Oxera's response to NERA's new submissions

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Contents

1 Introduction and summary

1.1 Oxera has previously submitted a report—'AlphaTheta Corporation/Serato: response to the NERA report' (Oxera 1)—commissioned by inMusic with respect to the proposed acquisition by AlphaTheta Corporation (ATC) of Serato Audio Research Ltd (Serato). This first report was in response to NERA having submitted a report—'AlphaTheta Corporation/Serato: unilateral effects and foreclosure theories of harm' (NERA 1)—commissioned by MinterEllisonRuddWatts (counsel to ATC).

1.2 Since then NERA has submitted two memos. One in response to the Commerce Commission's Statement of Issues (SoI), dated 8 April 2024 (NERA 2); the second in response to Oxera 1, dated 16 April 2024 (NERA 3). Oxera has been commissioned to write this submission in response to these two additional NERA memos.

1.3 First, NERA 3 called into question the importance of market shares, claiming that they are uninformative as to future constraints in a dynamic market. We discuss this and related issues in Section 2. We highlight that NERA has not shown that this is a sufficiently dynamic market such that market shares are uninformative as to future constraints. The merged entity would have a market share of around 60%, possibly more within the professional DJ segment. While market shares should not be determinative, they are used by antitrust agencies worldwide as a screening tool to determine which mergers should attract detailed scrutiny. A transaction leading to a merged entity with such a large market share should qualify for increased scrutiny that cannot be dismissed on the basis of unevidenced claims to dynamism. Furthermore, over the last five years, these market shares appear to have been relatively stable.

1.4 Second, NERA has argued in NERA 2 that the merged entity would have no incentive to foreclose because of specific terms in the Sale and Purchase Agreement (SPA), meaning that they would have to compensate the current shareholders of Serato if they did. In Section 3, we highlight that NERA's analysis on this point effectively assumes that the market is sufficiently stable that Serato's forecasts of software sales and non-ATC shares of hardware for those using Serato software remain relevant. We do not have access to those Serato forecasts, but we observe that the forecasts do not run to the end of the SPA period. As a result, NERA has forecast its missing months assuming that revenues in a missing month are the same as in the same month of the previous year. This approach is not consistent with its assertion that market shares are uninformative as to future constraints due to market dynamism.

1.5 We also show that NERA has not considered the incomplete contracting issues inherent in the SPA, or the potential for longer-term issues in terms of whether the profits from a vertical foreclosure strategy going forward might exceed the compensation that would have to be paid to Serato.

1.6 Third, we address the point made in NERA 3 on likely rival responses and how they would supposedly prevent a vertical foreclosure strategy from being implemented. Section 4 discusses why switching to non-Serato software might not be as immediate or viable as suggested by NERA. Furthermore, NERA's arguments raise a number of questions regarding why ATC's rivals do not exercise that same competitive constraint today.

1.7 Fourth, section 4 of NERA 3 suggested that Oxera's focus on high-end hardware has been erroneous.[1] NERA argues that Oxera 1 'did not evaluate whether it would be possible for the merged entity to exploit this reliance without sacrificing significant profits from other users'.[2] Section 5 explains why that is not the case. We show that, according to the information available to us, this segment is more likely to experience vertical foreclosure. Additionally, we explain that the merged entity would have the ability to target foreclosure at professional users by only foreclosing the high-end segment of the DJ hardware market.

1.8 Finally, Section 6 discusses the argument in NERA 3 on the influence of dynamic factors. The specific dynamic factors referred to are 'competitor responses', 'reputational effects', and 'reduced market size'. Their conclusion is that these factors would be enough to dissuade ATC from adopting a vertical foreclosure strategy. We argue that NERA's suggestions are highly speculative and are not backed by sufficient evidentiary support.

[1] See Oxera (2024), 'AlphaTheta Corporation/Serato: response to the NERA report', 8 March 2024, ('Oxera 1'), paras 3.16 and 4.16–4.17.
[2] NERA 3, para. 25.

2 The importance of market shares

2.1 In our initial report, Oxera reported on industry sources that showed that Serato DJ was the most popular software with a global market share of 32.92% closely followed by ATC's rekordbox with a market share of 28.16%. The combined market share would therefore be 61.08%.[3] This information was sourced from the 2023 Global DJ Census.

