactual in merger investigations

The joint merger guidelines of the UK Office of Fair Trading (OFT) and the CC set out the approaches adopted by the UK competition authorities in selecting the counterfactual.[2] Although the publication of joint merger guidelines signals an attempt to harmonise merger assessment between phase 1 and phase 2 competition authorities, their approaches remain different. When assessing whether a merger is likely to lead to an SLC, the OFT will consider the most competitive counterfactual (as long as it is realistic). Although this is usually taken to be the market conditions prior to the merger, the OFT will look at alternative counterfactuals if it considers the continuation of the pre-merger conditions to be unrealistic (for example, if one of the merging parties is an exiting firm or a potential entrant). These situations are described in more detail below.

The CC's approach, on the other hand, is to consider several counterfactuals and then choose the most likely scenario. Where there are several potential counterfactuals and where the choice would affect its overall assessment, the CC carries out an additional detailed investigation before choosing which to use.[3]

The joint guidelines highlight the following three circumstances in which the counterfactual may be different from the situation that prevailed in the market before the merger.

- **Exiting firm**—to determine whether the failing firm should be excluded from the market analysis in the counterfactual, the competition authorities need to consider what would have happened to the firm and its assets in the absence of the merger, including whether it would have failed or been bought by another firm in the market, and how its customers would have been redistributed among its rivals had it exited the market.

  The Stagecoach/Preston Bus merger provides an interesting case study in which the merging parties used this argument. The CC adopted a novel counterfactual which involved considering the

Oxera provided advice to Stagecoach during the CC's inquiry into the merger between Stagecoach and Preston Bus.

competitive situation 18 months prior to the merger, but this was later disputed by Stagecoach as part of its appeal to the CAT.

- **Loss of a potential entrant**—competition authorities will consider whether the counterfactual should include the entry by one of the merging parties into the market of the other, or, if both firms are already in the same market, whether either or both would have expanded had the merger not gone ahead. Such a conclusion may increase the likelihood of the authorities finding an SLC.

  Counterfactuals involving entry can also be used to clear a merger, for example if the merger attracts new entry into the market from third-party rivals. In *Greif/Blagden* (see box below), the existence of a potential third-party entrant, whose entry was accelerated as a direct result of the merger, resulted in the merger being cleared.

- **Competing bids and parallel transactions**—if several potential acquirers have placed bids for the target business, the OFT will examine them on a stand-alone basis to determine which, if any, might lead to an SLC. The OFT does not compare alternative bids with one another. The CC will consider various counterfactuals, including the bids of alternative purchasers that were not referred. Where all bids have been referred, the counterfactual will often be the pre-merger situation.

The difference between the CC and OFT's approaches can be explained by their different assessment timescales. The OFT has a much tighter timetable and, as a phase 1 competition authority, faces a lower threshold for an SLC finding than the CC.

Counterfactual in *Stagecoach/Preston Bus*

In November 2009 the CC found that the completed acquisition of Preston Bus by Stagecoach Group had led to an SLC, and proposed the divesture of a reconfigured Preston Bus business. Upon appeal, the CAT agreed that the merger had resulted in an SLC, but questioned the CC's choice of counterfactual, and was therefore concerned with the extent of the SLC resulting from the merger.

Background

Stagecoach Group Ltd is a UK-wide bus and rail operator. Preston Transport Holdings Ltd was an employee-owned company operating 125 buses from a freehold depot, providing intra-urban bus services in the Preston area in the north-west of England. When Stagecoach's first offer in 2006 to purchase Preston Bus, with a view to improving the performance of its Preston depot, was rejected, it began an expansion plan in the Preston area, launching a number of intra-urban services in 2007, largely in competition with Preston Bus. Preston Bus launched services in response. Both Stagecoach and Preston Bus services incurred losses as a result of this competition. After a year of unprofitable services, Preston Bus suffered financial difficulties and decided to sell its business, approaching Go Ahead and Arriva for offers. Stagecoach made an offer in October 2008, which was accepted.

