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THE APPRAISAL OF COLLECTIVE DOMINANCE AND EFFICIENCY GAINS UNDER THE SUBSTANTIVE TEST OF THE NEW EU MERGER REGULATION

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Abstract

In this paper I will focus on the main economic and legal issues which stem from the adoption of the new Merger Regulation (139/2004) by the European Commission. In particular, I will consider the factors that, in the case-law history of the European Communities, have increasingly posed the Merger Regulation reform as a priority issue in the agenda of the European Commission.

My starting point is the new wording of Art. 2(3); it encompasses a one-pronged test, makes the significant impediment of effective competition the only investigation benchmark and marks the switch from a Market Dominance test to a Substantial Lessening of Competition test. Alongside the new set of Horizontal Merger Guidelines, the SIEC test is conceived to include in the assessment of market compatibility those cases of collective dominance that previously could not be caught by the investigations of the Commission. More importantly, though, the new substantive test is deemed to strengthen the economic analysis of prospective concentrations by balancing both the anti-competitive and the pro-competitive effects of a merger (efficiency defence). The numerous cases of overruling by the Court of First Instance, the controversy between the Commission and the US antitrust authorities over the GE/Honeywell case and the critiques of several economists, triggered a long-lasting debate about the comparative effectiveness of the MD test and the SLC test. Had the Commissions antitrust policy to be aligned with the US standards or was it already sufficient to make the competition control effective?

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In the last part of my paper I will consider some of the main arguments both in favour and against the reform of the Merger Regulation. Thereafter I will finally address the paramount question of whether the new test will actually provide the Commission with more effective instruments for the interpretation and enforcement of competition rules.

Keywords: EU Merger Regulation 139/2004, Significant impediment of effective competition (SIEC), Collective dominance, Efficiency gains.

JEL classification: K21.

1 Introduction

The 1st of May 2004 will be remembered not only as the date of enlargement to 25 members but also as the date in which the European Union (hereinafter EU) has officially initiated a new merger control policy with the adoption of the Commissions Regulation 802/2004 for the implementation of Council Regulation No. 139/2004 on the control of concentrations between undertakings. The new text, which was unanimously adopted by the Council on November 2003, reflects the long demanded shift from a more legalistic approach to one in line with current economic thinking.

As all antitrust authorities, the Commission and the European Court of Justice (hereinafter ECJ) are nowadays confronted with increasingly complex competition issues and the challenges of a globalized economy. This requires the Commission to acquire more effective instruments and a more rigorous economic approach to the interpretation and enforcement of competition rules.

The new Merger Regulation has been conceived as one of the priorities in the broader review process towards the modernisation of the European competition policy. It embodies a wide set of reforms on jurisdictional, procedural and substantive issues. In particular, it clarifies the Commission's decision-making powers and the division of competencies between the Commission and the Member States (subsidiarity principle) so as to achieve a more efficient case-allocation. It reviews the timetable of the investigation procedure, reinforces the one-stop shop principle and contains a set of new Guidelines for horizontal mergers (published in January 2004).

However the crucial modifications have concerned the substantive matters through the replacement of the Market Dominance test (hereinafter MD test) with a US-style Substantial Lessening of Competition test (hereinafter SLC test) in the appraisal of concentrations that are likely to pose anti-competitive effects.

In my work I will be focusing on the substantive issues related to the adoption of new Substantial Lessening of Competition (hereinafter SLC) test especially with respect to the assessment of collective dominance and efficiency gains. My starting point is the long-dated debate within the European arena over the opportunity to replace the MD test which was urged by the Court of First Instance (hereinafter CFI) and started with the issuance of the Green Paper in 2001.[1] In particular, I will be addressing the main arguments put forward by the SLC test advocates which constituted the crucial thrust towards the merger regulation reform:

1. The alleged higher effectiveness of the SLC test relative to the MD test in dealing with collective dominance and efficiency gains.
2. The three judgements delivered in 2001 by the European Court of First Instance (CFI) which overturned the Commissions decisions to prohibit mergers and raised important issues concerning the functioning of the merger review process.
3. The need of stronger harmonization between the EU competition system and the US one in the field of anti-trust regulation.

Throughout the paper I will be also overlooking the past decisions of the Commission on cases of collective dominance and efficiency defences in order to highlight the main shortcomings of the MD test. Then, I will consider the major changes of the Horizontal Merger Guidelines and compare them with the analogous provisions of the US Merger Guidelines. Finally, in the concluding part of the paper I will focus on the on-going debate concerning the opportunity of adopting a new substantive test: whether it will bring about the expected practical improvements in terms of efficiency and alignment with the US system.

2 The Road to the new Merger Regulation

The revised Merger Regulation forms the centrepiece of a far-reaching reform programme that started at the end of 2001. The European Commission began its formal review of the Merger Regulation 4064/89 (as amended by regulation

1 Green Paper on the review of Council Regulation (EEC) No. 4064/89, COM(2001), 745/6 Final, Brussels 11.12.2001.

1310/97) with the publication of a Green Paper seeking comments on the proposal of revising its text. Then, in December 2002, it followed up on the consultation phase and published the draft of a new Merger Regulation (and the draft of Horizontal Merger Guidelines). The Green Paper contained a number of suggestions for possible changes in both formal and substantial issues. It especially represented the framework for a better assessment of the role and scope of efficiencies in the field of merger control. Most of the comments agreed with the recommendation that the Commission should, as part of a sound economics-based merger control policy, take efficiencies into account in conducting its analysis of the effects produced by a proposed merger. In other words, they considered that there should be an "efficiency defence" that might mitigate the finding of a dominant position and enable the clearance of a concentration for its overall welfare-enhancing outcome. As to this purpose, the Green Paper invited comments on the effectiveness of the MD test compared to the SLC test used in several jurisdictions (and notably in the USA) in dealing with the full range and complexity of competition problems that mergers may engender. The express objective of the discussion was to throw light on their central characteristics in order to compare their respective advantages and disadvantages.

While not formally taking a position on the issue, the Commission expressed clear reservations about such a change. It pointed out that the greater degree of international convergence that would be achieved with the SLC jurisdictions[2] had to be counterbalanced against the rift that might be opened with those Member States and Accession countries that have just adopted the MD test. The Commission also noted the similarities of the SLC and the MD test. It considered the latter appropriate to the purposes and goals of the EU competition law, in particular given its evolution under the Merger Regulation from a "blunt and relatively imprecise market share test" to incorporate both the notion of collective dominance and the use of econometric tools to measure market power.[3] Equally, the feedback received by some of the interested third parties did not quite suggest a great deal of enthusiasm for the switch to the new criterion standard. On the other hand, however, a vast number of the respondents supported the SLC test by reason that it is:

- Closer to the spirit of the economically-based analysis of concentrations due to its primary focus on relevant market factors other than market shares,
- More flexible and efficient,

2 Not only the US but also Canada, Australia, Japan and now even UK and Ireland which have recently adopted the SLC standard.

3 Commission, Green Paper on the Review of Council Regulation 4064/89, COM(2001) 745/6 final, para. 166.

- Better adapted to addressing merger-specific efficiencies.

On 28 November 2003, the Council of Ministers reached a political agreement on the Commission's proposed reforms of the EU Merger Regulation. The amended Regulation was shortly adopted and eventually came into force in May 2004.

Nevertheless, strong controversy remained over the new substantive test. Supported by some of the delegations (especially the German delegation,[4] the Commission refused to substitute the original MD test with a genuine SLC test on the basis that it did not want to lose the benefit of thirteen years of jurisprudence under the former Regulation. On the other side, though, a large number of economists, scholars and opinion-leaders[5] urged for a thoroughly consistent reform. In order to satisfy both camps, a compromise was ultimately reached that redefined rather than replaced the substantive test. The wording of the new test is closer to the US test of a Substantial Lessening of Competition, but it also allows the Commission to somewhat retain the case law of its original MD test.

3 The New Substantive Test: Significant Impediment of Effective Competition (SIEC)

In the reformed regulation, Art. 2(3) on the appraisal of concentrations reads as follows: "A concentration which would significantly impede effective competition, in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market".[6]

The former wording of the same article was: "A concentration which creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it shall be declared incompatible with the common market".[7]

In the rephrasing of this article lies the switch to a new type of substantive

4 Bge and Müller: "From the Market Dominance test to the SLC test; are there any reasons for a change?" European Competition Law Review, Vol. 23, issue 10 – October 2002, p. 496.

5 Especially in the UK many commentators such as the Chairman of the Competition Commission, Sir Derek Morris, and the Director General of Fair Trading, John Vickers, were very critical of the dominance test and were instrumental in the adoption of the SLC test in the UK in the 2002 Enterprise Act.

6 Council Regulation (EC) No. 139/2004.

7 Council Regulation (EEC) No. 4064/89.

test that has been christened Significant Impediment of Effective Competition test (SIEC), a formula that provides for a form of co-habitation of a variant of the SLC test and the MD one.