2.2 In that initial report we noted that ATC dismissed this source because the share of mobile users in the survey differed from that measured by ATC's own data. However, this assumes that ATC's data is more representative of the global population of users of DJ software than a global survey. This seems improbable.[4]

2.3 We went on to highlight that the market shares used by NERA underestimated the market share of Serato, because the market shares of those companies with mobile Apps had been inflated by the inclusion of their mobile App sales.[5]

2.4 NERA's response on this point in NERA 3 is that it does not consider that historic market shares are particularly important in this case because they 'are unlikely to be informative about future constraints in a dynamic market'.[6]

2.5 Market shares and the underlying exercise of market definition are—of course—subject to a number of limitations.[7] Nevertheless, market shares can provide useful information. This is why they are used by most competition agencies as a first screening tool to assess proposed mergers and identify those that might require closer attention.

2.6 According to the NZCC Mergers and Acquisitions Guidelines:

> Market share and concentration measures, and changes in market share or concentration resulting from a merger, can indicate the extent to which firms in a

[3] See Oxera (2024), 'AlphaTheta Corporation/Serato: response to the NERA report', 8 March 2024, ('Oxera 1'), para. 3.22.
[4] Oxera 1, paras 3.11–3.14.
[5] Oxera 1, Section 3A.3.
[6] NERA 3, para. 7.
[7] In particular, we would agree with NERA that the focus of merger analysis should be on the key issue of the constraints that would be faced by the merged entity post-transaction, and the market definition should not crowd out those key issues.

> market are subject to competitive constraints, and the extent to which those constraints might change as a result of a merger.[8]

2.7 According to the EU Commission's horizontal merger guidelines:

> Market shares and concentration levels provide useful first indications of the market structure and of the competitive importance of both the merging parties and their competitors.[9]

2.8 A merger that will bring together the two largest providers in the market, each with around a 30% market share, and create a joined firm with around a 60% market share should raise concerns. We understand that this share might increase significantly if one focusses on the professional segment.[10]

2.9 It is of course possible that this combined market share may be uninformative with respect to future constraints because the market is dynamic. However, we would expect that argument to be evidenced with, for example, signs of rapidly shifting market shares from the recent past. NERA does not provide this—rather, its memo is speculative on this point:

> Competitors (including mobile apps) **may** grow in future and/or constrain the merged entity through innovation regardless of market share – especially if the merger entity were to worsen its offering through any unilateral or vertical strategies post-merger.[11] [emphasis added]

2.10 In the absence of evidence that the market is dynamic, and is dynamic in a way that would allow smaller rivals or new entrants to act as a constraint on established firms with a high market share, we do not consider that NERA has effectively allayed concerns over this issue.

2.11 However, what evidence is available would suggest that market shares have been

[8] See New Zealand Commerce Commission (2022), 'Mergers and acquisitions Guidelines', May, para. 3.48. See also paragraph 3.50: 'We use market share and concentration indicators to identify mergers which are less likely to raise competition concerns. These indicators are intended to provide an initial guide to merging firms, but are not a substitute for a full competition analysis.'
[9] See Official Journal of the European Union (2004), 'Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings', March, para. 14.
[10] inMusic (2023), 'Cross submission on Statement of Preliminary Issues', November, para. IV(d)(ii)6.
[11] NERA 3, para. 7.

relatively stable. The website digitaldjtips.com runs the Global DJ Census via an annual survey of DJs, part of which asks what software respondents use to DJ. We have looked at the results for each of the last six surveys covering 2018–2023. The following observations suggest that market shares have been relatively stable over that period.[12]

- In each of the last six years it was only firms in the top-four software solutions that had a share of more than 10%.
- In each of the last six years it was the same four software solutions that were in the top four (Serato DJ, Rekordbox/Rekordbox DJ, Virtual DJ, Traktor pro).
- In every year the combined share of the top-four firms appears to have exceeded 80%.
- In every year from 2019 to 2023, the two biggest software solutions in terms of their share were Serato DJ, Rekordbox/Rekordbox DJ.
- In every year from 2019 to 2023, the combined share of the top two firms has been in the range of 50–65%.

