

The Global Competition Law Centre Working Papers Series

GCLC Working Paper 02/05

The Commission's New Horizontal Merger Guidelines

—

An Economic Commentary

Derek Ridyard
RBB Economics
derek.ridyard@rbbecon.com

The Commission's New Horizontal Merger Guidelines

–

An Economic Commentary

Derek Ridyard^(*)

In January 2004, the EC Commission published its revised text for the EC Merger Regulation, and an associated set of enforcement guidelines on the analysis of horizontal mergers (“the Notice”).¹ The Notice followed a consultation based on an earlier draft published by the Commission in December 2002.² It forms part of a wider set of reforms, which cover both procedural and substantive issues, aimed at improving the quality of the economic analysis conducted by DG COMP in all areas of EC competition law enforcement.

The Notice makes a major contribution in confirming the recent advances that have taken place in the application of modern economic analysis to European merger control. 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 contentious policy issues. This paper highlights two of the main areas of controversy, and comments on the way in which the Commission has adjusted its position between the Draft and Final versions of the Notice.

First, the Notice indicates that we could be about to encounter a markedly more interventionist policy towards mergers. In attempting to close an alleged gap in the old dominance test, the Notice has significantly widened the potential scope of EC merger control below the traditional threshold associated with findings of single firm dominance. In its approach to collective dominance, the final version of the Notice has stepped back from the suggestion in the Draft Notice that would have implied a reversal of the burden of proof for a substantial class of mergers taking place in oligopolistic market (i.e. most) settings, but has still left the Commission's options wide open.

^(*) RBB Economics. derek.ridyard@rbbecon.com. This paper draws heavily on an earlier article discussing the Draft Notice that was co-written by Simon Bishop and Derek Ridyard, and published as “Prometheus Unbound – Increasing the scope for intervention in EC merger control”, ECLR Issue 8, 2003.

¹ “Commission Notice – Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings”, DG COMP, 28 January 2004.

² The draft Notice was part of the Commission proposals announced on 11 December 2002. See <http://europa.eu.int/comm/competition/mergers/review/>

Second, the Notice also leaves unresolved important issues as to how mergers will be assessed in practice. Although the Notice draws upon the relevant economic theory in describing the conceptual framework the Commission will use to assess the competitive impact of mergers, questions remain as to the approach that will be taken to the empirical analysis that must accompany any theory of competitive harm. It is critically important to recognise that whilst theoretical models provide a valuable framework for the competitive assessment of mergers, any theory of competitive harm must be tested rigorously against the facts. That is indeed the lesson provided by the recent judgments of the CFI in the mergers area.³ Enforcement guidelines cannot by their nature be expected to provide a workable blueprint for the way in which each and every merger will be assessed in practice, but the Notice retains such broad discretion for the Commission that legitimate questions remain as to whether the lessons provided by the CFI will be absorbed into the Commission's practice.

The remainder of this paper considers these two areas in turn.

1. 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*, though the Notice has chosen to coin a new term, *non-coordinated effects* to capture this class of case.
- 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

1.1 Widening the scope for intervention: non-coordinated effects

Most attention has rightly been focused on non-coordinated effects. In the Draft Notice, the Commission chose to divide this area of concern artificially into two separate headings, one (the creation of a position of "paramount market importance") apparently corresponding to the traditional concept of single firm dominance, whilst the other ("non-collusive oligopoly") defined a set of unilateral effects concerns that

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.

⁵ This is also known as *conscious parallelism*.

could apply at smaller post-merger market shares, below the dominance threshold. The existence of this latter category in the Draft Notice clearly indicated the Commission's intention to close explicitly the gap in merger control to which the old concept of dominance was alleged to give rise.⁶ Since this sub-category is now subsumed within the wording of the non-coordinated effects concern, the final version of the Notice still closes this gap. Most economists would agree that the formulation adopted in the Notice is conceptually purer than the 3-tier classification that was found in the Draft Notice, even if means that the extension in the Commission's merger powers is less explicit in the Final Notice.

The categorisation adopted in the Notice gives rise to a potentially important policy consequence. If the new category of non-coordinated effects has any role to play beyond the dominance test at all, it must be likely to result in the Commission challenging mergers at levels of market share 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.⁷ 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-coordinated oligopolies will substantially increase the proportion of mergers that are exposed to the possibility of detailed investigation.