While the original test required both created/strengthened dominance and significant impediment of effective competition (SIEC) as a result, the new test has SIEC as the key criterion and created/strengthened dominance as a prime instance of SIEC. A far more complicated matter is what SIEC means in practice and if it is the same as the SLC criterion. One interpretation is that they are synonymous. Another interpretation is that "substantial lessening" relates to how much competition is lost, while "impediment to effective competition" has to do with how much competition remains after the merger.[8]

A clarification in this sense can be derived from recital 25 of the new Regulation which says that: "The notion of significant impediment to effective competition' should be interpreted as extending, beyond the concept of dominance, only to the anti-competitive effects of a concentration resulting from the non-coordinated behaviour of undertakings which would not have a dominant position on the market concerned."[9]

It makes clear that all mergers having the effect of significantly impeding effective competition will be caught by the Regulation regardless of whether the concentration creates or strengthens a dominant position. Hence, dominance is no longer the main scenario as well as the creation/strengthening of market power is no longer the sole criterion to assess the compatibility of a concentration with the common market. The new test shifts the attention onto the effects in the post-merger market, which naturally leads to an examination of the extent to which efficiencies can mitigate or rebut the incentives to raise prices.[10]

More important, the scope of merger control is broadened so as to encompass the anti-competitive effects in all oligopolistic situations ("collective dominance" or duopolies) where the position of the merged company is not strictly dominant in the common sense of the word as the market share falls below the traditional dominance threshold (which remains unchanged).

In conclusion, further clarification of the SIEC will only be provided over time

8 Vickers, John: "Merger Policy in Europe: Retrospect and Prospect", European Competition Law Review, Vol. 25, issue 7 - July 2004. p. 455.

9 Council Regulation (EC) No 139/2004.

10 Colley, Liam: "From defence to attack? Quantifying efficiency arguments in mergers", European Competition Law Review, Vol. 25, issue 6 - June 2004, p. 343.

as the case law evolves. However, it is already clear that the new formulation of Art. 2(3) as interpreted by the Commission is intended to fill the gaps of the former MD test with respect to collective dominance and the efficiency defence.

4 The "Gaps" of the MD Test

When asked to highlight the main shortcomings of the former test, several commentators[11] stressed on its exclusive concern with the determination of whether the new merged entity gains or strengthens its dominant position. Although the provisions of Art. 2(3) in the former Regulation established a two-pronged test requiring for a concentration to be prohibited (1) the creation or strengthening of a dominant position, and (2) a significant impediment of effective competition, the Commission normally contented itself to examine the fist prong. Unless a merger was caught by the first part (likely to create or strengthen a dominant position), the question of the second part (whether competition would be significantly impeded as a result) did not arise. Likewise, where a merger was caught by the first part, the Commission interpreted the second prong as providing a margin of discretion on whether a merger giving rise to a potentially dominant position would breach the Regulation. But without the first part (dominance) being met, the second part (impediment to competition) could not be used to challenge a merger. This approach gave rise to the crucial distortion of the former merger control practice in that it only prohibited mergers which created or reinforced dominance.[12]

In contrast, economic analysis suggests that there are numerous mergers that could seriously jeopardise competition without crossing the threshold of dominant market power.

In principle the definition of dominance with reference to Art. 82 was propounded by the ECJ in the judgment of the Hoffmann /La Roche v. Commission case:

"The dominant position thus referred to relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective

11 In a letter addressed to Mario Monti on the 10th of July 2002, a number of eminent academic economists such as Jacques Crmer, David Encaoua, Marc Ivaldi, Massimo Motta, Damien Neven, Lars-Hendrik Röller, Eric Van Damme and others, advocated the modification of the substantive test and the consideration of the efficiency gains as fundamental factors in the reform of the Commission's anti-trust policy.

12 Motta, Massimo: "Economic analysis and EC Merger Policy", European University Institute Working Papers RSC No. 2000/33 European University Institute, p. 1.

competition being maintained in the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers".[13]

In practice, it has always been difficult to translate this definition into economic terms and for this reason the notion of dominance has often been associated by the Commission with a benchmark market share of around 35-40%. Generally it was found that this notion of dominance was too stringent and did not embrace situations where it was thought market power existed even if below this threshold. In fact, experience has largely proved that substantially higher prices can arise as a consequence of a merger even if this condition is not met. Considering for instance a market where a (possibly dominant) firm holds a 55% share, and two other firms have respectively 12% and 20% of the market, a merger between the firm holding the highest market share and any of the other firms will likely increase prices while creating (or reinforcing) dominance. However, a merger between the second and the third firm might well allow them to increase prices without giving rise to (single-firm) dominance. It is not because the merging companies face a larger competitor that they will refrain from increasing prices. In fact, economic analysis shows that in many circumstances an outsider firm will also increase its prices as a result of the merger. Therefore, a merger might significantly lessen competition and increase prices, independently of whether it affects the scope for collusion and/or creates or reinforces any single dominant position. As a result, in the view of many respondents to the Green Paper the MD test was biased because it did not allow the prohibition of mergers that are detrimental to social welfare.

A second distortion was going in the opposite direction:[14] as the EC merger policy did not recognise the role played by cost savings and enhanced innovation, mergers were prohibited that could be welfare-increasing. The merged firm, in fact, might well increase its production efficiency and reduce its costs to an extent that, despite lessened competition, it will find it more profitable in the long run to lower prices. For these reasons, the higher market concentration and the higher share of the new merged firm might be more than offset by gains in efficiency which will be ultimately passed on to consumers and have the net effect of increasing the overall social welfare. Throughout time it became apparent that the efficiency defence arguments were considerably lacking in the Commission's decision-making procedure under the former test. The resulting shortcomings were especially emphasized by the advocates of the US system and the CFI for

13 Case 85/76: (1979) E.C.R. 461.

14 Motta, Massimo: "Economic analysis and EC Merger Policy", European University Institute Working Papers RSC No. 2000/33 European University Institute, p. 22.

the purpose of urging a more effective economic analysis of concentrations. The proposition that mergers should be evaluated according to consistent economic criteria and that the merger assessment should focus on the impact of mergers on market power constituted the background on which the new Merger Regulation was shaped.

In the following section I will be considering the economic insights of these two elements (collective dominance and efficiency gains) and the role they have played in the EU competition law under the MD standard.

5 Collective Dominance in EU Competition Law

Traditional economic theory distinguishes two main cases to be considered when studying the effects of mergers on social welfare. Firstly, the case where the merger might allow a firm to unilaterally exercise market power and profitably raise prices without losing customers.[15]

In the US, this amounts to analysing the unilateral effects of a merger whereas in the EU this corresponds to the case of single firm dominance.[16]

The other case arises when a merger might favour collusion in the affected industry. Here, the merging firm would not be able to unilaterally increase prices above a certain threshold, but the merger could determine new industry conditions which enhance the scope for tacit collusion. Prices could then increase as firms are more likely to obtain supra-normal profits, where "normal" profits corresponds to the equilibrium situation (perfect competition).[17]

This issue falls under the category of collective dominance (or joint dominance, sometimes also oligopolistic dominance) or coordinated effects in the wording of US Merger Guidelines and, now, also of the EU Guidelines.[18]

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15 Given the downward sloping demand function, it is more realistic to assume that the merged firm will lose part of its customers as a result of increased prices. Nevertheless, it will find it profitable to raise prices as the profit gain due to higher prices will more than outweigh the loss of profits due to fewer customers.

16 Motta, Massimo: Chapter on horizontal mergers, chapter 5 from the book "Competition Policy: Theory and Practice", p. 4.

17 Motta, Massimo: Chapter 4, "Collusion and horizontal agreements", from the book "Competition Policy: Theory and Practice", p. 2.

18 Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings: section 39.

From a legal standpoint, some confusion might arise due to the fact that lawyers tend to distinguish between the two ways in which the non-competitive strategy can be achieved. If firms come to an agreement after talking about prices, competition lawyers would call this collusion. If there were no explicit agreement to a norm this would be considered “parallel conduct”.[19]

Lawyers make this sharp distinction because they consider collusion through explicit agreement (i.e. with communication) illegal, while “parallel conduct” is considered legal since there is no violation of competition rules. However, this distinction becomes meaningless in the light of economic theory. From this point of view the only thing that matters is whether firms are likely to raise prices towards the monopoly outcome regardless of the motivation of the firms operating in the industry.

No economic or analytical techniques are available that can predict with certainty the propensity of firms to collude in a market or the strength of a dominant position created by a merger or acquisition. Traditional economic theories suggest that two elements must exist for a collusion to arise: there must be the possibility to detect deviations from a certain collusive action (for instance, in case one of the co-operating firms seeks to undercut competitors) in a timely way and there must be a credible punishment (retaliation) which follows a deviation.[20]

To be sustainable, retaliation must be sufficiently likely and costly to outweigh the short-term benefits from “cheating” on the collusive path. To be effective, it must imply a significant loss in profits for the deviating firm, compared with the profit that it would have obtained by sticking to the collusive path. In general, the easier the detection of deviations from collusion and the more credible the punishment, the lower the incentives to cheat and, in turn, the more difficult to retain effective competition.