2.12 We note that the European Commission guidance cited above continues to say that the Commission would normally use current market shares and would only adjust them to reflect 'reasonably certain' future changes in light of entry, exit or expansion.[13] The fact that competitors may grow in future does not obviously meet this threshold of being reasonably certain. This is especially so, given that Bell

[12] See Santos, J. (2018), 'Results are in for the world's biggest DJ survey', *Digital DJ Tips*, 20 March, https://www.digitaldjtips.com/2017-dj-census/ (last accessed 25 April 2025); Santos, J. (2019), 'DJing in 2019: 15 revealing facts from our global survey', *Digital DJ Tips*, 14 February, https://www.digitaldjtips.com/final-results-are-in-for-the-worlds-biggest-digital-dj-survey/ (last accessed 25 April 2024); Morse, P., 'Here are the results from our 2020 census, the biggest DJ survey in the world', *Digital DJ Tips*, https://www.digitaldjtips.com/highlights-from-the-global-digital-dj-census-2020/ (last accessed 25 April 2024); Morse, P., 'Here are the results from our 2021 census, the biggest DJ survey in the world', *Digital DJ Tips*, https://www.digitaldjtips.com/global-dj-census-2021-results/ (last accessed 25 April 2024); Morse, P., 'Here are the results from our 2022 census, the biggest DJ survey in the world', *Digital DJ Tips*, https://www.digitaldjtips.com/here-are-the-results-from-our-2022-census-the-biggest-dj-survey-in-the-world/ (last accessed 25 April 2024); Morse, P., 'Here are the results from our 2023 census, the biggest DJ survey in the world', *Digital DJ Tips*, https://www.digitaldjtips.com/here-are-the-results-from-our-2023-census-the-biggest-dj-survey-in-the-world/ (last accessed 25 April 2024).

[13] See Official Journal of the European Union (2004), 'Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings', March, para. 15.

Gully has instructed us that the relevant legal test for a clearance requires the applicant to satisfy to the NZCC that an SLC is not likely.

2.13 While most of the ensuing discussion goes to the potential foreclosure effects, the merged entity having a market share of 60% has the potential to lead to unilateral price effects as well.

2A NERA's analysis neglects potential adjustment costs

2.14 Even if alternative providers were to invest in ensuring that their software had the same breadth and depth of interoperability with DJ hardware as Serato, this would not be expected to happen overnight. Such investments and developments take time and inevitably involve a bit of trial and improvement.

2.15 There would then be some period of adjustment which may incur some additional costs. First, there would be direct switching costs. inMusic has highlighted that the switching costs for DJs in terms of software may not be as low as NERA has assumed. We understand that this may be a particular issue in terms of transferring music libraries which may be storage and labour intensive.[14]

2.16 Second, there may be some frictional costs if a rival to ATC/Serato is not able to achieve universal roll-out such that their software is compatible with all high-end hardware systems. There may be situations where a DJ has already switched to a rival software provider, but the venue is still using hardware that is not (yet) compatible with that software. Such frictional costs might be ameliorated if it is relatively easy for DJs to multi-home and have both Serato and a rival software solution installed on their laptop.

2.17 However, the same factors that inMusic has identified as driving higher switching costs may make multi-homing both labour intensive, and resource intensive in terms of storage space on a laptop. In particular, inMusic notes that:

[14] See inMusic's Response to AlphaTheta Corporation/Serato Audio Research Limited's Cross-Submission in Relation to Submissions Made in Response to Statement of Preliminary Issues', Public Version, III(b).

DJ software providers all use their own, exclusive file format to store the substantial user-generated data that is critical to DJ performance, and cross-compatibility is not automatic.[15]

2.18 These factors may mean multi-homing is not a practical option for DJs and so frictional costs may slow the adoption of any rival software solution that is developed.

[15] See inMusic's Response to AlphaTheta Corporation/Serato Audio Research Limited's Cross-Submission in Relation to Submissions Made in Response to Statement of Preliminary Issues', Public Version, III(b)(2).

3 The SPA cash-out analysis is inconsistent and incomplete

3.1 NERA has performed (in NERA 2) its vertical arithmetic calculations on a different basis from that in NERA 1. This new version of the vertical arithmetic calculation takes into account that under the terms of the SPA, Serato must be operated as a standalone profit-maximising entity.[16]

3.2 Adopting this characterisation, NERA posits that if ATC was to pursue a foreclosure strategy, it would need to be profit maximising for a standalone Serato—meaning that ATC would need to compensate the sellers for the lost margins on sales that would no longer be made as part of the foreclosure strategy.

