

## Statement of Issues

**Cengage / McGraw-Hill**

**3 February 2020**

### Introduction

1. On 30 October 2019, the Commerce Commission (Commission) registered an application (the Application) from Cengage Learning Holdings II, Inc. (Cengage) and McGraw-Hill Education, Inc. (McGraw-Hill) (together the Applicants), seeking clearance to merge their global publishing businesses (the Proposed Acquisition). The Application relates to the Proposed Acquisition to the extent that it affects markets in New Zealand.
2. We have been unable to reach a decision on Cengage and McGraw-Hill's application for clearance within the initial 40 working day statutory timeframe provided under the Commerce Act 1986 (the Act).
3. This Statement of Issues (SoI) sets out our concerns about the potential competition issues we have identified following our initial investigation so that the Applicants and interested parties can provide us with submissions relating to those concerns.
4. While we have yet to reach any final views on market definition, for the purpose of assessing the Application we are considering whether the Proposed Acquisition substantially lessens competition for the supply of educational products in six subject markets within the higher education sector (HED sector) due to:
  - 4.1 unilateral effects by giving a combined Cengage and McGraw-Hill the ability to profitably raise prices, and/or reduce quality (such as reducing the range of textbooks, the frequency of the introduction of new textbooks or ancillary services), in the supply of the relevant products; and
  - 4.2 coordinated effects by enhancing the prospects for market allocation and/or a general softening of competition such that coordination is more likely, more complete, or more sustained.
5. At this time, we are not investigating further and do not require any further information from the Applicants or interested parties in respect of:
  - 5.1 conglomerate and/or vertical effects in the supply of higher educational products because the Proposed Acquisition is unlikely to affect the ability and/or incentive for the merged firm to foreclose competitors in the relevant markets, and to date we have found no evidence that causes us any concerns; and

- 5.2 the supply of educational products to either the primary school sector (due to minimal overlap and the presence of existing domestic competition), or the secondary school sector (in which no overlap has been found).
6. In reaching the preliminary views set out in this Sol, we have considered information provided to date by the Applicants and other industry participants. We have not yet made any final decisions on the issues outlined below (or any other issues) and our views may change, and new competition issues may arise, as the investigation continues.
7. If we identify any further issues during our analysis of the Proposed Acquisition that are not discussed in this Sol, we will update the Applicants and other interested parties through an updated Sol.

### Process and timeline

8. We have agreed with the Applicants an extension of time until 12 March 2020 in which to make a decision.
9. The Commission would like to receive submissions and supporting evidence from the Applicants and other interested parties on the issues raised in this Sol. We request responses by close of business on **18 February 2020**, including a public version of any submission.
10. All submissions received will be published on our website with appropriate redactions.<sup>1</sup> Parties will have the opportunity to cross submit on the public versions of submissions from other parties by close of business on **24 February 2020**.
11. Submissions and cross-submissions will generally only be accepted within the notified submission timeframe.<sup>2</sup> This ensures that we continue to progress the investigation in a timely fashion. We may place less weight on submissions received after our deadline. Parties wishing to make a submission that are unlikely to meet our deadline should let us know beforehand and explain why. We will only grant extensions to the deadline in exceptional circumstances.

### The relevant markets

12. We define markets in the way that best isolates the key competition issues that arise from a merger. In many cases this may not require us to precisely define the boundaries of a market. What matters is that we consider all relevant competitive constraints, and the extent of those constraints. For that reason, we also consider products and services which fall outside the market but which still impose some degree of competitive constraint on the merged entity.

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<sup>1</sup> Confidential information must be clearly marked (by highlighting the information and enclosing it in square brackets). At the same time, a schedule must be provided which sets out each of the pieces of information over which confidentiality is claimed and the reasons why the information is confidential (preferably with reference to the Official Information Act 1982).

<sup>2</sup> Commerce Commission, *Mergers and Acquisition Guidelines* (July 2019), at [6.111] and [6.112].