The likelihood to reach collusion in the post-merger market also depends on a series of additional factors such as transparency of prices, existence of exchange of information among firms, frequency of market interactions and, above all, the number of market participants as well as the distribution of their market shares. The smaller the number of competitors in a relevant market or the higher the degree of concentration, the greater the likelihood that these firms reach a common understanding on the terms of co-ordinated behaviour, and further detect and punish deviations from that understanding.

19 Kuhn, Kai-Uwe: “An Economists’ Guide Through the Joint Dominance Jungle”, p. 8.
20 Kuhn, Kai-Uwe, “An Economists’ Guide Through the Joint Dominance Jungle”, p. 7.

While economic theory provides many insights on the nature of tacitly collusive conducts, it says very little on how a particular industry will or will not co-ordinate on a collusive equilibrium.

5.1 Collective Dominance in the EU Case Law

The economic concept of collective dominance was not specifically covered by the former Merger Regulation. Throughout time it was derived by the legal practice on a case-by-case basis in response to the growing number of mergers where collective dominance considerations became necessary.

It was first established by the Commission in the Nestl/Perrier case. In 1991 IFINT, an Italian company belonging to the Agnelli family, launched a bid to gain control of the French company Perrier operating in the mineral water industry. The bid was followed by a counter-offer of Nestl, a Swiss multinational, which had previously reached an agreement with BSN, both firms being active in the mineral water industry. After a period of uncertainty the take-over battle was won by Nestl. Under the terms of the agreement, Nestl would have sold the Volvic source of Perrier to BSN.

After a detailed investigation, the Commission held that the operation would have resulted in joint dominance of the mineral water market in France by Nestl and Perrier. Eventually the merger was cleared subject to the condition that some of Perrier sources were to be transferred to an independent producer.

The acquisition would have reduced the number of big firms in the relevant market from three to two and gave the merged firm a dominant position. After considering some crucial factors such as the degree of supply concentration (the two remaining significant firms on the French market for bottled water would have been holding about 75 % of the market volume and more than 82 % of the market value), price transparency and monitoring of the duopolists' market behaviour, price inelasticity of the demand and the high barriers to enter the market, the Commission concluded that "that the incentives and possibility to increase prices jointly had already been recognised by the companies in the past and that the proposed concentration would facilitate and reinforce the likelihood of such a strategy (joint dominance).[21]

"However, the Commission decided to accept the remedy proposed by Nestl and the merger with Perrier plus the transfer of Volvic to BSN were allowed under

21 Commission's decision of 22 July 1992, O.J. L356/1.

the condition that Nestl would have sold to an unspecified independent firm (other than BSN) the other brands it owned in the mineral water market.

The decision taken by the Commission was surely innovative. For the first time it employed the concept of collective dominance to block a merger by reason that the purpose of undistorted competition within the Common Market would have been endangered if the word "dominant position" was only referred to single firm dominance. Nevertheless, the concept of collective dominance was brought under the former merger regulation only by a teleological interpretation.[22]

This interpretation is in conflict with those who argue that, although prima facie the MD test may not seem suitable for examining oligopolistic situations, it does encompass cases of collective dominance. This was at least the view of the ECJ which, in France v. Commission[23] stated that "collective dominant situations do not fall outside the scope of the Regulation"[24] and, therefore, of the MD test. In this case, the merger would have resulted in the merged firm and another state owned company holding an aggregate market share of 60% in the market for mineral fertiliser kali. The Commission decided that the merger would result in a lack of internal competition as a result of product homogeneity, lack of technical innovation and a high level of market transparency. Although the ECJ eventually annulled the Commission's decision on grounds of failure to prove collective dominance, the Court did confirm in that case that the former Merger Regulation was applicable to collective dominant situations.

An analogous approach was adopted by the Commission on subsequent cases (Kali und Salz/MdK,[25] Gencor/Lonrho,[26] ABB/Daimler-Benz[27]) whereby merger proposals were turned down on the ground of joint dominance claims. However, the investigation of mergers was carried out in unsystematic fashion according to a check list of criteria that the Commission had set out in its appraisal of post-merger anti-competitive implications. Regarding this issue, the European Commissioner for Competition policy Mario Monti, addressing the main challenges for a new decade of EC Merger Control, had stated: "we do not have an analytical strait-jacket that will mechanistically determine the outcome of future cases where oligopoly issues arise. We will continue to refine our analysis in this area on a case-by-case

22 Anderson, Aila V.: "Collective Dominance in E.C. Merger Control: An Analysis of Legal and Economic Arguments", p. 9.
23 Case C-68/94 and C-30/95: (1998) E.C.R. I-1375; (1998) 4 C.M.L.R. 892.
24 Ibidem, para. 178.
25 M. 308 Kali und Salz (1993), OJ C 196.
26 M. 619 Gencor/Lonrho (1996), OJ C 314.
27 M. 580 ABB/Daimler Benz (1995), OJ L 11/1.

basis".[28]

The lack of a systematic and consistent approach was the target of many critical comments included in the Green Paper. Many of the checklist statements turned out to be incorrect in the light of modern theoretical analysis or could not be made in the generality that they were applied. Secondly, most of the criteria were of a qualitative nature and, as such, did not allow any empirical conclusion about the importance of the potential effects on the actual behaviour of the market. A rather logical conclusion was that the MD test seemed largely inappropriate to deal with mergers involving co-ordinated effects. Thus the Green Paper raised the question of whether the regulation should be amended to incorporate the "substantial lessening of competition test".

The issue gained momentum especially after the Court of First Instance overturned three Commission decisions to prohibit mergers between June and October 2002 (Airtours/First Choice,[29] Schneider/Legrand[30] and Tetra Laval/Sidel[31]) on grounds of the alleged shortcomings of the Commission's efficiency analysis. In all decisions, the CFI held that the Commission failed to provide satisfactory evidence that the notified merger would lead to tacit collusion given the absence of a credible retaliation threat due to the insufficient information to detect deviations.

Most importantly, it set new standards for determining when a merger can be prohibited under the theory of collective dominance. For collective dominance to be found in any particular case, the Commission was required to establish that each of the following criteria had to be met: (1) there must be sufficient market transparency so that each member of the dominant oligopoly has the ability to know how the other members are behaving in order to monitor whether or not they are adopting the common policy; (2) there must be a means for other oligopoly members to retaliate against any departures from the common policy, so that members have an incentive not to depart from the common policy; and (3) the Commission must show that the foreseeable reaction of current and future competitors, as well as consumers, would not jeopardise the results expected from the common policy.[32]

These criteria are similar to those set out in the US Merger Guidelines, which

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28 Merger Control 10th Anniversary Conference, Brussels, 14-15 September 2000.

29 Case T-342/99, Judgment of 06/06/2002, Airtours/Commission (Rec.2002, p. II-2585).

30 Case T-310/01, Judgment of 22/10/2002, Schneider Electric/Commission (Rec.2002, p. II-4071).

31 Case T-5/02, Judgment of 25/10/2002, Tetra Laval/Commission (Rec.2002, p.II-4381).

32 Motta, Massimo: "E.C. Merger Policy and the Airtours Case", European Competition Law Review, Vol. 21, issue 4 – April 2000, p. 202.

state that, in evaluating whether a merger will increase the likelihood of post-merger co-ordination among industry members, it is important to consider how likely each competitor could “detect” and “punish” deviations from the co-ordinated conduct and how likely new entry/expansion by others would defeat any anti-competitive impact.

In order to make sure that all types of anti-competitive mergers would fall within the Regulation, towards the end of 2002, the Commission proposed amendments that would have given “dominance” a sufficiently broad meaning so as to cover non-coordinated as well as coordinated effects and single firm dominance. However, such a way of proceeding was stigmatised by a theoretical point of view as it would have risked creating other problems. Broadening the meaning of dominance in the context of the Regulation might have had a “spill over” effect in other areas of the law, with undesirable consequences relating to the scope of Art. 82 (prohibition of abuse of a dominant position). For cross-contamination, in fact, it would have broadened the category of companies to whom the special rules of Art. 82 apply.[33] On the other hand, it would have been equally undesirable to attach distinct meanings to the same word (and therefore have separate legal provisions) depending on whether it referred to mergers or abuses of dominant position. In the light of these considerations the Commission got increasingly persuaded about the utility of changing the test from MD to a direct effect-on-competition formulation.[34]

6 Efficiency Gains

The foremost rationale of competition law is its connection to economic efficiency. Competition spurs firms to achieve efficiency or, put differently, efficiency is generated through competition, leading to societal welfare. Art. 2.1(a) of the Merger Regulation states that the Commission in its merger control has to take into account “the need to maintain and develop effective competition within the common market”. However, if certainly effective competition may bring about economic efficiency, it is not synonymous with it.

While it underlines the desirability of competition, the Merger Regulation does not define what constitutes “effective competition”. From an economic standpoint, what is important is not the merger-induced deviation from “effective competition” whatever it is defined. Rather, it is the impact of the merger on economic efficiency.

