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Full Marks? The Draft EC Notice on the Appraisal of Horizontal Mergers

In December 2002, the EC Commission announced a series of reforms designed to improve its assessment of mergers.[1] The proposed reforms cover not only procedural issues but also substantive ones and an integral part of this reform process is the improvement of the quality of the economic analysis conducted by DG COMP. As far as horizontal mergers are concerned, substantive changes are largely covered in the Draft Notice on the appraisal of horizontal mergers that accompanied the reforms (hereafter, "the Notice").[2] This Brief assesses the Notice and its implications for the assessment of mergers.

In general the Commission is to be congratulated on its Notice. In particular, the Notice acknowledges that the assessment of mergers needs to go beyond the definition of the relevant market and the calculation of market shares and explicitly to allow for the consideration of buyer power, efficiencies created by the mergers and possible failing firm defences. More importantly, in line with the desire to improve its economic reasoning, much of the Notice focuses on the nature of the analysis needed to identify the competitive constraints that each of the merging parties currently poses for the other. This signals a welcome intention to move beyond purely structural indicators.

Nevertheless, the Notice raises some important policy issues. First, in attempting to close an alleged gap in the existing dominance test, the Notice has significantly widened the potential scope of EC merger control. Second, the approach in the Notice is firmly based on the relevant economic theory, and whilst theoretical models provide a valuable framework for the competitive assessment of mergers, the recent CFI judgments have underlined the need for any theory deployed by the Commission to be tested rigorously against the facts.[3]

Potential competition concerns from horizontal mergers

The Notice covers only horizontal mergers. The distinguishing feature of horizontal mergers is that they reduce the number of firms active on the relevant market, with a consequent increase in market concentration. The primary competition concern over these mergers is that the structural changes they create will lead to prices higher than would have prevailed but for the merger.[4]

Broadly, such adverse effects can arise in one of two ways. First, by eliminating the competitive constraint between the parties, a horizontal merger may allow the merged firm to increase its prices regardless of the response of its remaining competitors. A merger which has these characteristics is commonly said to give rise to unilateral effects. Second, by creating an environment more favourable to sustainable tacit collusion a merger could reduce the effectiveness of competition, and consequently lead to price rises. A merger which has these characteristics is commonly said to give rise to coordinated effects.[5] Unilateral effects have often been equated with the legal concept of single firm dominance, whilst coordinated effects have been equated with the concept of collective dominance.

However, the Notice has departed from this traditional categorisation. It instead adopts a three-way classification of potential effects. These are:

– Paramount market position: A merger is said to create or strengthen a paramount market position where it results in the merged firm enjoying a very large market share and a considerable market share advantage over rival firms.

1 The Commission proposals were announced on 11 December 2002. See http://europa.eu.int/comm/competition/mergers/review/

2 The commitment to improving its level of economic analysis is also evidenced by the decision to create a new post of Chief Economist.

3 See cases Tetra Laval BV v Commission (T-5/02 and T-80/02), October 2002, Airtours v Commission (T-342/99) June 2002, and Schneider Electric v Commission (T-310/01 and T-77/02), October 2002.

4 The reference to price also covers reduced quality and diminished technological innovation. See footnote 6 of the Notice.

5 This is also known as conscious parallelism.

– Non-collusive oligopoly: A merger may diminish the degree of competition in an oligopolistic market by eliminating important competitive constraints between the merging parties.
– Co-ordinating oligopoly: A merger may reduce the effectiveness of competition by creating or reinforcing a situation where firms are able to compete less vigorously with one another by tacitly coordinating their behaviour.

The first and second categories described in the Notice are both forms of unilateral effect, whilst the third closely corresponds to the concept of coordinated effects. This raises the question as to why the Commission has decided to adopt a new categorisation rather than relying on the traditional two tier distinction.

The most likely explanation is that the Commission has taken the opportunity to close explicitly the gap in merger control to which the current substantive test of dominance is alleged to give rise.[6] However, the proposed amendment to Article 2 of the Merger Regulation, which defines dominance with respect to merger control as any merger that permits prices to be increased above levels that would have prevailed but for the merger, effectively removes any such concerns without the need to create this third analytical category.