13. The Proposed Acquisition relates to the educational publishing industry. As noted above, the key area of overlap between the merging parties is in the supply of higher educational publishing in New Zealand. This involves the development, publishing and supply of various educational products (including textbooks and supporting material) for use by teachers and students in the HED sector (ie, universities and polytechnics).
14. A key feature of the higher educational publishing sector is that while students are the ultimate consumers of textbooks and other educational materials, the course coordinators (typically the main lecturers) are generally responsible for selecting textbooks and supporting course material. So, educational publishers compete for the adoption of their products by the course coordinator and the sale of the selected textbook and supporting material to students is a by-product of that competitive process.
15. In its Application, the merging parties submitted that the relevant market for assessing the Proposed Acquisition is the supply of educational publishing in New Zealand, which includes primary and secondary schools and higher education providers.<sup>3</sup>
16. In addition, the merging parties submitted that it is not necessary to adopt a narrower definition of the product market because:<sup>4</sup>
  - 16.1 most of the major publishers operating in New Zealand operate in more than one educational sector and it is relatively easy to switch between supplying different sectors; and
  - 16.2 although major publishers may be stronger in particular subject(s) within an educational sector, it is relatively easy to switch between subjects by sourcing a relevant author.
17. We consider that on the demand-side the product market is narrowly defined by higher education course. That is, a course coordinator is only likely to consider textbooks to be close substitutes if they include material suitable for their particular course(s). For example, a course coordinator teaching an introductory economics course is only likely to consider textbooks that cover introductory economics and not textbooks that contain intermediate or advanced economics or different subject categories (eg, psychology or mathematics).
18. However, a key issue for us in defining the product market is the degree of supply-side substitutability; namely, the extent to which publishers can easily expand their portfolio of textbooks and therefore place constraint on rival publishers even if they do not currently offer titles in a given course. If supply-side substitution is relatively easy then it may be appropriate to define the product market more broadly than on a course-by-course basis. We also discuss this issue later in the Sol.

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<sup>3</sup> Application at [6].

<sup>4</sup> Application at [6.10].

19. On the issue of supply side substitution we note that:
- 19.1 many educational publishers, including the Applicants, appear to offer a range of titles across a number of different subject categories; however
  - 19.2 competitive conditions appear to vary across different subject categories; for example, some publishers specialise in particular subject categories and some publishers have a stronger position in other subject categories.
20. On the basis of the information available to us to date, we consider that in this instance, the relevant product markets are likely to be narrower than those proposed by the Applicants. At a minimum, we consider that HED, secondary and primary sectors are separate markets.
21. Further, because of the differing competitive constraints faced by some of the subject categories, we consider that delineating the HED sector into narrower product markets by subject (eg economics, mathematics etc) better reveals the potential competition issues. In our view, if conducting the analysis on narrow subject level markets does not give rise to competition concerns then there are unlikely to be competition concerns in a broader higher education market.
22. While we have yet to reach any final views on market definition, for the purpose of considering the likely competitive effects of the Proposed Acquisition, we have used markets for the supply of higher educational products and supporting material by subject.
23. Our investigation to date has identified potential competition concerns in the following subject categories (the relevant subject markets):<sup>5</sup>
- 23.1 business management;
  - 23.2 marketing;
  - 23.3 finance;
  - 23.4 quantitative business;
  - 23.5 mathematics; and
  - 23.6 physical education.
24. Having identified 15 subject categories where the Applicants overlap, we applied our concentration indicators as set out in our Mergers and Acquisitions Guidelines.<sup>6</sup> We then analysed sales revenue data collected from each of the four major higher educational publishers (Cengage, McGraw-Hill, Pearson and Wiley) for each of the 2016, 2017 and 2018 years and narrowed down our investigation to the six subject markets listed at paragraph 23.

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<sup>5</sup> These subject categories are based on the Nielsen classification system.

<sup>6</sup> Commerce Commission, *Mergers and Acquisitions Guidelines* (July 2019) at [3.51].

25. We are continuing to assess the scope of the relevant subject markets and would welcome any comments, including the likely extent of supply-side substitutability.
26. In addition to the product market definition, we have also considered the relevant geographic market definition. Given that text books are generally distributed nationwide, we consider that the relevant product markets are likely to be national in scope.