33 Selvam, Vijay S.V.: “The EC Merger Control Impasse: is there a solution to this Predicament?”, European Competition Law Review, Vol. 25, issue 1 – January 2004, p. 58.

34 Vickers, John: “Merger Policy in Europe: Retrospect and Prospect”, European Competition Law Review, Vol. 25, issue 7 - July 2004, p. 456.

This is traditionally defined as the situation that occurs only when both productive and allocative efficiency are fulfilled so that no resources are wasted. Under these conditions, producers are continuously induced to satisfy the consumers' demand at the lowest possible price (allocative efficiency) while using the fewest resources (productive efficiency).

Although not explicitly mentioned even in the new version of the merger regulation,[35] efficiency gains are certainly a crucial variable in the analysis of the impact of mergers. Should they be absent, a merger would be likely to lead to lower consumer surplus and lower net welfare. But it is well established in the economic doctrine that efficiency gains might offset the increased market power of merging firms and result in higher overall welfare.

Thus, the economic evaluation of mergers consists of weighing up any diminution in competition against any efficiency gains that might result from them. For example, any adverse effects on prices due to a reduction in competition (negative externality) may be more than offset by cost reductions arising from efficiency gains (positive externality). This occurs because mergers might cause the parties to the merger (insiders) to be more efficient and save on their unit costs. Therefore, if these cost savings are large enough to outweigh the increase in market power, consumers will ultimately benefit from the merger. Alternatively if a merger produces efficiencies but prices nevertheless rise due to the reduced competition, producers will gain while consumers will lose out. The effect on total welfare will depend on the relative size of these gains and losses.

The problem is that in general allocative and productive efficiency are very unlikely to be simultaneously realised. The famous Williamson's model illustrates this issue in terms of trade-off between the cost gains from a reduction in marginal costs against any allocative efficiency losses from a price increase. In essence, at least in the short terms, the interests of consumers need to be balanced against those of producers when analysing the relationship between efficiency and competition. This trade-off depends on the relative weight allotted to the interests (welfare) of both groups. The relevant welfare standard (consumer welfare or total surplus model) determines which weight is assigned to which group and, moreover, what type of efficiencies is likely to be most beneficial.

Part of the anti-trust economists argue that consumer losses should be accorded greater weight than producer gains. According to them, the European competition policy should adopt a consumer welfare model and restrict the analysis of the price

35 A specific paragraph of the Horizontal Merger Guidelines deals with them.

effects brought about by the merger even in the presence of efficiency gains.

Other economist, instead, take the view that competition policies should be directed to maximise “total surplus”, the sum of consumers’ and producer’s surplus. The total surplus standard implies that even a merger leading to higher prices may be cleared if the efficiency gains realised by the merged entity exceed the losses suffered by consumers or, in terms of Williamson, the dead-weight losses due to price increase.[36]

An exhaustive examination of this discussion, however, would be beyond the scope of this paper. What really matters is that the “efficiency defense” clause is normally thought to allow the evaluation of both positive and negative externalities of mergers for the sake of social welfare.

Hereafter I will give a brief account of the main pros and cons associated with the implementation of a merger and thereafter I will turn to considering what treatment the efficiency claims have had in the EC under the MD test and the US Merger Guidelines. Finally I will deal with the debate on the desirability of the efficiency defence in the field of merger regulation.

6.1 Losses Due to the Anti-Competitive Effects of Mergers

The prime reason why competition authorities are concerned with mergers is that they reduce competition, which may have significant unwanted repercussions in the affected markets. The main effect of a diminished competition is typically two-fold and related to the notion of market power: market power is defined as the ability of a firm (or a group of firms acting jointly) to set prices above the competitive level (above marginal costs) without losing sales to an extent that the price increase is unprofitable and must be rescinded.

The price rise above marginal cost implies a transfer of resources from consumers to producers and normally creates production inefficiency (also called the dead-weight loss)[37] if production is below its optimal level. It must be noted that the risk of price increases following mergers may be limited if, due to the presence of actual competitors in the market, the market share of the new entity is

36 Luescher, Christoph: “Efficiency Considerations in European Merger Control-Just Another Battle Ground for the European Commission, Economists and Competition Lawyers?”, European Competition Law Review, Vol. 25, issue 2 -February 2004, p. 82.

37 Röller, Lars-Hendrik, Johan Stennek, and Verboven Frank: “Efficiency Gains from Mergers”, Working Paper No. 543, (2000) IUI, p. 23.

low, if entry into the market is easy or if strong buyers may exercise countervailing bargaining power.

The reduction in competition may also diminish the disciplining power of the market on the firm's efficiency because, when competition is weaker, the management and the employees exert less effort.[38] This leads to a sub-optimal allocation of human and financial resources and to higher production costs. Similarly, reduced competition may also reduce firms' incentives to innovate because R&D decisions are taken strategically, in response to actions of competitors. Especially if R&D are very risky, a dominant firm would rather enjoy the current monopoly rent than invest in R&D. Where many firms are competing on almost equal terms, the rents derived from innovation are likely to be competed away and, depending on how stringent the legal protection for innovation is, the incentives to invest in R&D are likely to decrease.

6.2 Gains Due to the Pro-Competitive Effects of Mergers

As already said, mergers might enable the parties to raise their efficiency and thereby decrease their production costs. The reasons why firms combining their assets might benefit from the merger are many-fold. The most evident one is the better exploitation of economies of scale and economies of scope: through the merger firms are able to reorganise their production so as to improve the division of labour and attain economies of scale, or to lower costs due to joint production.

Economies of scope arise when the cost of producing two products together is lower than the sum of the costs of producing them separately as they require a common input.[39] Learning effects, instead, are the reduction in unit cost due to accumulated experience, as measured by cumulative past output. A merger may also enhance technological progress and innovation by promoting the diffusion of know-how or by increasing the incentives for R&D activities among the merging firms (synergies). The diffusion of know-how across the participants may occur either by allowing the firm with less know-how to learn and adopt all skills from its partner with superior know-how, or (when firms have complementary capabilities) by pooling research for the development of their skills. As a result, the incentives to invest in R&D may increase because a merger helps internalise the benefits from R&D among the participating firms and secure sufficient rents to make it profitable to invest in innovation.

38 Ilzkovitz, Fabienne, and Meiklejohn, Roderick: "European Merger Control: do we need an efficiency defence?", Paper prepared in 2001 for the 5th Annual EUNIP Conference, p. 5.

39 Ibidem, p. 6.

Additionally, mergers often enable a swifter exploitation of economies of scale than internal expansion[40] both in the long run and in the short run. Short-terms (with physical capital held fixed) economies of scale may include the costs associated with certain administrative and support tasks required to keep a firm operational such as the purchasing of materials, the personnel service or the billing of customers. Long-run economies of a scale, instead, may be realised through a merger if the formerly separate firms' investments in physical capital are combined and integrated. Moreover, long-run economies of scale may also arise in production (for example, energy requirements for a large machine may be proportionally lower than those of a small machine), in research and development (for example, as the production of the firm increases, it becomes worthwhile to invest more in sophisticated technologies) and in marketing activities since a single brand name can be created to reduce advertising expenditures.

A merger is also likely to lead to a lower cost of capital, especially for a small firm joining a large corporation, due to the fact that capital markets do not function perfectly and tend to discriminate against small and expanding firms.

It has been argued that the main purpose of mergers is to combine the non-tradable assets of the merging firms, such as reputation, relationships with customers and the corporate culture, since otherwise the firms could simply exchange tradable assets. This combination may be a major source of any efficiency gains.[41]

6.3 On the Costs Associated with the Efficiency Defence

The appropriate regulation of mergers is an important policy issue in the field of competition law and the question of whether the efficiency gains (either proven or only claimed) should constitute a justification not to challenge an otherwise anti-competitive merger is much debated.

The debate entails a wide range of issues which need to be weighted. From an economic point of view the US SLC test is held preferable as it allows the trade-off between the beneficial and detrimental externalities of a merger that the MD test ignores. When a proposed merger is likely to raise competition concerns,

40 Posner, Richard: "Antitrust Law", The University of Chicago Press 2nd Edition (2001), p. 119.

41 However, many commentators stare that this is also the major risk factor in any merger as it inevitably disturbs established customer relationships and relationships with the workforce. In addition, forging a common corporate culture out of two disparate ones, communicating it to managers and workforce and persuading them to accept it can be costly and time-consuming.

the merging parties have nonetheless the opportunity to get the merger cleared by providing evidence of the efficiency gains the transaction will produce. This is highly desirable since apparently harmful mergers might end up with increasing the total surplus and therefore should be encouraged. However, there is also the flip-side of the coin: a vast part of the literature points out that one conceivable benefit with making an irreversible commitment not to permit mergers for efficiency reasons is that this may discourage two types of social cost that the MD test does not imply; costs of evidence production and rent-seeking costs.