Although the factors that determine whether a merger gives rise to a paramount market position have close correspondence with those associated with the traditional analysis of single firm dominance, there ought to be little substantive difference between the economic assessment of firms in a paramount position and those forming part of a non-collusive oligopoly. Both are essentially concerned with assessing the possibility that the merger will give rise to unilateral effects. Indeed, the method of analysis of non-collusive oligopoly outlined in the Notice applies equally to the assessment that ought to be undertaken in respect of firms with paramount market positions.[7] In short, the distinction that the Notice draws between paramount market positions and non-collusive oligopolistic markets is, from an economic perspective, an artificial one.

Widening the scope for intervention: unilateral effects

The categorisation adopted in the Notice gives rise to a potentially important policy consequence. Since a paramount market position accords closely with the traditional concept of single firm dominance, the introduction of non-collusive oligopolies implicitly widens the scope of mergers that the Commission will challenge. If this second category has any role to play at all, it must be likely to result in the Commission challenging mergers at levels of market share well below the traditional thresholds for a finding of single firm dominance. By effectively removing the safe harbour previously implicit in the definition of single firm dominance, the Notice opens the way for intervention in a significantly larger number of mergers than is currently the case.[8] Furthermore, since by definition all horizontal mergers remove some competitive constraint, there is a danger that the explicit extension of the scope of the regime to non-collusive oligopolies will substantially increase the proportion of mergers that are exposed to the possibility of detailed investigation.

Widening the scope for intervention: coordinated effects

The Notice provides a generally sound and useful framework for assessing potential concerns of post-merger coordination drawing both on the relevant economic principles and reflecting the lessons handed down from the CFI in cases such as Airtours/First Choice and Gencor/Lonrho.[9] The Notice outlines four necessary steps that need to be established before a market is subject to co-ordinated behaviour. These are the need for a co-ordinating mechanism, the need for transparency to monitor adherence to it, the

6 See the text of the speech of John Vickers, "How to reform the EC merger test?", 8 November 2002, for a summary of the perceived gap in the dominance test.

7 In both cases the Notice states that the merger assessment needs to consider the competitive constraints that the merging parties exert on each other pre-merger and to examine whether the elimination of these constraints will lead the merged firm to raise prices. See paragraphs 23 and 25.

8 This would include a number of mergers that the Commission has previously tried to shoe-horn into the collective dominance box.

9 See Gencor v Commission (T-102/96), March 1999, and Airtours v Commission (T-342/99), June 2002.

existence of a credible enforcement mechanism, and the need for the oligopolists to be sufficiently insulated from potentially destabilising external forces. Whilst it is useful, this framework cannot be applied mechanistically. Crucially, the assessment of coordinated effects needs to identify how and why the structural change implied by a merger can be expected to alter the nature of competition between firms.

However, the Notice appears to go beyond this when it states that "…[i]t is unlikely that the Commission would approve a merger if co-ordination were already taking place prior to the transaction unless it determines that the merger is likely to disrupt such co-ordination."[10] Thus, rather than assessing only how the change implied by the merger will affect competition, the Notice appears to envisage the Commission conducting an assessment of the extent of pre-merger competition and, where it concludes that a market is already subject to coordination, placing on the merging parties the burden of showing that the merger will disrupt that co-ordination.

10 Paragraph 41.

This approach is fraught with difficulties since distinguishing between a market subject to effective competition and one subject to tacit coordination is unlikely to be simple in many cases.[11] In practice, the existence of some coordination might involve no more than evidence that firms take account of likely competitor reactions before acting on profitable opportunities. The number of industries in which firms can prove that no such evidence exists may be much smaller than the authors of the Notice assume. This raises not only the unwelcome prospect of a significant increase in uncertainty, but also a largely unjustified shift in the burden of proof, with a consequent increase in intervention on the grounds of post-merger co-ordination.

11 It is for this reason that some commentators have argued that Article 82 should not cover collective dominance.

Assessing mergers in practice: theory and evidence

As well as potentially widening the scope of mergers in which the Commission will intervene, the Notice also raises some important policy issues relating to how the Commission will conduct its merger assessment in practice. A key requirement of substantive merger guidelines is that they provide guidance as to how mergers will be assessed. Of course, any set of guidelines can only set out the framework within which the merger analysis takes place, and cannot pre-specify precisely how each case will be determined. However, the framework proposed in the Notice is based on a highly theoretical characterisation of competition. This can be seen in its categorisation of competition and in its treatment of market share thresholds.