3.3 However, as we show below, NERA's new analysis is inconsistent (Section 3A) and incomplete (Section 3B). We discuss each of these shortcomings below.

3A The analysis is inconsistent

3.4 NERA claims (in NERA 3) that 'historical market shares are unlikely to be informative of future constraints in a dynamic market' because 'competitors (including mobile apps) may grow in future and/or constrain the merged entity…'. We discussed this claim in more detail in Section 2.[17] We note here that the 'dynamic market' to which NERA refers may suggest shifts in market shares.

3.5 However, in the cash-out analysis, NERA assumes that the proportion of Serato users on non-ATC hardware will remain the same for five years.[18] Additionally NERA's calculations use as inputs:

- Serato's expected monthly royalty revenue from hardware producers (in return for ensuring that hardware is optimised for Serato's software and can use Serato's branding);
- Serato's expected software revenue over the SPA period.

3.6 However, these Serato forecasts only run up to [CONFIDENTIAL DATE 1]. They

[16] See NERA 2, para. 2.
[17] See NERA 3, para. 7.
[18] See NERA 2, Table 1.

explain that, between [CONFIDENTIAL DATE 1] and [CONFIDENTIAL DATE 2], the expected hardware royalty fee has been constructed using year-on-year growth rates (which are consistent across the forecast period) and revenues from the previous year's same month. In a similar vein, the software revenue forecast for that same period was calculated by simply equating monthly revenues in the period between [CONFIDENTIAL DATE 1] and [CONFIDENTIAL DATE 2] with those of the previous year's same month.

3.7 Therefore, NERA is basing its future income estimates on historical income data, which seems to place a great deal of weight on historical software market shares. If NERA's arguments in Section 2 of NERA 3 were accurate—i.e. that the market is dynamic, meaning limited weight can be attached to the current situation—these historical market shares would be uninformative.

3B The analysis is incomplete

3.8 The analysis is incomplete for two reasons. First, the relevant clauses of the SPA itself may prove ineffective as such contracts cannot be written in a way that is complete.[19] Second, it ignores the possibility that a firm might pursue strategies that sacrifice short-term profit in order to increase profit over a longer horizon.

3B.1 The SPA as an incomplete contract

3.9 The SPA delays some part of the payment from ATC to the shareholders of Serato, and makes that part contingent on Serato's financial performance. As part of these clauses, ATC must compensate Serato's current shareholders if Serato's financial performance is impeded by elements of a foreclosure strategy. Specifically:

> Any refusal to allow Serato to partner with rival DJ hardware brands, refusing to allow Serato to operate with rival DJ hardware (if it were technically possible to prevent Serato from being so used) or refusing to make the full version of Serato's DJ software product available to rival DJ hardware suppliers would breach ATC's

[19] See Patrick Bolton and Mathias Dewatripont, 'Contract Theory', (2005), MIT Press, p. 36.

obligations under the SPA which would entitle the sellers to damages to compensate [ ].[20]

3.10 However, such contractual clauses are difficult to write in a manner that is complete and anticipates every way in which Serato could be reprogrammed to give ATC hardware a competitive advantage. In terms of due diligence, this is a commercial issue for Serato's shareholders and they must bear responsibility for any losses they incur as a result of contractual incompleteness or subsequent litigation. However, Serato will only have taken account of the costs of these measures on Serato's business and the contingent payments they expect to receive post-transaction. It will not have designed these clauses taking account of the wider potential costs resulting from reduced competition.

3.11 In this context, we note that Appendix B to Serato's submission includes a table of the possible ways in which the merged entity might engage in foreclosure and how Serato believes that various clauses in the SPA would prevent the merged entity from acting in that way.[21] The appendix refers to Clauses 6.1, 6.2.1 and 6.2.9(a) of Schedule 11. We reproduce these clauses below:

> [ATC] undertakes to the sellers that it will, during the Contingent Consideration Period, act in good faith and, using all reasonable endeavours, support the growth of and operate and manage [Serato] with a view to maximising the [**relevant profit metric**] for each Relevant Period.[22]
>
> [ATC] will ensure that [Serato] is managed in a prudent manner consistent with the 12 months immediately prior to Completion.[23]
>
> [ATC] will ensure that [Serato] does not (without the prior written consent of the Sellers' Representative)… materially change the nature or scope of its Business as presently conducted.[24]