It has been stated that the change is designed to fill a perceived gap in European merger control. If so, the key question is how many mergers escape scrutiny under the old dominance test but will be blocked under the non-coordinated effects provisions of the new test?

In principle, it is hard to disagree with the possibility that mergers could give rise to adverse unilateral effects on competition even if they do not create a post-merger firm that enjoys a clear position of dominance. The most likely scenario is one in which the merging brands in a differentiated product market are particularly close competitors to one another. To capture such mergers under the old dominance test, it may have been necessary for the Commission to define an artificially narrow market, whereas a unilateral effects analysis is able to remain more open-minded on this question, and focus instead directly on the perceived impact.

In practice, however, it is very hard to identify a substantial set of mergers that falls into the "gap" category. Despite the time and effort that the advocates of the SLC ("substantial lessening of competition") test have devoted to this debate, very few concrete cases illustrating the gap that is left by the traditional EC dominance test have been identified. There are also serious question marks as to whether the suggested candidate cases would actually fall into the alleged gap. For example, consider the two oft-cited cases, *Lloyds TSB/Abbey National* and *Baby Foods*.

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

- Advocates of the gap like to cite the prohibited LloydsTSB/Abbey National merger in the UK as one that involved unilateral effects at levels of market share well below normal dominance thresholds (the post-merger firm's share would have been around 27%, with a further 50% of the personal current accounts market being supplied by the other three established rivals). But from the language of the UK Competition Commission's (CC) report on that merger, it is apparent that the CC saw the problem primarily as a coordinated effects concern, which (had the case fallen under the ECMR) could most naturally have been pursued under the collective dominance heading. For example, the CC report's conclusions are framed within a structure that explicitly assesses "the market's vulnerability to tacit collusion." After outlining all the classic elements of a collusion checklist (homogeneity, stability, transparency, etc) the CC concludes at para 2.64 that "the PCA market is vulnerable to tacit collusion in pricing".⁸
- The baby foods merger in the US was a 3 to 2 merger in which the firms ranked 2 and 3 combined to form a post-merger entity that would not have enjoyed a paramount market position.⁹ It is open to question whether the harmful effects of that merger could have been analysed in the context of a coordinated effects analysis. The immediate competition concern was the elimination of the pre-merger rivalry between the merging brands as they fought to be the "other" brand stocked by retailers alongside Gerber, the brand leader (which sounds like a unilateral effects concern), but the ultimate state of post-merger competition in that market would have rested on the nature of the rivalry between the post-merger firm and Gerber (which sounds more like a coordinated effects issue).

In short, the proponents of the "gap" criticism of ECMR have so far not conveyed a convincing account of the materiality of the supposedly missing merger cases. The gap seems more like a chink than a chasm. Indeed, while the proponents of the SLC test have devoted great attention to the potential *benefits* of the SLC test in terms of its ability to block mergers with anti-competitive effects that would have fallen into the gap left by the dominance test. But there has up to now been little if any discussion of the *costs* associated with plugging the gap.

These costs are likely to be significant. The adoption of non-coordinated effects concerns gives the Commission significantly greater discretionary power and in consequence leads to increased uncertainty for merging firms who will be unclear whether their transactions *might* fall into the new category. Since all horizontal mergers by definition remove a demand-side constraint of some sort, there is a real danger that with sufficient imagination, it is always possible to identify some relaxation of competitive constraints on the demand-side. As we discuss further below in relation to the HHI thresholds in the Notice, the Commission has defined its

⁸ The CC was under no obligation to fit its analysis artificially into one legal box or another, since its legal remit under the Fair Trading Act was to assess the effects on the public interest, which in practice has been interpreted as a competition criterion.

⁹ For a discussion of this case see Thomas B Leary, "An Inside Look at the *Heinz Case*" (available at www.ftc.gov/speeches/leary/babyfood.htm)

“safe harbours” very narrowly, such as to maximise its room for enforcement discretion.

Although the traditional dominance test can be artificial and unwieldy in some instances, it did signal a higher burden of proof on the regulator that affirms the need to identify a serious breakdown in competition before a decision to prohibit a merger can be justified. The CFI Judgments on the *Airtours/First Choice*, *Schneider/Legrand* and *TetraLaval/Sidel* cases illustrated how the burden of proof inherent in the dominance test can be used to call the regulator to account if it has failed to build a robust case against the merger. The removal of the dominance threshold could easily pave the way for a more interventionist (and less accountable) EC merger regime.