The CC's assessment of the counterfactual

Stagecoach submitted to the CC that Preston Bus was a failing firm as the financial assessment of Preston Bus had confirmed that it would have halted its operations in the near future in the absence of the merger. Stagecoach also argued that a third party would not have been able to restructure Preston Bus to make it profitable in the face of competition from Stagecoach. Stagecoach proposed that the most likely outcome for Preston Bus under the counterfactual would have been administration and liquidation, in which case it is unlikely that its assets would have been acquired to provide local bus services in Preston. Stagecoach's counterfactual was the situation in September 2008 (when Stagecoach was approached by Preston Bus). However, the CC found that it was inappropriate to assess the counterfactual as the situation immediately prior to the merger, arguing that

Counterfactual in *Greif/Blagden*

In 2007, the CC investigated the completed acquisition by Greif UK, the largest manufacturer of new large steel drums in the UK, of the €210m new steel drum and closures business of Blagden Packaging Group, which included its UK large steel drum operations. The merged entity's share of the UK market was 85%, with an increment due to the merger of 32%. The merging parties appeared to be each other's closest competitors. The CC found that Greif and Blagden lost more custom to each other pre-merger than to any other competitor in the relevant market. There was a limited constraint on the merging parties from other alternatives, smaller producers and imports.

The CC found that the merging parties could be constrained by a new large steel drum manufacturing line by Schütz Group at its new facility in the Netherlands. Schütz Group said that the line would have been installed in the absence of the merger, but that the installation might then have been up to 18 months later. The CC found that Schütz Group's capacity would be adequate to supply large orders from UK customers. The CC's analysis showed that, at Greif's prevailing prices, imports from Schütz Group's new plant could be competitive for some drums and for some customers in Great Britain if it maintained its planned sales margins in the Netherlands. In light of this evidence, the CC cleared the merger.

Source: Competition Commission (2007), 'Greif Inc and Blagden Packaging Group: A Report on the Acquisition by Greif Inc of the Steel Drum and Closures Business of the Blagden Packaging Group', August 17th.

the expansion of Stagecoach into Preston intra-urban services in 2007 had several characteristics that made the competition 'abnormal'. The CC found that the new services were operated with 'little regard for profit and normal commercial considerations', and that Stagecoach's conduct led to the acquisition of Preston Bus. In light of the losses incurred by both parties during this conduct, the CC concluded that the competition at that time would not be a fair representation of the rivalry between the companies in the absence of the merger, and rejected Stagecoach's failing-firm argument.

The CC concluded that the counterfactual should be assessed against the most recent period of 'normal' competition—ie, with Preston Bus profitably running intra-urban Preston services and Stagecoach running inter-urban services outside Preston while trying to improve profitability. It found that, before June 2007, Preston Bus was constrained by Stagecoach in the form of both actual and potential competition in the market, resulting from Stagecoach's comprehensive network of frequent services (although largely outside Preston) and low fares. Stagecoach was to a lesser extent constrained by potential competition from Preston Bus in the following ways:

- there was a possibility that Preston Bus could enter Stagecoach's routes;
- there was a constraint from Preston Bus's high frequencies and low fares, which it operated to pre-empt entry on its routes;
- Stagecoach's expectation that Preston Bus would be purchased by another, more efficient operator that could enter into more direct competition with Stagecoach.

As the merger removed these constraints and would result in an SLC, the CC considered that a divesture was required.

The CAT's assessment of the CC's decision

Stagecoach's appeal to the CAT was on four grounds: the CC treated the completion of the transaction as a relevant merger situation, but did not consider whether the creation of that situation resulted in an SLC (only whether the events over the 18 months prior to the merger had done so); the CC based its findings on the situation 18 months prior to the merger, which were not supported by sufficient evidence; the CC unfairly preferred the evidence of Preston Bus's witness over the evidence of other witnesses; and lastly, the remedy proposed was disproportionate.[4]

In relation to the first of these, the CAT agreed with the CC that Preston Bus was not a failing firm, and upheld the CC's decision that the merger would lead to an SLC by reducing the number of firms in the market from two to one. However, the CAT upheld the second ground, which in turn had an impact on the CC's choice of remedy (the fourth ground), since the choice of counterfactual affected the extent of the SLC. If the CC had chosen a different counterfactual in which competition was less sustainable, the merger would have been found to cause a lesser degree of SLC, which might have led to a less onerous remedy.[5]

The CAT examined why the CC had chosen to disregard the events of June 2007 to September 2008 in constructing the counterfactual. It commented that there was a disconnect between the CC's assessment of the failing-firm proposition (which it considered based on the situation at September 2008) and the remainder of the analysis of the counterfactual. The CAT examined four possible reasons for dismissing the period.