#### **The factual and counterfactual**

27. To assess whether a substantial lessening of competition is likely requires us to compare the likely state of competition if the Proposed Acquisition proceeds (the scenario with the acquisition, often referred to as the factual) with the likely state of competition if it does not (the scenario without the acquisition, often referred to as the counterfactual) and to determine whether competition is likely to be substantially lessened comparing those scenarios.
28. We agree with the Applicants that with the Proposed Acquisition, the global educational publishing businesses of Cengage and McGraw-Hill would be combined.
29. At this stage we also agree with the Applicants that the likely counterfactual is the status quo. That is, the merging parties continuing to compete with each other as well as their rival publishers.

#### **Competition assessment**

##### **Unilateral effects**

30. Unilateral effects arise when a firm merges with or acquires a competitor that would otherwise provide a significant competitive constraint (particularly relative to remaining competitors) such that a market participant can profitably increase prices above the level that would prevail without the merger (and/or reduce quality). 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.
31. The Proposed Acquisition would combine two of the four major suppliers of higher educational products in New Zealand, including in the relevant subject markets.
32. In their Application, the merging parties submitted that the Proposed Acquisition would not be likely to substantially lessen competition in any of the relevant markets or in any educational sector due to unilateral effects because:
  - 32.1 the merging parties are not each other's closest competitor with different product offerings and a largely complementary range of products;

- 32.2 in the HED sector, the parties only overlap in nine subject areas,<sup>7</sup> and these overlaps are minimal with strong competition provided by other publishers;
  - 32.3 the educational publishing industry is highly dynamic; and
  - 32.4 there are no material barriers to entry into educational publishing.
33. We are continuing to investigate whether the Proposed Acquisition would substantially lessen competition in the subject markets due to unilateral effects. In particular, whether by removing the existing rivalry between the Applicants, the Proposed Acquisition would be likely to give the merged entity the ability and/or incentive to:
- 33.1 reduce the quality of the textbooks published in any of the relevant subject markets; and/or
  - 33.2 reduce the frequency of the introduction of new textbooks; and/or
  - 33.3 reduce the production and supply of ancillary services to course coordinators (such as the provision of teaching materials including slides or test materials); and/or
  - 33.4 raise prices (noting the evidence indicates that course coordinators do not consider price as a primary factor when selecting a particular textbook).

*Existing competition*

34. So far the evidence shows that:
- 34.1 Cengage and McGraw-Hill are currently two of the major higher education publishers both globally and domestically, and through their New Zealand-based sales representatives compete strongly in New Zealand for the adoption by course coordinators of existing and new higher education textbooks and supporting materials in the relevant subject markets.
  - 34.2 Cengage and McGraw-Hill face competition for the adoption of their higher education textbooks from two other major publishers, Pearson and Wiley.
35. Table 1 sets out the major competitors there would likely be in in each of the relevant subject markets post-merger.

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<sup>7</sup> Language studies, science and mathematics, education and teaching, psychology, business, economics, finance and accounting, medicine, and engineering and technology.

**Table 1 – Major competitors in the relevant subject markets post-merger**

<b>Subject</b>	<b>Major suppliers</b>
Management	Merged entity Pearson
Marketing	Merged entity Pearson
Mathematics	Merged entity Pearson Wiley
Finance	Merged entity Pearson Wiley
Quantitative business	Merged entity Pearson
Physical education	Merged entity Pearson

36. As can be seen from Table 1, the relevant subject markets appear to be relatively concentrated.
37. In addition to the four major publishers, there are a number of smaller publishers such as Taylor & Francis, Oxford University Press and Macmillan that supply higher educational textbooks and supporting material in New Zealand. We continue to consider the extent of the competitive constraint that these publishers would impose on the merged entity in the relevant subject markets.
38. Therefore, the key issues that we are continuing to investigate and seek submissions on are:
- 38.1 how closely Cengage and McGraw-Hill compete with one another in the relevant subject markets; and
- 38.2 the extent to which Pearson, Wiley and other existing publishers would constrain the merged entity in the relevant subject markets.
39. To the extent that any constraint is material, we will assess whether the loss of any competition between Cengage and McGraw-Hill could be offset by rival publishers entering or expanding in the relevant subject markets.

#### *Entry and expansion*

40. We are still considering conditions of entry and expansion in the relevant subject markets and whether/to what extent existing publishers could readily expand, or new firms could enter, to constrain the merged entity in those subject markets. Our assessment of entry and expansion conditions in the affected markets is relevant to our consideration of both unilateral and coordinated effects that may result from the Proposed Acquisition.