In summary, therefore, the inclusion of the non-coordinated effects category in the Notice is capable of introducing a new and potentially far-reaching increase in the degree of intervention in EC merger control. No convincing case has been made for such increased intervention, and at the very least this aspect of the Notice will generate substantial costs in the form of greater uncertainty.

1.2 Widening the Commission’s discretion for intervention: coordinated effects

The Notice provides a generally sound and useful framework for the conditions in which coordinated behaviour is likely in a market, 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*.¹⁰ The Notice outlines four necessary steps that need to be established before a market is subject to a likelihood of co-ordinated behaviour. These are the need for a co-ordinating mechanism, the need for transparency to monitor adherence to it, the existence of a credible enforcement mechanism, and the need for the oligopolists to be sufficiently insulated from potentially destabilising external forces.

However, an assessment of the factors that make coordination feasible does not necessarily answer the question that is at the heart of a merger assessment – when will the change in market structure caused by a merger increase the risk of coordination such as to make the market *less competitive* than it was pre-merger?

The Draft Notice was criticised for confusing the question of whether coordination was feasible, with the assessment of how or when a merger would actually increase coordination. In particular, the Draft Notice stated 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.” This seemed to envisage the Commission conducting an assessment of the extent of pre-merger competition, and, where it concluded that a market was already subject to coordination, then placing on the merging parties the burden of showing that the merger will positively disrupt that co-ordination.¹¹

¹⁰ See *Gencor v Commission* (T-102/96), March 1999, and *Airtours v Commission* (T-342/99), June 2002.

¹¹ The objective of the wording of para 41 of the Draft Notice was to allow the Merger Regulation to prevent mergers that have the effect of entrenching coordinated behaviour that would, in the absence of the merger, have broken down. That is in principle a legitimate objective if the Commission can

This wording has been eliminated from the final version of the Notice. Instead, the Notice now states that “evidence of past coordination is important”, but does not explain why this is so, or how such evidence will be used by the Commission in its assessment.¹² Thus, whilst the explicit threat of a shift in the burden of proof has been removed, it remains unclear what now lies in its place. This is far from a hypothetical issue. In practice most serious analysis of coordinated effects concerns will take place in industries in which the fear is that a merger will increase coordination in a market that already shows some susceptibility to tacit collusion. In industries where the market characteristics and dynamics rule out the risk of pre-merger coordination, it will be comparatively rare for increases in concentration to affect this conclusion.¹³

The underlying issue here is the extent to which horizontal merger analysis needs to take a view on the state of pre-merger competition. One aspect that makes merger analysis more tractable (and feasible within the often tight timescales) is that it is normally regarded as an assessment of *what changes* as a result of the merger, and so the analysis can stay agnostic on the state of pre-merger competition. In its extreme form, this logic admits to the possibility of a successful “Bob Dylan defence” (“when you got nothing you got nothing to lose”) whereby in theory any merger amongst firms who are already colluding perfectly to achieve monopoly outcomes ought to be cleared, since that merger does not lessen competition or create or strengthen dominance.

Even if the idea of a successful Bob Dylan defence is in practice somewhat theoretical, there is an important substantive point here that pervades the approach that should be taken to merger analysis. There are numerous cases in which the Commission’s merger analysis has betrayed an apparent desire to use merger control to regulate pre-existing positions of market strength, and the analysis in such cases has seldom if ever been satisfactory.¹⁴ In the final version of the Notice, the Commission has missed out on a chance to clarify that its focus will lie solely on what changes as a result of the transaction. The danger is that this positively invites the Commission to blur the distinction between the state of pre-merger competition in an industry and the assessment of how the merger affects that competition. This could seriously prejudice analytical clarity and predictability.

2 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, guidelines can only set out the framework within which the

demonstrate this likely effect, but there is no justification for a reversal of the burden of proof in this class of cases.

¹² In its discussion of HHI safe harbours, however, para 20 of the Notice lists “indications of past or ongoing coordination” as a factor that could justify the Commission in investigating a merger even if it falls below the HHI thresholds.

¹³ There is an analogy here with the single firm dominance distinction between the creation and the strengthening of dominance.