Dead Frenchmen: Cournot and Bertrand

The Notice distinguishes mergers according to whether competition takes place primarily in price or in output.[12] Such a categorisation is based on two standard textbook models of competition, the Cournot model and the Bertrand model. The Cournot model of competition assumes that firms compete by setting output to maximise profits assuming that the output of other firms is fixed. In contrast, the Bertrand model assumes that firms set price in order to maximise profits taking as given the prices of other firms.

12 Paragraph 17.

The standard Cournot model predicts that all horizontal mergers will lead to price increases. If this model were taken literally any merger that the Commission deems to be characterised by competition in output could be prohibited. Similarly extreme results arise from an overly literal interpretation of some variants of the Bertrand model. However these models provide only a schematic representation of a particular mode of competition and it would be a mistake to assume that firms in real world markets can be neatly classified as competing starkly in either output or price, or that real merger outcomes match these models' predictions.[13] An increase in price and a restriction of output are intrinsically linked, and even in markets where output or capacity decisions are the primary focus, competitive outcomes are generally influenced by the exercise of firms' discretion on pricing. Furthermore, there will generally be other equally important aspects to competition

13 Indeed, the Nobel Prize winner George Stigler raised an important criticism of these models for policy purposes. Both models fail in the fundamental sense that they assume the nature of competition rather than derive it.

to be considered, such as product quality and innovation. For these reasons translating the predictions of either of these theoretical models directly into predictions of post-merger behaviour is likely to lead to erroneous results in many instances.

Of course, this does not necessarily mean that the Commission would apply these theoretical models in a naïve mechanistic manner. However, the fact that the Notice's analytical framework is based on two highly stylised models of competition, allied to the added uncertainty and discretion created by the new category of non-collusive oligopoly, fuels concerns that the Commission will remain susceptible to its historical weakness of relying primarily on theories of competitive harm rather than evidence.

Market share thresholds

The Notice introduces market share thresholds that provide some indication as to which mergers are likely to require a detailed assessment.[14] In setting out the thresholds the Notice draws a distinction between homogeneous and differentiated product markets. On one level this distinction is justified because in markets in which products are differentiated market shares can provide a poor indicator of the likely competitive effects of a merger. Market shares alone fail to reflect the fact that some products are likely to be "closer" competitors to the products of the merging parties than others.

However, there is a danger that the Notice draws too stark a distinction between the two cases. Some differentiation almost always exists between firms, making it difficult neatly to classify a market as either homogeneous or differentiated.[15] Even in homogeneous markets there are numerous reasons why market shares might provide a poor indicator of the impact of the merger on competition. For example, competitors that have a comparatively small market share pre-merger might provide an important competitive constraint if they would be in a position significantly to expand their sales post-merger.

Notwithstanding the additional complexities of market definition where products are differentiated, the 25% de minimis market share guideline suggested at para 29 of the Notice acknowledges that market shares can still provide a reasonable initial basis for assessing whether a merger raises serious competition concerns. In the presence of highly differentiated products, if, even within a very narrowly defined relevant market, the combined share of the two merging parties is relatively low, it is extremely unlikely that the merger will give rise to serious competition concerns.

14 See paragraphs 25 and 29 of the Notice

15 For example, even in those cases in which firms produce products that are perfectly homogeneous in a physical sense, consumers may still have distinct preferences for one producer over another due, for example, to the proximity of their production sites, outlets or service centres. In such cases, a simple market share analysis would be as inadequate in predicting the effects of the merger as it would in a market with more obviously differentiated products.

Conclusions

The Notice provides a welcome contribution to developing an economic framework for assessing horizontal mergers, and illustrates the extent to which economics has been explicitly adopted in this area of EC competition policy. However, the successful application of a merger control regime ultimately depends on how any such guidelines are applied in practice. Decisions to intervene in the merger process should be based on a clear articulation of the theory of anticompetitive harm together with a robust body of evidence that supports the application of that theory to that particular merger.

This implies that merger control rests critically on the interpretation of available evidence which necessarily varies from case to case in its quality, quantity and form. Ultimately, whatever the precise framework set out in the final Notice, it will be the Commission's application of the guidelines, influenced in turn by its proposed procedural reforms, that will determine whether the Notice assists in achieving the stated goal of improving the quality of the economic content of the Commission's decisions.

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