41. To date we have not found any recent examples of new entry into the supply of educational publishing in the HED sector, or existing publishers switching into the supply of textbooks in a different subject market. This could indicate barriers to entry and expansion in the relevant subject markets.
42. In particular, we are continuing to assess:
  - 42.1 the extent to which existing publishers would expand their portfolio of educational products into the relevant subject markets, including by extending their product range if they do not already publish in these areas; and
  - 42.2 the extent to which an existing publisher without a New Zealand-based sales representative could expand its portfolio into supplying educational products into the relevant subject markets in New Zealand.
43. We are also considering whether the following factors may be barriers to entry and/or expansion into the relevant subject markets:
  - 43.1 engaging with authors, developing a reputation, forming relationships with course coordinators, establishing a sales force to promote products and distributing in scale; and
  - 43.2 course coordinators and how reluctant or otherwise they may be to switching to alternative publishers/textbooks.

*Other issues*

44. In addition to the factors outlined above, the merging parties submitted in the Application that they are constrained by customers bypassing educational publishers through the increased use of:
  - 44.1 'white space'; that is where students acquire educational products by alternative means (eg, the purchase of second-hand or rental textbooks); and
  - 44.2 open education resources; that is where education institutions and teachers use (and sometimes develop) openly licenced and freely available teaching and learning materials.
45. We are continuing to consider the extent to which students would pose some indirect constraint on the merged entity by bypassing education publishers and obtaining educational products in the relevant subject markets from a number of alternative channels such as second-hand textbooks, rental and library copies.

**Competition assessment: coordinated effects**

46. 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 such that output reduces and/or



prices increase in the relevant market. Unlike a substantial lessening of competition which can arise from the merged entity acting on its own, coordinated effects require some or all of the firms in the market to be acting -in a coordinated way. This could take the form of coordination on pricing or other non-price attributes, or of customer allocation across suppliers.

47. 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:<sup>8</sup>
- 47.1 there are a variety of different models of operation such that costs are likely to vary greatly between each market participant;
  - 47.2 pricing can also be complex;
  - 47.3 generally, educational products are highly differentiated products which are rarely direct substitutes for one another;
  - 47.4 the industry is dynamic; and
  - 47.5 the existing players in the industry are subject to a high degree of competitive constraint, including low barriers to entry and general disruption.
48. We are considering whether the Proposed Acquisition would give rise to coordinated effects in the relevant subject markets. Our preliminary view is that such coordination could occur in two ways;
- 48.1 enhancing the prospects for market allocation by subject market; and/or
  - 48.2 a general softening of competition resulting in, for example, longer periods of time between publication of new editions, or non-inclusion of more recent material.
49. Our preliminary view is that the latter is more likely. However, we are continuing to consider whether:
- 49.1 conditions in the relevant subject markets make them vulnerable to coordination; and
  - 49.2 the removal of a major supplier from the supply of higher educational textbooks and supporting materials with the Proposed Acquisition would make coordination more likely, more complete, or more sustainable in the relevant markets.
50. We agree with the Applicants that there are some factors that indicate the Proposed Acquisition might not increase coordination. For example, there is product differentiation and price variance because no two textbooks, even those

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<sup>8</sup> Application at [7.36].

aimed at similar subjects (or even courses) are identical. Further, publishers appear to compete strongly with each other for the adoption of their textbooks, and due to the apparent stickiness of course coordinators, the relative rarity, and value of an adaptation may provide a high incentive to cheat on any coordination.

51. However, there are also some factors that might facilitate coordination. For example, we have found some evidence that sales representatives have visibility of each other's visits to institutions or course coordinators, and in some cases consult and exchange information about recent market developments such as the adoption of new textbooks by course coordinators. Further, the market data referred to above suggests that, post-merger the merged entity, Wiley, and/or Pearson will have similar market shares in some of the relevant subject markets.

#### **Next steps**

52. We are continuing to undertake inquiries and seek information from industry participants about the impact of the Proposed Acquisition. However, we welcome any further evidence and other relevant information and documents that the Applicants or any interested parties are able to provide regarding the issues identified in this Sol.
53. If you wish to make a submission, please send it to us at [registrar@comcom.govt.nz](mailto: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 **18 February 2020**.