¹⁴ The TetraLaval/Sidel case is the most recent illustration of this, though prior merger cases involving Coca-Cola, Boeing, Air Liquide/BOC, GE, Telia/Telenor and others could also be cited in support.

merger analysis takes place, and cannot pre-specify precisely how each case will be determined. However, some aspects of the framework proposed in the Notice suggest a reliance on a highly theoretical characterisation of competition.

2.1 Market share thresholds

The Notice introduces market share thresholds that provide some indication as to which mergers are likely to require a detailed assessment. Throughout, it uses the HHI measure of market concentration, as employed by the US horizontal merger guidelines. The Notice sets out a single set of thresholds that are designed to capture both non-coordinated and coordinated effects concerns.

In principle, thresholds could play a useful role in constraining the Commission's enforcement discretion and placing a limit on the problem of increased uncertainty. At paragraph 19, the Notice states that markets with HHI's below 1000 "normally do not require extensive analysis". This, however is exceptionally timid guidance, since an HHI of 1000 implies a market with ten equal-sized post-merger firms. Only the most paranoid observer would believe that unilateral or coordinated effects concerns could arise at such low levels of concentration.

Paragraph 20 of the Notice then sets out two tentative safe harbours, as follows:

- Mergers where the post-merger share is between 1000 and 2000, and where the "delta" (i.e. the change in HHI arising from the merger) is less than 250;¹⁵ and
- Mergers where the post-merger HHI is above 2000 but where the delta is less than 150.

However, even for mergers that meet these safety criteria the Notice then goes on to list no fewer than six conditions that might create an exception to the safe harbour. Some of these exceptions relate to non-coordinated effects (e.g. if one of the firms had a pre-merger share in excess of 50%), but most are designed to deal with coordinated effects concerns (e.g. if one of the parties is a "maverick" player, if there is existing evidence of coordination, etc).

HHIs have not been routinely used in EC merger analysis, and it is instructive to consider the practical implications of these thresholds. Any merger that reduces the number of players from 6 to 5 will result in an HHI in excess of 2000, and the vast majority of significant transactions in such industries will also add 150 HHI points.¹⁶ Thus, the Notice is saying that "6 to 5" mergers cannot assume that they will be free of regulatory risk.¹⁷ If carried through to Commission enforcement practice, the fact that 6 to 5 mergers are in the "at risk" category would represent a radical increase in

¹⁵ The delta can be quickly calculated as 2 times the product of the shares of the merging firms. Thus, in a merger between firms with 10% and 20%, the HHI delta would be 400. The delta is independent of the distribution of the shares of the rest of the firms supplying the market.

¹⁶ For example, in a merger involving two firms in an industry that previously had 6 equal-sized firms, the post-merger HHI would be over 2,200, and the HHI delta would be 556.

¹⁷ It must be acknowledged that this is a major advance on the Draft Notice which asserted that such mergers would be likely to be subject to a phase II inquiry if the industry is homogeneous.

the degree of intervention in EC mergers policy. But if there is no intention to clamp down on such mergers, one wonders why the Commission has adopted this wording.¹⁸

The Commission might seek to justify its position on the grounds that the 2000 HHI is higher than the US guidelines' "highly concentrated" HHI threshold (of 1800). Indeed, close inspection of the US guidelines reveals a statement that such mergers are likely to attract antitrust scrutiny. However, the actual enforcement practice of the US agencies does not match this statement of intent. A recent review of US merger enforcement trends, for example, reveals that the median HHI level for cases that were closed (i.e. not challenged) by the US agencies had stayed at around 2,500 since the mid 1980s. For cases that were subject to challenge, the median HHI had been 5,000 or more since 1991, and the lowest HHI in challenged cases had been well in excess of 2,000 ever since the mid-1980s.¹⁹ It is clear from these figures that the HHI presumptions in the US guidelines are not determinative in US enforcement, so if the EC Notice is seeking to rely on the US to give authority for their stance, that reliance is misplaced. By striking such a timid position on market concentration thresholds, the Notice has missed out on a rare chance to lead rather than follow the US agencies in providing guidance.