[20] AlphaTheta Corporation – Serato clearance application, October 2023, paragraph 7.21.
[21] See 'Serato submission in response to Commerce Commission Statement of Issues', Public Version, Final – 8 April 2024, Appendix B.
[22] Clause 6.1, Sch 11 (Overarching Obligation) as reported in 'Serato submission in response to Commerce Commission Statement of Issues', Public Version, Final – 8 April 2024, Appendix B.
[23] Clause 6.2.1, Sch 11 (Prudent and Consistent Management), as reported in 'Serato submission in response to Commerce Commission Statement of Issues', Public Version, Final – 8 April 2024, Appendix B.
[24] Clause 6.2.9(a), Sch 11 (Scope of Business), as reported in 'Serato submission in response to Commerce Commission Statement of Issues', Public Version, Final – 8 April 2024, Appendix B.

3.12 From the perspective of incomplete contracts, it is positive that these clauses have been drawn relatively broadly so that they could cover any number of foreclosure strategies. However, this breadth has been achieved through the use of a degree of generality. As a result, the merged firm could exploit ex ante uncertainty as to what actions would maximise the relevant profit metric to opt for measures that would have a foreclosure effect, claiming that—in their business judgement—these measures were the most likely to maximise the relevant profit metric at the time. For example, they might be able to make these claims about licensing price increases that were, in fact, designed to have a partially foreclosing effect.

3.13 We note that behavioural remedies are frequently subject to similar criticisms in terms of only being effective where all possible business strategies could be anticipated, and only if they are appropriately designed.

3B.2 Longer-term issues

3.14 There are two relevant issues when considering this issue over a longer timeframe.

3.15 First, assuming that NERA is correct and that any foreclosure strategy would not be implemented until 2029, then it is unclear to us why this is an argument for inaction with respect to considering this merger today.[25] The reason that merger policy is an important tool of antitrust is because ex ante prevention of any significant reduction in competition ensures that consumers continue to enjoy the benefits of competition. So although the competition issue may only present in 2029, today may be the best opportunity for a competition authority to avert the competition problem.[26]

3.16 Second, NERA's analysis makes no allowance for ATC taking a long-term view in its profit-maximisation strategy. The merged entity might want to go ahead with a foreclosure strategy *today* even though it might involve payments to Serato

[25] See NERA 2, para. 2.
[26] There is a rich debate among competition authorities and regulators about how far into the future their analyses should look in both merger control and antitrust enforcement. A notable recent development is that the UK Digital Markets, Competition and Consumers Bill (as currently drafted) requires the UK competition authority to carry out a forward-looking assessment, covering a period of at least five years, as part of its assessment of whether to designate a firm as having 'strategic market status' (SMS), taking into account developments that would be expected or foreseeable if the firm in question were not designated as having SMS. Latest version of the Bill as currently drafted: https://bills.parliament.uk/publications/54683/documents/4580 see Chapter 2, section 5.

shareholders which would make the policy sub-optimal in terms of short-term profit. In other words, it may find it optimal to forego some immediate profits to push rivals out of the market, which would then allow it to recoup those lost profits in the future.

4 The viability of switching to non-Serato software

4.1 In Oxera 1, we presented an analysis of the merged entity's ability and incentive to foreclose other hardware manufacturers by making their software compatible only with hardware from ATC.[27] In NERA's recent memo, it criticises this analysis on the grounds that much of it relies on the assumption that no other software developer could match Serato's quality post-merger.[28]

4.2 NERA criticises this as a static view which neglects the possibility of rival responses in the following ways:

- NERA argues that 'Software rivals would have an incentive to enter, expand, reposition, or improve their product to respond to unilateral or vertical strategies by the merged entity.'[29] In other words, NERA is arguing that even if there is a quality gap now, it may well be closed in the short term post-merger.