In the US decision making procedure over mergers, the alleged efficiencies are required to be demonstrable and merger-specific. In other terms, the parties must provide evidence that, absent the merger, the welfare-enhancing outcome would not otherwise be produced through alternative and more desirable means such as internal growth, a joint venture, a specialisation agreement, a licensing, lease or other contractual agreement, or another merger. It has been noted that the are two remarkable drawbacks associated with such a way of proceeding: the first is the difficulty of computing the efficiency benefits of a merger and translating them into quantitative terms due to the difficulty of precisely predicting the merger effects before it has been consummated. The second is that firms will typically have a strong incentive to exaggerate the efficiencies and it can be extremely difficult for a competition authority to verify them in advance. Even if sometimes efficiency arguments are easy to make, they are always hard to evaluate.[42]

In fact, typically the merging firms have exclusive or superior access to information about any efficiencies and, for this reason, in most of cases the information available to the parties and to the anti-trust agencies are highly asymmetric. In other terms the regulators are affected by an information-disadvantage relative to firms on the true extent of merger-specific cost savings. The way the SLC regime alleviates this informational shortcoming is by requiring a high standard of evidence and placing the burden of proof on the parties. This is the case of some jurisdictions like the US and Canada where it is explicitly indicated what firms should prove and what kind of documentation they should use in a manner that the anti-trust agencies are able to verify the likelihood and magnitude of each asserted efficiency, how and when it would be achieved (and any costs of doing so), how it would enhance the merged firm's ability and incentives to compete, and why it would be merger-specific.

Within such systems, it is therefore the proposing firms that are expected to

42 Fisher, Franklin M.: "Horizontal Mergers: Triage and Treatment", Journal of Economic Perspectives, Vol. 1, issue 2 – 1987, p. 38.

bear the full costs of providing evidence of the claimed offsetting efficiencies. These costs are typically two-fold: in the first place, the merging firms have to invest resources in collecting and processing information in order to prove the claimed efficiencies. Secondly, they will have to invest resources in reporting this information to the competition authority in a persuading manner so as to increase the likelihood of having the merger cleared.

This procedure consists of transforming the soft information (privately available to the parties and, as such, not verifiable) into hard information (as reported to the anti-trust agency) and it is indispensable to the efficiency defence.[43] Tough, it can also be extremely costly and time-consuming. The higher the standard of proof requirement, the higher the costs the parties have to bear relative to the prospective gains and the lower the incentives for the would-be merging firms to invest in evidence production and ultimately engage in the merger. When assessing the profitability of a concentration, in fact, the insiders will weigh the expected post-merger revenues against the expected costs of the merger procedure. As a consequence, an excessively strict competition authority imposing excessively stringent standards of evidence may result in an under-optimal (inefficient) level of mergers; too few potentially welfare-increasing mergers (because the gains would be higher than the merger's costs) are implemented.

Besides the costs incurred by the parties in gathering, processing and transmitting information, the SLC standard may imply another type of social cost which is related to the higher likelihood of influence activities (lobbying and bribing). This, in turn leads to a dissipation of resources into rent seeking.[44] The core assumption is that by strategically transmitting such information to the antitrust authority, the parties may be able to achieve a favourable decision. This provides the merging parties with strong incentives to over-invest in the final stage of the merging process (transmission) and to under-invest in the previous two stages (gathering and processing of information). Since the transmission of information is the stage at which the contribution to increase the competition authorities' know-how about the merger's efficiencies is minimal, the resources invested in this stage are more likely to go wasted. However, yet it is not clear whether all kinds of influence activities should count as a social cost of allowing for an efficiency defence. For if the activities take the form of outright monetary bribes, then they merely represent a transfer of wealth between different economic agents. In

43 Lagerlöf, Johan, and Heidhues, Paul: "On the Desirability of an Efficiency Defense in Merger Control", (2002), p. 3.
44 Fisher, Franklin M.: "Horizontal Mergers: Triage and Treatment", Journal of Economic Perspectives, Vol. 1, issue 2 – 1987, p. 39.

this circumstance, the welfare effects of such influence activities could be either positive or negative, depending on whether the cost of gathering, processing, and transmitting the information is offset by its social benefits.[45]

Putting aside the on-going debate over the opportunity and feasibility of having an efficiency defence system, what appears to be unquestionably accepted by the economic doctrine of mergers is that the efficiencies should never be treated as an offence. Where a merger increases efficiency, it is likely that this will increase competitive pressure on rivals. This should be seen generally as a positive move, encouraging rivals to improve efficiency. Absent the application of sound theories of foreclosure that can be calibrated with a high degree of certainty, efficiencies that place competitors at a disadvantage should not be used to prohibit a merger. Ultimately it is inappropriate to prohibit mergers simply because, by improving efficiency, they make life tougher for the competitors or may even drive competitors out of business at a later stage. The appropriate presumption here, unless clearly challenged by the facts, is that rivals to an efficiency enhancing merger will have greater incentives to improve efficiency, bringing benefits of increased competition to consumers. The Commission's case-law experience shows that efficiency arguments have never been applied as "efficiency defence" but have rather been used as "efficiency offence".

6.4 The Efficiency Defence under the MD Test

Although it is widely accepted that economic efficiency is a central issue in competition law, formally so far it has not been true for E.C. competition rules under the MD test. As noted above, the MD test was founded on the co-existence of two requirements for a merger proposal to be deemed incompatible with the common market: the creation or strengthening of a dominant position, and a significant impediment of effective competition.[46] While the purpose of the first prong evidently entails an assessment of dominance as primary focus of the test, the second prong of the Art. 2(3) test entails an assessment of a "significant impediment of competition". Its purpose was set out in France v. Commission where the ECJ stated that the second prong is "…intended to ensure that the existence of a causal link between the concentration and the deterioration of the competitive structure of the market can be excluded only if the competitive structure resulting from the concentration would deteriorate in similar fashion even if the concentration did not

45 Lagerlöf, Johan, and Heidhues, Paul: "On the Desirability of an Efficiency Defense in Merger Control", (2002), p. 2.
46 Art. 2(3) of Merger Regulation 4064/89.

proceed".[47]

In theory both prongs were supposed to be applied separately but in practice, though, the Commission repeatedly neglected the second part of the article and seemed exclusively concerned with the creation or strengthening of a dominant situation.

The factors the Commission had to take into account when finding a dominant position are listed in Art. 2(1) which has remained unchanged from the former Regulation. Its effectiveness has been subject to strong criticism for not being an exhaustive list of criteria and not providing any guidance as to a possible ranking of the factors. However, even stronger criticism was raised over time on the substantive test as it was not leaving any room for the efficiency factors.

It must be specified, though, that the causal link between the former phrasing of the merger regulation and the lack of efficiency defence is highly controversial. In particular, it has been observed that, even if it is desirable to deal explicitly with efficiency gains like the US Merger Guidelines do, the Commission could take efficiency benefits into account even in the framework of the MD test by defining the market in a broader way so that the dominant position would not be found. According to these comments, the efficiency defense clause was enshrined in Art. 2(1)(b) of the former regulation (that the new text retains unchanged) which required that the Commission, when appraising whether or not a merger was compatible with the common market, should take into account "the development of technical and economic progress provided that it is to consumers' advantage and does not form an obstacle to competition".

This, the Commission alleged, allowed it to carefully consider any efficiency claim. Given the way it is formulated, however, the factors contained in these provisions are exclusively meant to indicate means of appraising possible dominance. Once dominance is detected pursuant to Art. 2(2) and (4), the Regulation seems not to permit a trade-off with possible efficiencies. Although the wording itself does not necessarily exclude such a trade-off, numerous commentators have nonetheless concluded that, far from being close to a true "efficiency defense" as contained in section 4 of the US Merger Guidelines, Art. 2(1)(b) is thus defunct as a means of balancing anti-competitive and pro-competitive effects.[48]

47 Case 68/94: 1998 E.C.R. I-1375; 1998 4 C.M.L.R 829, para. 115.

48 Von Hinten-Reed, Nils, and Camesasca, Peter D.: "European Merger Control: Tougher, Softer, Clearer?" European Competition Law Review, Vol. 24, issue 9 – September 2003, p. 460.

Obviously not everybody agreed with these arguments. With the intention of proving that switching to the new substantive test was unnecessary, some analysts have also noted that the term “competition” takes on different meanings in the literature. In some literature the word competition is synonymous to the absence of market power as measured by the price to cost mark-up that firms charge. Under this definition, it is obvious that horizontal mergers most often reduce competition (that is increase mark-ups) at least slightly, and some of them reduce it to a significant degree. If the word “competition” is interpreted in this sense, it means that all mergers that significantly increase mark-ups are to be prohibited and the provisions of Art. 2(1)(b) could not be used to save any horizontal mergers, since they inevitably do form an obstacle to competition. This is the economic interpretation the Commission has traditionally attached to the word competition. According to part of the doctrine, however, the word competition has been used in another sense, namely to mean the price level. Using this definition, horizontal mergers can be both pro-competitive (those that reduce price) and anti-competitive (those that increase price). Assuming that the Merger Regulation uses the word “competition” in this second sense, then a merger would be prohibited if, and only if, it raises price and Art. 2(1)(b) would amount to an efficiency defense. This to say that a reformulation of the article and the switch to a SIEC test was not indispensable to set up the efficiency defense.

