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Statement of Preliminary Issues

Cengage / McGraw-Hill

15 November 2019

Introduction

1. On 30 October 2019, the Commerce Commission registered an application (the Application) from Cengage Learning Holdings II, Inc. and McGraw-Hill Education, Inc. (together the Applicants), seeking clearance to merge their global publishing businesses (the Proposed Acquisition).[1] The Application relates to the Proposed Acquisition to the extent that it affects markets in New Zealand.

2. The Commission will give clearance if it is satisfied that the Proposed Acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand.

3. This statement of preliminary issues sets out the issues we currently consider to be important in deciding whether or not to grant clearance.[2]

4. We invite interested parties to provide comments on the likely competitive effects of the proposed acquisition. We request that parties who wish to make a submission do so by **Friday 29 November 2019**.

The parties

5. Cengage (previously known as Thomson Learning), is a global education and technology firm, although it primarily carries on business in the USA.

6. In New Zealand, Cengage supplies educational textbooks, and other learning materials in a digital format, to the following sectors:

    6.1 schools (including primary and secondary schools);[3] and

    6.2 the higher education (HED) sector, comprising vocational, university, and post-graduate levels.

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1 A public version of the Application is available on our website at: http://www.comcom.govt.nz/business-competition/mergers-and-acquisitions/clearances/clearances-register/.

2 The issues set out in this statement are based on the information available when it was published and may change as our investigation progresses. The issues in this statement are not binding on us.

3 McGraw-Hill sold its secondary school publishing business to Cengage in 2010.

7. McGraw-Hill is a global learning science company and, like Cengage, its businesses are primarily located in the USA. In New Zealand, McGraw-Hill supplies products primarily to the HED sector and, to a lesser degree, primary schools.

Our framework

8. Our approach to analysing the competition effects of the Proposed Acquisition is based on the principles set out in our Mergers and Acquisitions Guidelines.[4] As required by the Commerce Act 1986, we assess mergers and acquisitions using the substantial lessening of competition test.

9. We determine whether an acquisition is likely to substantially lessen competition in a market by comparing the likely state of competition if the acquisition proceeds (the scenario with the acquisition, often referred to as the factual), with the likely state of competition if the acquisition does not proceed (the scenario without the acquisition, often referred to as the counterfactual).[5] This allows us to assess the degree by which the proposed acquisition might lessen competition.

10. If the lessening of competition as a result of the proposed acquisition is likely to be substantial, we will not give clearance. When making that assessment, we consider, among other matters:

    10.1 constraint from existing competitors – the extent to which current competitors compete and the degree to which they would expand their sales if prices increased;

    10.2 constraint from potential new entry – the extent to which new competitors would enter the market and compete if prices increased; and

    10.3 the countervailing market power of buyers – the potential constraint on a business from the purchaser's ability to exert substantial influence on negotiations.

Market definition

11. We define markets in the way that we consider best isolates the key competition issues that arise from the proposed acquisition. In many cases this may not require us to precisely define the boundaries of a market. A relevant market is ultimately determined, in the words of the Commerce Act, as a matter of fact and commercial common sense.[6]

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4 Commerce Commission, *Mergers and Acquisitions Guidelines*, July 2019. Available on our website at www.comcom.govt.nz

5 *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [63].

6 Section 3(1A). See also *Brambles v Commerce Commission* (2003) 10 TCLR 868 at [81].

12. The merging parties submitted that the market relevant to our assessment of the Proposed Acquisition is the supply of education publishing in New Zealand, which includes primary, secondary and HED providers.[7]

13. We will consider the extent to which:

    13.1 individual education subject publications are in separate product markets; and

    13.2 digital and printed education products are in separate product markets, i.e. whether they are readily substitutable with each other.

14. At this stage, it appears that the appropriate market definition will likely depend on supply-side substitution, namely the extent to which publishers are able to switch supply between different educational sectors.

Without the acquisition

15. We will consider what the parties would do if the Proposed Acquisition does not go ahead. We will consider whether the without-the-acquisition scenario is best characterised by the status quo, or whether there are other likely counterfactual scenarios. In particular we will consider whether, in the absence of the Proposed Acquisition, the merging parties would be strong competitors in New Zealand in the emerging digital education products area.

Preliminary issues

16. We will investigate whether the Proposed Acquisition would be likely to substantially lessen competition in the relevant market (or markets) by assessing whether horizontal unilateral and/or coordinated effects might result. The key questions on which we will be focusing are:

    16.1 horizontal unilateral effects - would the loss of competition between the parties enable the merged entity to profitably raise prices or reduce quality or innovation by itself; and[8]

    16.2 coordinated effects - would the Proposed Acquisition change the conditions in the relevant market(s) so that coordination is more likely, more complete or more sustainable?

Horizontal unilateral effects: would the merged entity be able to profitably raise prices by itself?

17. Horizontal unilateral effects arise when a firm merges with or acquires a competitor that would otherwise provide a significant competitive constraint (particularly

[7] Application at [6.1].

[8] For ease of reference, we only refer to the ability of the merged entity to "raise prices" from this point on. This should be taken to include the possibility that the merged entity could reduce quality or innovation, or worsen an element of service or any other element of competition, i.e. it could increase quality-adjusted prices.

relative to remaining competitors) such that a market participant can profitably increase prices above the level that would prevail without the merger. A merger could also reduce competition if one of the merging firms was a potential or emerging competitor. In such a case, the merger may preserve the market power of the incumbent firm.