Of course, any discussion of HHIs as a quick look guide to regulatory risk presupposes that it is clear how the relevant market should be defined. But in differentiated products markets, where the discretion for defining narrow markets is at its greatest, it is arguable that even the limited (and qualified) safe harbours defined by the Notice could be withdrawn by a decision to define the market narrowly.

In summary, the HHI thresholds contained in the Notice do nothing to dispel the concerns of those who fear a lurch towards greater intervention. The language around the HHI thresholds has been toned down between the Draft and Final versions of the Notice, but the categories of merger omitted from the suggested HHI safe harbour thresholds remain worryingly broad. Ultimately, it may be that the use of a single structural index to encompass information about such a wide potential range of competition concerns is simply asking this measure to play a role that it is incapable of fulfilling.

2.2 The Influence of the Dead Frenchmen: Cournot and Bertrand

The Draft Notice distinguished mergers according to whether the competition takes place primarily in price or in output. That categorisation was based on two standard textbook models of competition, the Cournot model and the Bertrand model. Both models provide a convenient way to analyse the indeterminacy of oligopolistic

¹⁸ A number of other competition authorities have also followed this apparently slavish adherence to the US HHI thresholds. They are to be found in the Irish Competition Authority merger guidelines, and are referred to in the OFT's guide to merger assessment. Interestingly, however, the UK Competition Commission (whose role is essentially to carry out in-depth merger inquiries after a preliminary reference has been made by the OFT) has studiously avoided the temptation to use the HHIs as a guide to the outcome of its investigations.

¹⁹ See Scheffman, Coate and Silva, "20 Years of Merger Guidelines Enforcement at the FTC: An Economic Perspective". A case that is challenged by the US agencies is one in which a decision is taken to litigate, so this test is tougher than the issuing of an HSR second request (arguably the analogy to a phase II inquiry under the Merger Regulation).

interdependence. 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.

The standard Cournot model predicts that all horizontal mergers will lead to price increases. In fact it produces a smooth relationship between the HHI and the price-cost ratio in an industry. If this model were taken literally any significant horizontal merger in an industry that the Commission deems to be characterised by competition in output could be prohibited. Similarly extreme results arise from a literal application of some variants of the Bertrand model.

However, although these models are convenient, they 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.²⁰ Furthermore, there will generally be other equally important aspects to competition to be considered, such as product quality, innovation and the capacity of the post-merger firm's rivals to respond to mergers by re-positioning their products. For these reasons translating the predictions of either of these theoretical models directly into predictions of post-merger behaviour is likely lead to erroneous results.

It is encouraging therefore that the final version of the Notice has stepped back from this very simplistic characterisation of competition and has eliminated explicit references to price or quantity competition. This change probably reduces the danger that the Commission would apply these theoretical models in a naïve mechanistic manner. However, the suspicion remains that the Commission will remain susceptible to its historical weakness of relying primarily on theories of competitive harm rather than evidence.

Between the publication of the Draft and Final versions of the Notice, the Commission has also published two research papers carried out for the purposes of informing the economic approach that has been adopted in the Notice.²¹ These studies, which have been carried out by some of Europe's most distinguished industrial economists, reflect much of the approach that was contained in the Draft Notice. In the report on unilateral effects, for example, the following general statement is made:

“Whether firms compete in prices or quantities (or capacities), a merger between competitors increases the remaining firms' market power (both for the merged firm and its competitors), thereby leading (absent any efficiency gain) to higher prices and lower output”.

²⁰ 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. More generally, the notion that a smooth causal relationship exists between the structure of an industry and the price level has been discredited in the economic literature since at least the 1970s.

²¹ “The Economics of Tacit Collusion”, and “The Economics of Unilateral Effects (Preliminary version)”, by Marc Ivaldi, Bruno Jullian, Patrick Rey, Paul Seabright and Jean Tirole (IDEI, Toulouse), March 2003.

The report then provides a clear exposition of the prevailing oligopoly models from which this conclusion arises, but it does not adequately justify the use of those models as a realistic or reliable basis for assessing the actual effects of mergers. There is an important disconnect here between the models described and the previous enforcement policy of the Commission (and indeed other merger control authorities).