- NERA also argues that 'This assumes that hardware rivals are helpless. While some currently appear to focus their efforts on integration with Serato, faced with foreclosure they would have an incentive to instead introduce their own software, improve their existing software (as many rivals already have their own software), or endorse compatibility with non-Serato software providers (which many do already)'.[30]

- Finally, NERA argues that 'Both software and hardware rivals would have every incentive to ensure their products were well-integrated.' They paraphrase us in the following terms: 'Oxera says that foreclosed DJs would have no other option but to switch to ATC if they want to achieve the same level of hardware/software integration, but this is unlikely given the various other competitors that provide software with the intention of it being used with a wide range of hardware...'[31]

4.3 These lines of argument from NERA raise further questions. If 'software rivals *would*

[27] Oxera 1, Section 4.
[28] NERA 3, para. 13.
[29] NERA 3, para. 14 (footnotes omitted).
[30] NERA 3, para. 14 (footnotes omitted).
[31] NERA 3, para. 14 (footnotes omitted).

have an incentive to enter, expand, reposition, or improve their product' [emphasis added] in response to any foreclosure, why do they not have that incentive today? Similarly, if foreclosure might lead hardware rivals to develop and improve their existing software or endorse compatibility with Serato rivals, why are they not doing so today? Why do software and hardware rivals not have every incentive to ensure their products are well-integrated pre-merger as well as post-foreclosure? More specifically, why does ATC not have an incentive to expand or improve its own software offering, rekordbox, but is instead intending to pay more than 100m NZD to acquire Serato? This choice might indicate that developing and improving rival software to Serato's is not a low-cost endeavour.

4.4 NERA suggests that the arguments in Oxera 1 are premised on Serato having 'an intrinsic and/or insurmountable advantage over *any* rival software products'. While Oxera does not claim that the advantage is insurmountable, we do highlight that the existence of *an* advantage of some form is implied by Serato's market-leading position. We do not claim that this position can be maintained in perpetuity, but it would be speculative to allow the merger on the basis that that a rival *might* be able to replicate Serato's quality and level of integration that could be achieved for non-ATC hardware. Bell Gully has indicated to us that the burden of proof is on the parties to the proposed transaction to satisfy the Commerce Commission that a substantial lessening of competition is not likely.

5 The focus on high-end hardware

5.1 In NERA 3, the authors argue that Oxera's report 'erroneously focussed' on professional DJs using high-end hardware. First, they dispute Oxera's characterisation of their initial arguments as to whether the merged entity would have the ability and incentive to engage in foreclosure. They then raise questions as to whether the merged entity would be able to target a specific group.

5A Was Oxera's focus on high-end hardware 'erroneous'?

5.2 We dispute the suggestion that our focus on high-end hardware was erroneous.

5.3 First, a proper market definition exercise would reveal whether high-end or professional DJs constituted a market in themselves, or should only be considered as part of a wider market including all users of DJ hardware and software. This is precisely the reason that the market definition exercise is important.[32] If a merger might lead to an increase in market power in one market (but not others) that would still be grounds for concern about the competitive effects of the merger. In order to show that Oxera's focus on this segment was 'erroneous', NERA would need to show that this segment was not a separate market (and if not a separate market, that it was not a significant section of the market such that that it could be ignored when considering the impact in the wider market overall),[33] and they have not done so.

5.4 Second, NERA disputes our characterisation of its original report. Our characterisation highlighted that NERA acknowledged that higher margins for high-end equipment meant that, 'mechanically', there would be lower critical diversion ratios for customers purchasing this high-end equipment. Oxera took this to suggest that incentives to foreclose in the high-end segment would be higher, and so that this segment would be more prone to foreclosure. However, NERA is suggesting that there may be countervailing forces in terms of this segment exhibiting lower actual diversion, because high-end hardware usually has

[32] NERA's arguments to the contrary notwithstanding—see NERA 3, para. 5.
[33] See New Zealand Commerce Commission (2022), 'Mergers and acquisitions Guidelines', May, para. 2.25, which says 'A lessening of competition does not need to be felt across an entire market, or relate to all dimensions of competition in a market, for that lessening to be substantial. A lessening of competition that adversely affects a significant section of the market may be enough to amount to a substantial lessening of competition.'

embedded software. However, in the absence of data, discussion about the actual diversion ratio is somewhat speculative (in either direction).

5B Would the merged entity be able to target a specific group?

5.5 NERA also questions whether the merged entity would be able to effectively target a specific group. In principle, our view from an economic perspective is that this would be relatively simple. NERA claims that one of two conditions would need to hold in order for the merged entity to target a specific customer group for foreclosure.