Nevertheless, the wording of the article is so ambiguous that it is impossible to give a unanimous and undisputed interpretation. In addition, the statements issued by the Commission in the course of its decisions have rarely been consistent with respect to the consideration of a efficiency defense. For this reasons, other interpretations of the same provisions do not agree with the above mentioned explanation and come to diverging conclusions. If “form an obstacle to competition” was synonymous to “significantly impeding effective competition” the development of technical and economic progress could only be considered in those situations where the merger is to be allowed anyway. The main problem with this interpretation is that it makes the provision logically meaningless. Also the Commission itself specified that “there is no real legal possibility of justifying an efficiency defense under the Merger Regulation. Efficiencies are assumed for all mergers up to the limit of dominance, the concentration privilege”.[49] Any efficiency issue was therefore considered in the overall assessment to determine whether dominance was being created or strengthened and not to justify or mitigate that dominance in order to clear a concentration which would otherwise be prohibited.

49 Contribution of the European Commission Delegation to the 1996 OECD (Organisation for Economic Co-operation and Development) report, OCDE/GD(96)65: “Competition Policy and Efficiency Claims in Horizontal Agreements”.

On the other hand, it must also be acknowledged that the former merger regulation did not explicitly rule out the possibility to clear mergers which enhance economic efficiency. In this respect, the Commission also stated that "a concentration which leads to the creation of a dominant position may, however, be compatible with the common market (...) if there exists strong evidence that this position is only temporary and would be quickly eroded because of high probability of strong market entry. With such market entry the dominant position is not likely to significantly impede effective competition (...)."[50]

Notwithstanding this statement of good intentions, the Commission's practice of mergers control demonstrates that it has never shown much sympathy for such considerations nor has it ever explicitly applied efficiency gains in its decisions so far. If there is some evidence that efficiencies were considered in clearing mergers, there has not been a clear case where the efficiencies considerations rebutted a finding of dominance. Whenever cost reductions had been claimed by the merging parties, the Commission had dismissed those claims on various grounds (Aerospatiale-Alenia/DeHavilland,[51] Accor/Wagon-Lits,[52] MSG/Media Service[53]).

7 The Horizontal Merger Guidelines

In the reform of the Merger Regulation a crucial role was played by the objective of bringing the EU merger control practice in line with US experience not only for the need of higher effectiveness but also for the sake of greater harmonisation between the two systems. This effort is particularly reflected in the provisions of the Horizontal Merger Guidelines which accompany the Regulation and represent the cornerstone for the Commission's investigation of mergers. This is the first time the Commission comprehensively sets out the analytical approach it takes when assessing mergers and provides a clear and detailed guidance to the legal and business communities as to whether a deal is likely to face regulatory problems. The Guidelines complement the new wording of Art. 2 of the Merger Regulation with respect to the substantive test that underpins merger reviews. In many parts it resembles the US Guidelines. In this chapter I will examine the sections dealing with collective dominance and efficiency defence and compare it with the analogous provisions of the US counterpart.

The first US Horizontal Merger guidelines were published in 1968 and

50 Aerospatiale-Alenia/DeHavilland, Case IV/M.053 (October 1991), O.J. L334/42.
51 Decision 91/619/EEC, 2 Oct. 1991, O.J. L334/42.
52 Case IV/M53 (1991), O.J. L204/1.
53 Case IV/M.469 (1994), O.J. L364/1.

underwent subsequent revisions in 1982, 1984 and ultimately in 1992. The current US Merger Enforcement Guidelines were also amended 1997 in the section that deals with the treatment of efficiency claims. Following the extant case law, great relevance has been placed on the structural effects of a merger and on devising a screening system in terms of concentration to establish whether or not a merger is likely to substantially lessen competition or to create a monopoly. The analysis of the effects of a merger on concentration remains an important part of the assessment process, but a major change brought about by the 1992 Guidelines is that the agencies are deemed to provide a credible theory of how the merger under scrutiny will adversely affect competition if this is to be challenged. The theoretical benchmark of the current text is that mergers should not be condemned unless they facilitate both express and tacit collusion or enhance market power to proportions of a monopoly or quasi-monopoly: "mergers that either do not significantly increase concentration or do not result in a concentrated market ordinarily require no further analysis".[54] In other words, only those mergers which lead to a substantial lessening of competition in the affected market are deemed to be challenged. The US Horizontal Merger Guidelines begin with a definition of the relevant market[55] and an analysis of concentration within the relevant market. If the merger unduly increases concentration to unacceptable levels, the guidelines set out the competitive analysis that will be used to evaluate the effects of the merger. Potential competitive harms are classified as either "unilateral" or "coordinated". Also the EU Guidelines acknowledge that the analysis must begin with a consideration of the relevant markets and refer to the Commission's Notice on the definition of the relevant market. However, while they recognize the importance of market shares and concentration levels,[56] these are no longer the only criteria of the competitive analysis. Instead, they allow for the consideration of other non-structural indicators (such as buyer power, entry analysis, efficiencies and possible failing firm defences) and establish that possible anti-competitive effects can arise in cases of single firm or collective dominance. The language of the analysis differs somewhat from

54 US Merger Guidelines: section 1.0.

55 See US Merger Guidelines, section 1.0: a market is defined as a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future producer or seller of those products in that area likely would impose at least a "small but significant and non-transitory" increase in price, assuming the terms of sale of all other products are held constant. A relevant market is a group of products and a geographic area that is no bigger than necessary to satisfy this test.

56 In order to measure concentration levels, the Commission often applies the Herfindahl-Hirschman Index (HHI) which is calculated by summing the squares of the individual market shares of all the firms in the market and gives proportionately greater weight to the market shares of the larger firms: EU Horizontal Merger Guidelines, para. 16.

the US Horizontal Merger Guidelines but the same concepts of unilateral and coordinated effects are employed.

7.1 Coordinated Effects

The US Merger Regulation explicitly takes into consideration the issue of collective dominance (coordinated interaction as it is worded in the Guidelines) in the section of the potential adverse competitive effects of mergers.

Regarding this point, the US Merger Guidelines state that “a merger may diminish competition by enabling the firms selling in the relevant market more likely, more successfully, or more completely to engage in coordinated interaction that harms consumers. Coordinated interaction is comprised of actions by a group of firms that are profitable for each of them only as a result of the accommodating reactions of the others. This behavior includes tacit and express collusion and may or may not be lawful in and of itself”.[57] Also the new EU Merger Guidelines specifically acknowledge that one of the two main ways in which horizontal mergers may arise competitive concerns is “by changing the nature of competition in such a way that firms that previously were not coordinating their behavior, are now significantly more likely to coordinate and raise prices or otherwise harm effective competition. A merger may also make coordination easier, more stable or more effective for firms which were coordinating prior to the merger (coordinated effects)’.’[58]

In fact, a merger may change the structure of the affected market in such a way that both the merging firms and all the others operating in the market “. . . would it find possible, economically rational, and hence preferable, to adopt on a sustainable basis a course of action on the market aimed at selling at increased prices”.[59] In a concentrated market this outcome can be achieved even if the firms operating in the post-merger market do not enter into an agreement or resort to a concerted practice that might fall within the scope of Art. 81 of the Treaty (prohibition of cartels).

Coordination becomes easier, and therefore more likely, as the number of participants decrease and the market becomes more concentrated. Indeed it is easier to coordinate among a few players than among many. However, high concentration is not itself a sufficient condition to trace coordination. Market shares and concentration thresholds, in fact, provide only a first indication of the market

57 US Horizontal Merger Guidelines: section 2.1.
58 EU Horizontal Merger Guidelines: para. 22(b).
59 EU Horizontal Merger Guidelines: para. 39.

structure and of the competitive importance of both the merging parties and their competitors. For coordination to be sustainable, the EU Guidelines require three main conditions to be met.[60] First, the coordinating firms must be able to monitor to a sufficient degree whether the terms of coordination are being adhered to (market transparency) and, in case of deviation, to retaliate in a timely way. Second, there must be some form of credible deterrent mechanism that can be activated if deviation is detected. Third, the reactions of outsiders, such as current and future competitors not participating in the coordination, as well as customers, should not be able to jeopardise the results expected from the coordination.[61] Hence, in order to determine the likelihood of coordinated interaction, the Commission will take into account all available relevant information on the characteristics of the markets, including both structural features and the past behaviour of firms.[62]

This point is made clear also by the US Guidelines which states that, when assessing the possible implications of a merger, the Agency "will examine the extent to which post-merger market conditions are conducive to reaching terms of coordination, detecting deviations from those terms, and punishing such deviations".[63] The task is carried out by weighing, depending on the circumstances, a wide range of relevant market factors such as: the availability of key information concerning market conditions, transactions and individual competitors, the extent of firm and product heterogeneity, pricing or marketing practices typically employed by firms in the market, the characteristics of buyers and sellers, and the characteristics of typical transactions.[64]

It must be noted though that, even if the agencies begin with no pre-determined view, most of the recent merger cases brought by the Federal Trade Commission and Department Of Justice have been based on the analysis of unilateral rather than coordinated effects. It needs to be remembered that, since the Guidelines do not have legal force and only serve as a guide to enforcement practice, a merger can only be prohibited in the US through court proceedings. This explains why few cases end in the courts and most are settled at some prior stage of the process, often after some restructuring of the transaction to meet the agency's concerns, usually by a consent order. Therefore, despite the 1992 Guidelines greatly enhanced the concern with coordinated interaction in the US merger control proceedings, there

60 Unlike the US counterpart, the EU Merger Guidelines do not employ a concentration screen but they reiterate the three pre-requisites for co-ordination established by the European CFI in the Airtours judgement.