18. The Applicants submitted that the Proposed Acquisition would not be likely to substantially lessen competition in the relevant market due to unilateral effects, arguing that:[9]

    18.1 the merging parties are not each other's closest competitors;

    18.2 in the primary school sector, the parties' offerings are complementary (McGraw-Hill offers "teacher led" learning materials, while Cengage's are "student led"), and McGraw-Hill has a small market share;

    18.3 in the HED sector, the parties only overlap in nine subject areas, and these overlaps are minimal with strong competition provided by other publishers;[10]

    18.4 the education publishing industry is highly dynamic and faces significant digital disruption;

    18.5 the merging parties are constrained by customers bypassing education publishers through the increased use of:

        18.5.1 "white space"; that is where students acquire education products by alternative means (eg, the purchase of second hand or rental textbooks); and

        18.5.2 "open education resources" (OED); that is where education institutions and teachers use (and sometimes develop) openly licenced and freely available teaching and learning materials; and

    18.6 there are no material barriers to entry into educational publishing.

19. To assess whether the Proposed Acquisition may enable the merged entity to raise prices, or reduce quality in the areas of overlap, we will consider:

    19.1 the extent of competition between the merging parties for the acquisition of content rights;

    19.2 how closely the merging parties compete with each other and their rivals to have their products adopted, including in relation to the subject categories in

[9] The Application at [1.2].

[10] In the HED segment, the merging parties have identified the relevant subject areas in which overlap occurs as: Language studies, Science and mathematics, Education and teaching, Psychology, Business, Economics, Finance and accounting, Medicine, Engineering and technology (including Plumbing). See Appendix 7 of the draft application for further details.

which they overlap, how that competition takes place, and what impact such conduct has on constraining prices and/or quality;

19.3 whether entry by new competitors or expansion by existing competitors is likely, sufficient in extent, and timely enough to overcome a potential lessening of competition, including an assessment of:

19.3.1 the relevant entry and expansion conditions, in both the printed textbook and digital formats; and

19.3.2 the potential impact of entry by digital providers; and

19.4 the extent to which students would constrain the merged entity by bypassing educational publishers and sourcing educational products from alternative channels, including:

19.4.1 OER;

19.4.2 digital content providers, and educational technology businesses; and

19.4.3 “white space” sources, such as rental, second hand textbooks, or borrowing.

20. In addition, the educational publishing industry is becoming increasingly digitised overseas, and so we will consider the extent to which the New Zealand market is being impacted by this as well as:

20.1 how the educational publishing industry is developing and whether innovation or a move to digitalisation is likely to change the dynamics of competition in the industry;

20.2 whether there is a real chance, absent the Proposed Acquisition, that the parties would be close competitors for the provision of digital educational publishing services compared to other potential entrants or innovators; and

20.3 whether the Proposed Acquisition would affect the parties’ incentives to innovate and therefore be likely to limit future innovation in digitalisation of the sector.

Coordinated effects: would the proposed acquisition make coordination more likely?

21. A merger can substantially lessen competition if it increases the potential for the merged entity and all or some of its remaining competitors to coordinate their behaviour and collectively exercise market power or divide up the market such that output reduces and/or prices increase.

22. In the Application, the merging parties submitted that the Proposed Acquisition will not increase the likelihood of coordination in the relevant market, due to the following factors:[11]

    22.1 there are a variety of different models of operation such that costs are likely to vary greatly between each market participant;

    22.2 pricing can also be complex;

    22.3 generally, educational products are highly differentiated products which are rarely direct substitutes for one another;

    22.4 the industry is dynamic; and

    22.5 the existing players in the industry are subject to a high degree of competitive constraint, including low barriers to entry and general disruption.

23. We will assess whether the Proposed Acquisition would make coordination more likely, more complete or more sustainable. As part of our assessment we will consider whether any of the relevant markets are vulnerable to coordination and whether the Proposed Acquisition would change the conditions in the relevant markets. In particular, we will assess whether the Proposed Acquisition is likely to give rise to coordinated effects:

    23.1 by subject category (ie, market allocation); and/or

    23.2 on the price of textbooks (given the ready public availability of Recommended Retail Price information).

Next steps in our investigation

24. The Commission is currently scheduled to make a decision on whether or not to give clearance to the Proposed Acquisition by **Thursday 16 January 2020**. However, this date may change as our investigation progresses.[12] In particular, if we need to test and consider the issues identified above further, the decision date is likely to extend.

25. As part of our investigation, we will be identifying and contacting parties that we consider will be able to help us assess the preliminary issues identified above.

Making a submission

26. If you wish to make a submission, please send it to us at registrar@comcom.govt.nz with the reference "Cengage/McGraw-Hill" in the subject line of your email, or by mail to The Registrar, PO Box 2351, Wellington 6140. Please do so by close of business on **Friday 29 November 2019**.

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11 Application at [7.36]

12 The Commission maintains a clearance register on our website at http://www.comcom.govt.nz/clearances-register/ where we update any changes to our deadlines and provide relevant documents.

27. Please clearly identify any confidential information contained in your submission and provide both a confidential and a public version. We will be publishing the public versions of all submissions on the Commission's website.

28. All information we receive is subject to the Official Information Act 1982 (OIA), under which there is a principle of availability. We recognise, however, that there may be good reason to withhold certain information contained in a submission under the OIA, for example in circumstances where disclosure would unreasonably prejudice the supplier or subject of the information.