- The merged entity is able to specifically target a particular group of customers (specifically professional DJs); or
- The specific group of customers would comprise a sufficient proportion of the overall foreclosed user base to be influential in the degree of actual diversion.[34]

5.6 With respect to the first of these issues, NERA says that it is not clear how the merged entity could discriminate against professional users when applying a foreclosure strategy beyond targeting specific high-end devices.[35] NERA is correct that its analysis considers the possible targeting of specific devices. However, targeting specific high-end devices would arguably be sufficient to allow the targeting of specific kinds of customers. To the extent that NERA has considered the targeting of specific high-end devices, it has only considered the critical diversion ratio. Its reasons for considering that the actual diversion ratio in this segment would be lower are speculative.

5.7 On the second condition, we do not consider this to be particularly relevant given that the first condition is likely to hold. However, we do consider that clarification is needed in relation to the relevant question as to the profitability of a foreclosure strategy being applied to all consumers but driven by high margins paid by this segment. The question is not whether 'professional DJs comprise a sufficient proportion of the overall foreclosed user base to be influential on the degree of

[34] See NERA 3, para. 22.
[35] See NERA 3, para. 23.

actual diversion', but whether r*evenue earned from professional DJs* comprises a sufficient proportion of the overall foreclosed revenue base. This is true even if it were *not* possible to target professional DJs This seems likely to be the case based on the estimate of the proportion of hardware revenues accounted for by professional DJs that we cited in Oxera 1.[36]

[36] See Oxera 1, para. 4.38.

6 The speculative influence of dynamic factors

6.1 In Oxera 1, we estimated diversion ratios from rival hardware offerings and showed that, in most scenarios, they exceeded the critical diversion ratios estimated in NERA 1.[37] NERA 3 argues that those estimates of the actual diversion ratios are likely to overstate the diversion ratio that will be experienced in the hardware market in the event of any foreclosure strategy being pursued because 'there are several dynamic factors that are likely to depress actual diversion in practice'.[38]

6.2 The specific dynamic factors referred to are 'competitor responses', reputational effects', and 'reduced market size'. However, each of these dynamic factors is speculative. For example, NERA suggests that hardware rivals would have every incentive to integrate with alternative software or self-supply their own integrated software. If this were to happen, then it probably would improve the viable alternative hardware/software combinations that would be available to DJs and so depress diversion to the ATC/Serato combination. However, it is purely speculative to say that this is what *would* happen. The very fact that ATC is acquiring Serato rather than improving its own software offering suggests that these potential rivals' responses may not be as simple as has been proposed.

6.3 It is similarly speculative to suggest that any attempted foreclosure would lead to negative reputational effects which would reduce the appeal of the ATC/Serato combination, and so depress the actual diversion to ATC hardware. Indeed, NERA offers no evidence that sufficiently strong reputational effects would be present *in this case* to negate any incentive to foreclose. If it were generally the case that reputational effects would be that strong then foreclosure would not be a concern in vertical mergers. Besides, even if an outright refusal did carry a reputational risk, partial foreclosure strategies could still be adopted to achieve the same goal without incurring as much risk.

6.4 Furthermore, it is speculative to suggest that an attempt at vertical foreclosure could result in a 'less competitive DJ hardware market' that 'may inhibit growth in the hardware and software markets (or even shrink it) post-foreclosure…'

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[37] See Oxera 1, Section 4B.1.
[38] NERA 3, para. 29.

6.5 The authors of NERA 3 also contemplate possible repercussions from a foreclosure strategy leveraging market power in the market for DJ software into the market for DJ hardware that might materialise in other markets. Particularly in the music production market.[39] This could take place either via retaliation in the (larger) music production market, or via reputational effects. These suggestions are similarly speculative.

6.6 We acknowledge that when considering possible business strategies and possible consequences of those business strategies, analysis will necessarily be forward looking. Potential future events cannot be known with complete certainty. However, forward-looking scenarios and analysis should be backed by relevant evidence which is—in this case—lacking. Furthermore, some of these speculative proposals raise further questions.

6.7 For example, if competitor responses to a foreclosure strategy might mean that alternative software suppliers are capable of providing the same level of integration and quality as Serato, why have these alternative suppliers not already moved in that direction? Why would they need a merger between Serato and ATC accompanied by a foreclosure strategy to incentivise such developments? If the answer is that the cost of investment may be prohibitive compared with the reward, then that raises questions about the barriers to entry in the industry, and whether they are indeed as low as has been suggested elsewhere.[40]

[39] NERA 3, para. 30.
[40] NERA 1, para. 13.

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