61 EU Horizontal Merger Guidelines: para. 41.

62 EU Horizontal Merger Guidelines: para. 43.

63 US Merger Guidelines: section 2.1.

64 Ibidem.

have been so far very few litigated cases in which the courts have had to adjudicate on an agency's assessment of coordinated effects.

On one hand, this is largely the result of more developed analytical techniques which make it possible, when the data are available, to estimate the likely impact of the structural change on prices in case of unilateral effects. On the other hand, it reflects in some respects the weaker predictive strength of economic models of oligopoly and the difficulty of establishing evidence sufficient to satisfy a court. That is why, even though the Guidelines set out in consistent details the considerations that may be held to be conducive to coordination, the US competition authorities do not see these as more than a useful check-list or framework of thought.

7.2 Efficiencies

The EU Guidelines contain strong similarities with the US Guidelines also with respect to an efficiency defense. Like section 4 of the US Guidelines, also the EU text expressly acknowledges the potential benefits to the economy generated by mergers for their capability of "increasing the competitiveness of the industry, thereby improving the conditions of growth and raising the standard of living in the Community".[65]

It then adds that mergers may bring about various types of efficiency gains that can lead to lower prices or other benefits to consumers: costs savings in production or distribution (especially variable and marginal costs), new or improved products and services (for instance resulting from efficiency gains in the sphere of R & D and innovation), stronger incentives for the merged entity to increase production and reduce price (and therefore lower the risk of coordination).

Hence, the relevant benchmark in assessing efficiency claims is that they must be for consumers' benefit,[66] or at least they must leave the consumers as well-off as they were in the pre-merger situation. However, other two cumulative requirements must be fulfilled according to paragraph 78: efficiencies must be merger-specific and verifiable.

65 EU Horizontal Merger Guidelines: para. 76

66 The consumer welfare objective derives from Art. 2(1)(b) of the Merger Regulation.

Likewise, the 1992 Merger Guidelines[67] contend that efficiencies must be *cognizable*, that is to say merger-specific and verifiable. Efficiencies are merger-specific when they are unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anti-competitive effects and cannot be attained by less anti-competitive and realistic alternatives of both concentrative and non-concentrative nature (such as divestiture, cooperative joint venture or licensing agreement, a differently structured merger[68]). They are verifiable if the parties substantiate their claims in a way"…that the Commission can be reasonably certain that the efficiencies are likely to materialise, and be substantial enough to counteract a merger's potential harm to consumers."[69]

Hence, efficiency claims are not considered if they are vague or speculative or otherwise cannot be verified by reasonable means. In the EU Guidelines it is also specified that, when possible, efficiencies and the resulting benefits to consumers should be quantified. The "evidence relevant to the assessment of efficiency claims includes, in particular, internal documents that were used by the management to decide on the merger, statements from the management to the owners and financial markets about the expected efficiencies, historical examples of efficiencies and consumer benefit, and pre-merger external experts' studies on the type and size of efficiency gains, and on the extent to which consumers are likely to benefit"[70]

To sum up, under the Merger Guidelines the efficiency analysis is grounded on a two-part test. The merging parties must prove (1) that the concentration will result in merger-specific and verifiable efficiencies, and (2) these efficiencies will be passed on, to a sufficient degree, to consumers. Against any possible ambiguity in the evaluation, the second limb of the test makes clear that efficiencies can lead to a clearance of the merger only where there is a measurable benefit to consumers, regardless of whether there are increased firm's profits or not. From another perspective it can be said that the new substantive test, as embedded in Art. 2(3) and the Guidelines provisions, is designed to accept the viability of the efficiency defense but makes it very clear that the prerequisites for a rebuttal of the presumption of illegality will not easily be satisfied.

The Guidelines illustrate the extent to which economics has been explicitly

67 Unlike the 1968 Guidelines (that did not consider efficiencies as a general defense) and the 1982 Guidelines (that recognized an efficiency defense only in "extraordinary cases" by "clear and convincing evidence"), the 1992 Guidelines, together with the 1997 Revisions, unquestionably recognized the scope for efficiencies that enhance the ability and incentives to compete.

68 EU Horizontal Merger Guidelines: para. 85.

69 Ibidem: para. 86.

70 Ibidem: para. 88.

adopted by the EU competition policy and the Commission's analytical framework has been aligned to the US one. However, the successful application of such a merger control regime will ultimately depend on how the Guidelines will be put into practice by the Commission. About this issue, many commentators foresee that its approach to the new test will be very cautious, especially as it regards the efficiency arguments.

While it is rather unquestioned that the new Merger Regulation attaches a central role to the economic analysis of merger, two issues are still subject to debate: 1) Was the switch to the SIEC test absolute necessary to achieve this outcome or could it be achieved through a mere re-interpretation of the former test? and 2) Is the reformulation of the Merger's substantive test and the adoption of new Guidelines sufficient to remedy the shortcomings of the MD test and bridge the gap with the US standards? Herewith I will consider the principal arguments put forward pro and against the adoption of the new test.

8 The Debate Over the New Substantive Test

8.1 Arguments in Favor of the New Test

The rephrasing of Art. 2(3) was hotly debated and caused a lot of controversy over the alleged higher effectiveness of the SLC test in the field of merger policy. About this issue, the European opinion has been sharply divided in two. On one side, the advocates of the SLC test have argued that the difference between the two regimes lay essentially on the language of the respective texts. A simple reformulation of the text might be sufficient to bring the European system in line the American experience in terms of enhanced efficiency. Some of the arguments in favor of the SLC test stressed the gaps of the MD test in relation to collective dominance and efficiency defense. Some others rejected the proposed re-interpretation of the concept of dominance due to the "spill-over" effect on the interpretation of Art. 82. It was also argued that the adoption of the SLC test would foster the global convergence in the substantive aspects of merger control with countries like Australia, UK, Canada, Japan and, above all, the US.[71] In the process towards a globalized competition policy, it is mainly the US and EU regulators to set the pace of reforms. As a consequence, a higher degree of harmonization between the two systems becomes very important. This last point is especially emphasized by Patterson and Shapiro who noted that divergent substantive tests increase the

71 Although, on the other hand, it will create divergence with countries that have adopted the MD test.

transaction costs associated with the merger clearance process and undermine the strong political consensus supporting vigorous competition law enforcement.[72]

8.2 Arguments Against the New Test

On the other side, the pro-MD test analysts pointed out that the former EU Merger Regulation, as the Commission itself acknowledged, had already the potentialities to allow the same assessments and considerations as the US Merger Guidelines. There was no provision whatsoever in the former Regulation that would prevent the Commission from focusing primarily on factors other than market shares and the finding of dominance. The solution to the divergence from the SLC was to found in the better application of the mostly ignored second prong of Art. 2(3) as previously formulated ("…as a result of which effective competition would be significantly impeded …"). A clear distinction and application of the two separate prongs of the Art. 2(3) criteria would have been sufficient to introduce the efficiency defense clause and a much greater degree of flexibility into the merger analysis.[73]

Core of these arguments is that there is no real advantage of the SLC test vis--vis the MD test since they are essentially based on the same substantive assessment criteria. Under both regimes, in fact, it must be examined whether after the merger substantial competition exists between the firms still operating in the industry. If the creation of a single-firm dominance is ruled out, the possibility of collective market dominance being created or strengthened has to be considered under the MD test. Among other factors, the precondition for establishing such oligopolistic market dominance is that there is no substantial competition between the oligopolists. In this context it is not required to prove an active coordination of conduct. It is sufficient to establish the existence of anti-competitive parallel conduct as an adaptation to the market conditions.[74] A reduction of competition can thus be caught correctly under the MD test as well, even if there is no cooperation between the companies. And the efficiency defense could be included through a mere re-interpretation of the former regulation.

A case that the supporters of the SLC test often cite to highlight the gap with

72 Patterson, D.E., and Shapiro, C.: "Transatlantic Divergence in GE/Honeywell: Causes and Lessons", Anti-trust Magazine, November 2001, p. 18.

73 Selvam, Vijay S.V.: "The EC Merger Control Impasse: is there a solution to this Predicament?", European Competition Law Review, Vol. 25, issue 1 – January 2004, p. 62.