- **Conduct disregarded as a matter of principle**—the CAT examined whether the scope and nature of Stagecoach's conduct were reasons for the CC to disregard it on a matter of principle, but found that the CC did not provide enough evidence to support this.

- **'Abnormal' conduct in the pejorative sense**—the CC accepted that Stagecoach's conduct in entering the intra-urban market was not illegal, and the CAT judged that it would have been wrong for the CC to disregard Stagecoach's conduct as merely undesirable or reprehensible. It acknowledged that Stagecoach was under no obligation to maintain an 'equilibrium' where it focused on inter-urban routes and Preston Bus concentrated on intra-urban routes.

- **Lack of regard for profit and normal commercial considerations**—the CAT considered whether Stagecoach's lack of business plan for the new services, and subsequent losses on the new routes, supported the CC's conclusion that Stagecoach's conduct did not have regard for profit and normal commercial considerations. The CAT found that Stagecoach senior management were able to deploy 25 minibuses without producing revenue forecasts and net present value revenue calculations, relying instead on their expertise and experience of having a 7,200-vehicle business. The CAT disagreed with the CC that the lack of records showed that Stagecoach was not concerned about the profitability of new routes. It agreed with Stagecoach's expectations that the profitability would improve on those routes as more passengers switched from Preston Bus to Stagecoach, or that it was reasonable to expect Preston Bus to retrench (ie, the profitability of Stagecoach in Preston over the 18 months was not reflective of its future profitability).[6]

- **Stagecoach's limited goal in launching its new buses in June 2007**—Stagecoach stated that its original objective was to operate 25 buses in the intra-urban market and gain around 20–25% market share. The CC dismissed this since it perceived that

the scale (25 buses) and nature (ie, Stagecoach's new routes being placed on Preston Bus's most profitable routes) of entry suggested that Stagecoach's goal was to gain more than a 25% share. The CAT, however, highlighted that Stagecoach did not know the identity of Preston Bus's most profitable routes; that introducing a particular amount of capacity would remove most of Preston Bus's profits; or whether Preston Bus would decide to retrench rather than fight the entry. It therefore concluded that it was possible that Stagecoach's intention had been to gain only a 25% market share.

By dismissing these reasons, the CAT concluded that there was nothing in the CC's decision that explained or justified its conclusion on the counterfactual, and, therefore, upheld Stagecoach's appeal on ground 2.

Conclusion

The counterfactual is clearly important in a merger analysis, and in some cases, decisions on the counterfactual can significantly alter the overall assessment.

With any regime based on an SLC test, merger analysis is essentially an exercise in comparing the intensity of competition following the merger to the intensity of competition had the merger not taken place. Given this, determining the correct counterfactual is essential. In situations where the counterfactual is uncertain, competition authorities have to make a judgement. However, as shown by the example of the Stagecoach/Preston Bus merger, this can be complex.

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[1] Competition Appeal Tribunal (2010), 'Stagecoach Group PLC v. Competition Commission', Case 1145/48/09, May 21st.
[2] Competition Commission and Office of Fair Trading (2010), 'Merger Assessment Guidelines', a joint publication of the Competition Commission and the Office of Fair Trading, September.
[3] op. cit. para 4.3.6.
[4] Competition Appeal Tribunal (2010), 'Stagecoach Group PLC v. Competition Commission', Case 1145/48/09, May 21st, paras 3–4.
[5] The CAT did not find it necessary to reach a conclusion on the third ground, given the overlap with ground 2.
[6] The CC's conclusions on what other operators regarded as a normal period over which to sustain losses following the launch of a new service were found not to be supported by evidence it presented.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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