To illustrate the phenomenon of mergers that can give rise to a “strong impact on prices” through unilateral effects despite not creating a single dominant firm, the authors construct a Cournot model in which a 5 to 4 merger between equal-sized firms in a homogeneous goods market results in a post-merger price rise of 5.2%. The report specifies the assumptions that are required to achieve this outcome (including the result – which is itself driven by the assumptions underlying this version of the Cournot model - that the aggregation of the two firms with 20% share each must produce a post-merger firm with a share of just 25%). But it does not address whether these assumptions are too restrictive to make the model’s illustration a useful guide to a change in policy enforcement.

A similar weakness underlies the recent trend towards the use of merger simulation models to predict the effects of mergers in differentiated product industries.²² Although the measurement techniques used in these models can be extremely sophisticated, they rely for their theoretical motivation on extremely simple oligopoly models, normally assuming Bertrand behaviour. These models come hard-wired with an “all mergers are bad” assumption, and make no allowance made for the kind of strategic or dynamic reactions that characterise real life markets.

One side-effect of this focus on theoretical models is the emphasis that it places on the need to show efficiency benefits from a merger. In essence, the logic here is that if all mergers increase market power as measured by the price-cost margin, then the only way to justify a merger as having a benign effect on prices and consumers is if the merger causes a fall in the merging firms’ marginal costs that is greater than the post-merger increase in price-cost margins. A number of merging firms have been sucked in to this desire to show an efficiency defence, but in practice proving merger-specific changes in marginal costs is notoriously difficult. Even if successful, it carries with it the danger that superior post-merger efficiency will be added to the list of negative factors when the Commission comes to assess the risk of dominance.

This debate on the utility of theoretical models as a guide to merger effects cries out for some kind of sanity check based on the observed behaviour of post-merger firms and the role that regulators can play in predicting and preventing increases in market power through merger. One such sanity check is provided by a piece of work commissioned by the OFT in 1999 which balanced an assessment of the theoretical models against a series of empirical case studies that took a retrospective look at several completed mergers in highly concentrated markets in which mergers had been vetted and approved by the OFT.²³ The theoretical review contained in that work is echoed in the more recent studies carried out for the Commission, but in many respects the most striking feature of the OFT research was the lessons that could be

²² For a further discussion, see “The Emperor’s new clothes? The role of simulation models in merger analysis”, RBB Brief 12, January 2004, available at www.rbbecon.com.

²³ “Merger appraisal in oligopolistic markets”, OFT Research Paper 19, November 1999.

drawn from the case studies. In most cases, post-merger events were shaped as much or more by the strategic behaviour of rival firms and/or powerful buyers in the affected markets, or indeed by dynamic changes in the industry that had provided part of the rationale for the merger itself. This was summarised in the OFT research as follows:

“the case studies provide a reminder that mergers do not take place in a vacuum. The dynamic responses that take place after mergers underline the fact that post-merger predictions based purely on clues from demand-side relationships tell only part of the story. Thus, although models of unilateral effects provide useful insights into possible danger areas, they must be supplemented by an attempt to assess how the market may respond to structural changes caused by mergers.”

The EC Commission would do well to consider this important theme. A similar interest in empirical analysis can be found in many of the recent policy pronouncements from US merger enforcement officials. Their thinking on mergers policy shows a marked emphasis on the need for sound empirical analysis, and a willingness to become involved in detailed data and measurement issues.²⁴

When we compare the final version of the Notice with the Draft version, some comfort can be taken from the fact that the Commission has appeared to reduce the reliance it intends to place on simple theoretical models. But the proof of this conversion will ultimately be tested only by the practice of actual enforcement decisions.

3 Conclusions

The Notice provides a welcome contribution to clarifying the economic framework for assessing the competitive effects of 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. This paper has highlighted a number of areas in which the Notice appears to have set off on a path of much greater intervention than has been the case in European merger control to date. It has also identified areas in which the Commission has placed insufficient emphasis on the need for sound empirical analysis.

The ultimate success of the new EC mergers regime will depend on the Commission's ability to marry sound theory and measurement. Decisions to intervene in the merger process should be based on a clear articulation of the theory of anti-competitive 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 practical application of the resulting guidelines, influenced in turn by its proposed procedural reforms, that will determine

²⁴ See, for example, the recent set of remarks issued by US FTC Chairman Timothy Muris, “Improving the Economic Foundations of Competition Policy”, George Mason Law Review's Winter Antitrust Symposium, January 15 2003.

whether the Notice assists in achieving the stated goal of improving the quality of the economic content of the Commission's decisions.