74 Böge, Ulf, and Müller, Edith: "From the Market Dominance Test to the SLC test; Are there any reasons for a Change?" European Competition Law Review, Vol. 23 issue 10 – October 2002, p. 496.

the MD test is the Heinz/Beech-Nut[75] case. In the US market for baby food, Heinz held a market share of about 13% whereas Beech-Nut held 17% and the market leader was Gerber with 70%. The FTC considered that the proposed merger of the second largest with the third largest competitor would have resulted in only two primary competitors remaining and this would have increased the likelihood of coordination. It has been widely debated that this merger would not have been caught by the MD test as it would not have either created or strengthened a dominant position. On the contrary, Böge and Müller argue that application of the MD test to that merger would have yielded the same outcome. In fact, it could have been prohibited on account of the creation or strengthening of dominant position if there was lack of internal competition between Gerber and Heinz. The merger would have resulted in just two market players with shares of respectively 70% and 30% and, also in the light of the criteria of the dominance standard, it would have been to be blocked.[76] The same conclusions were drawn by the Bundeskartellamt (the German Cartel Office) following a study, carried out in 2001, based on a large scale analysis of the decision-making practice of various competition authorities. Whether oligopolistic market dominance, vertical integration or conglomerate mergers were under consideration, the examinations did not exhibit indications of any considerable differences in terms of the rigor, flexibility or effectiveness of the competitive assessment.

Some commentators even warned about the potentially risky scenario deriving from the new test. They argued that, applied to the EU competition policy, the SLC test might even yield a great deal of uncertainty with respect to the meaning that needs to be attached to its wording. The US anti-trust experience, in fact, demonstrates that a “Substantial Lessening of Competition” has been variously interpreted to mean, depending on the case, an increase in the market concentration, a reduction in the number of competitors, a loss of opportunity for small business or a reduction of local control over business. Throughout time, the functioning of the SLC test has developed on a strong jurisdictional background that the EU might still not have. For this reason, at least in the initial stage, the EU might be confronted with higher uncertainty.[77]

Further reasons of skepticism towards the new test refer to the practical effectiveness of the efficiency defense. In those jurisdictions that allow such a

75 246, F. 3rd 708 (D.C. Cir.2001).

76 Böge, Ulf, and Müller, Edith: “From the Market Dominance Test to the SLC test; Are there any reasons for a Change?” European Competition Law Review, Vol. 23, issue 10 – October 2002, p. 496.

77 Selvam, Vijay S.V.: “The EC Merger Control Impasse: is there a solution to this Predicament?”, European Competition Law Review, Vol. 25, issue 1 – January 2004, p. 53.

defence, efficiency considerations consist almost exclusively of mere qualitative information about the proposed re-organizations after the merger. The credible information that can be retrieved from the firms appears to be qualitative information about the projects they want to tackle rather than quantitative data on the expected marginal cost savings, which could be entered into the merger simulation calculus.

This type of information seems largely inapt to answer the question: “Are the efficiency effects of the merger greater than the anti-competitive effects?”. It is much better interpreted as evidence for the intent of firms than as information regarding the magnitude of the efficiency effects. Thus, it may simply serve to answer the question: “Is it credible that efficiencies are motivating this merger?” If the firm does present a credible justification, than it is simply less likely that anti-competitive effects are intended through the merger.[78]

To a relevant extent, these arguments find confirmation in the US precedents. In spite of having the clear asset of bringing the economic analysis on the forefront, the US standard has been criticized on different grounds. From a theoretical standpoint, most of critiques have pointed out its failure to provide competition authorities (FTC and Courts) with instruments that might enable a sufficiently correct prediction of efficiency gains and of their economic impact.

But the main shortcoming of the US Merger Guidelines is said to be its failure to answer the fundamental question of how substantial the savings must be before they offset any anti-competitive effects. In some regards, this is due to the insufficient guidance on the application of the Guidelines, how to make efficiency claims to the agencies, the extent to which they have led to decisions to approve mergers, what types of claims can be expected to work and why. Nor have the American Courts managed so far to develop any bright lines for deciding how efficiencies match with the unilateral effects models employed by the Government.

Moreover, on a practical ground there seems to be no decision so far that saved an otherwise anti-competitive merger because of its efficiency gains.Since the issuance of the Guidelines there have been three litigated decisions with extensive efficiency analysis: FTC v. Staples Inc.,[79] FTC v. Cardinal Health[80] and FTC v. H.J. Heinz Co.,[81] but in each case the efficiency defense was rejected. In the view of

78 Kai-Uwe Kühn: “Reforming European Merger Review: targeting problem areas in policy outcomes”, p.35.
79 970 F. Supp. 1066, 1082.
80 12 F. Supp. 2d 34, 61 (D.D.C. 1998).
81 246 F.3d 708, 345 (US Court of Appeals, District of Columbia Circuit, 2001).

many commentators, although the amendments to the Merger Guidelines in 1997 signaled a new approach to the treatment of efficiencies in mergers, the antitrust enforcement agencies and courts have only slowly begun to consider efficiencies in merger analysis.

All of these reasons seem to suggest that very little has been lost from the absence of an explicit efficiency defence in European merger policy. A switch to such a defence does not appear to address any of the major concerns about current merger controlḟootnoteOn the other hand one might well argue that there is no reason to have a procedure in which some information is systematically suppressed, even though it is only of qualitative nature. If there is no downside to an efficiency defence then we might as well have one (Kai-Uwe Kühn).

In the aftermath of the famous GE/Honeywell[82] case, the SLC skeptics (first of all German competition authorities[83]) rejected the opinion that the contrasting decisions of the FTC and the Commission was due to the application of a different substantive test. Even courts which examine merger control decisions made by competition authorities occasionally come to different results than the competition authority concerned. To this point, a bright example is offered by the Airtours/First Choice case. The diverging evaluation of circumstances by the Commission on one hand and the CFI on the other, led to different results in applying the same prohibition criteria but did not call into question the applicability of the MD test to oligopolistic situations as such.

Obviously, such differences are even more likely to occur between distinct competition authorities but, similarly, the opposing decisions of the Commission and the FTC in the GE/Honeywell case were not the result of a different substantive test but rather of a different understanding of the competitive effects of the merger in question.

Each regime follows its own competition-policy concepts and purposes of protection. There are several factors that might lead to a different evaluation of concentrations: the political and personal influence, the definitions of the relevant

82 Case No COMP/M2220, (2001) OJ C-46: in July 2001 the Commission's decision to block the $42 billion merger between General Electric and Honeywell after this had already passed the scrutiny of the US DOJ triggered harsh criticism on the policies of the Commission. The EU and US authorities came to completely divergent conclusions in the assessment of the claimed efficiencies and proved to apply different competition enforcement rules.

83 See Speech by Dr. Ulf Boege, President of the Bundeskartellamt (Federal Cartel Office) at the first annual conference of the International Competition Network ("ICN"), held in Naples (Italy) in September 2002. The text of the speech is available on the Internet at http://www.internationalcompetitionnetwork.org/boege.pdf

market, the willingness of an authority to apply new economic theories or the requirements of different legal systems and control instruments.

For these reasons there is still a widespread belief that in reality the gaps between the two regimes are rooted in the substantive differences of their doctrines and have their origins in a fundamentally different understanding of the scope and the goals of antitrust law. A comparative analysis of the MD test as applied by the European Commission and the US SLC standard shows that the most striking difference between the two systems concerns the competitive objectives. While the MD test has reflected a major concern of competition authorities with the protection of the merging firms' competitors (and thus the efficiency offense is often paramount), the SLC is founded on the central question of whether, as an effect of the merger, competition will be lessened in the industry concerned regardless of the creation/strengthening of a dominant position. Also the factors taken into account for the determination of a concentration have a different priority; market shares, for example, are a significant element in both analyses but, (as GE/ Honeywell shows) the E.U. authorities have been more inclined to assign a greater priority to market shares than their U.S. counterparts. The latter, in fact, measure potential competitive harm more directly by turning their attention to the output and price effects that might affect consumers and by attaching greater importance to the question whether the merger leads to a degree of concentration that will facilitate coordinated interaction. The rationale behind these two different approaches rests on the substantially different merger policy goals. While the U.S. competition policy focuses primarily on consumers, the European Union's policy has traditionally had a tendency to protect competition by shielding competitors in the pursuit of market integration as the overall goal of antitrust enforcement.

As a consequence, the real question in the underlying issue of divergence was not whether the EU had to formally replace the MD test with the SLC test but whether the Commission and the European courts should follow the example of their American counterparts and attach greater importance to economic factors in general and to consumer welfare and efficiency considerations in particular. A substantial reformation of the EU competition policy would be achieved only by shifting its policy benchmark from an inward-looking, integration-focused perspective to an outward-oriented policy of competitiveness of its firms in global markets. The new Merger Regulation, together with the Guidelines, has provided a robust analytical framework. Now it will be the Commission's practical application of the new rules to determine the achievement of the stated objective of improving the quality of the economic analysis in its decisions.

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