

# The New Merger Regulation and Horizontal Merger Guidelines: will they make a difference?

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**This article focuses on a number of issues that arise from the new Merger Regulation and the accompanying Horizontal Merger Guidelines. We conclude that: the new test is an improvement on the old one, but not a substantial one; the threshold for intervention has been lowered if the analysis in the Guidelines is to be taken seriously; the discussion of the efficiency defence is useful; and the discussion of the necessary conditions for coordinated effects is an improvement on the Commission's traditional 'checklist' approach.**

The article is not intended to be a comprehensive review of the new Merger Regulation and the Horizontal Merger Guidelines.<sup>1</sup> The four main issues that we focus on are:

1. Is the new test a substantive change from the old dominance test?
2. Has the threshold for intervention been lowered?
3. Efficiency defence.
4. The discussion of coordinated effects in the Guidelines.

## Is the new test a substantive change from the old dominance test?

The original debate over possibly moving away from the dominance standard for European merger control was often characterised, rather crudely, as being a question of whether to use a structural test (dominance) or a competition effects test (substantial lessening of competition (SLC)). The test that has been adopted is whether the merger leads to a "significant impediment to effective competition" (SIEC). This seems to be somewhere between the original two alternatives. On the one hand, it looks like an effects test, whilst on the other it is already in the Merger Regulation as a corollary to the dominance test, which suggests there may be a structural element to it.

The Commission has often treated the dominance test in mergers as an essentially structural test. Structural tests in merger control are based on the structure-conduct-performance (SCP) paradigm of the 1960s. This model holds that the more concentrated the market structure, the less competitively firms act, which in turn leads to both higher prices and higher profits than under more competitive conditions. The SCP model suggests that competition law should focus on the structure of markets and implies that the market

power of a firm can be approximated by its market share.

The essential problem with a purely structural test is that it fails to ask the question that should really be central to merger control: will this merger harm consumer welfare? In the past, European merger control has far too often forgotten that this is the relevant question and instead has focused solely on structural questions or on harm to competitors.

The SLC test is not a structural test. Instead it focuses on whether the merger actually lessens competition significantly. Whilst this is not a direct test of the relevant question ("Does the merger harm consumers?"), it is much closer to it than a structural test. If the intensity of competition is lessened in a market, then prices rise or quality falls, harming consumers in both cases.

The emphasis on competition in the SLC test seems to imply that there is a substantial difference between the dominance standard and the SLC standard. However, whilst this may be true at the theoretical level, we do not think that at the practical level the current implementation of the dominance standard by the European Commission and the SLC standard by the US authorities are as significantly different as some commentators have suggested. Firstly, the US implementation of the SLC standard has frequently been largely structural and post-merger market shares remain the single most important criterion looked at in US merger analysis. Second, the Commission is increasingly treating dominance as equivalent to "substantial market power".<sup>2</sup> A significant lessening of competition post-merger could only occur if the merger leads to substantial market power. So whilst the SLC standard is different to the dominance standard in theory, in practice it is not significantly different to

the interpretation of dominance that the Commission has been moving towards.

On the basis that the SIEC test is some sort of hybrid of the dominance and SLC standards, the implication of this discussion is that the move towards an SIEC standard will not in itself have a substantial impact on European merger control.

There is a possible exception to this: the 'Enforcement Gap'. This refers to a merger that leads to the parties unilaterally having market power post-merger but not being the largest firm in the market. This situation is allegedly a gap under the dominance standard because it cannot be captured by either single firm dominance (the parties are not the largest firm post-merger) or by joint dominance (by assumption, the issue is unilateral market power). Whilst as a matter of theory this may be true, in our view the enforcement gap has not in practice stopped the Commission from intervening in any merger where it thought a competition problem arose.

The conclusion of this section is that we do expect EU merger control to focus more directly on the competitive harm that a proposed merger might cause, rather than focusing almost entirely on structural issues. This development is to be welcomed. To the extent that the SIEC test facilitates this transition, it will be a good move. However, we believe that this improvement in EU merger control is likely to happen, and is already happening, regardless of the exact standard chosen. This will be particularly true to the extent that the concept of dominance is increasingly equated with that of substantial market power.

## Has the threshold for intervention been lowered?

Whether the threshold for intervening in mergers has been lowered is ultimately an empirical question that we will only be able to answer once the new regulation has been in force for a number of years. However, the Guidelines certainly imply that the threshold for intervention has been lowered, and we will be advising clients of this going forward.

The Guidelines set a safe harbour market share of 25% below which "concentrations ... are not liable to impede effective competition" (paragraph 18). If the Commission starts to intervene consistently in mergers that are close to but above this figure (i.e. in the 25-30% range) then it will represent an unambiguous lowering of the threshold for intervention.

The Commission has introduced Herfindahl Index (HHI) thresholds into the new Merger Guidelines. These have been used in the US

for many years, but are relatively new to the EU. These thresholds provide 'safe harbours' below which the Commission is 'unlikely to identify ... competition concerns'. The problem is that these thresholds are set very low. For instance, a merger in an industry with eight equal sized firms would not be in a 'safe harbour', even though historically such a merger would not be thought of as giving rise to competition concerns.

The Commission has been at great pains to stress that the Guidelines do not represent a lowering of the threshold for intervention and it is true that the Guidelines are careful to stress that the HHI tests will only be used as an 'initial indicator' of possible competition concerns, which is a long way from saying that they automatically imply a competition problem. However, if we are to treat the Guidelines as meaningful, then the thresholds must mean that the Commission does envisage sometimes intervening in mergers that just fail these HHI tests.

On a more prosaic level, the threshold for intervention has obviously been lowered for those mergers that previously would have fallen into the enforcement gap. As discussed above, we are doubtful that this represents a large number of cases and indeed are inclined to believe that it probably represents close to zero cases.

## Efficiencies

One very welcome aspect of the Guidelines is the explicit acceptance of an efficiency defence. An equally welcome aspect is the absence of an efficiency offence.

### Efficiency defence

The efficiency defence as proposed by the Commission is the idea that a merger might lead to a loss of competition, but that this loss of competition might not lead to prices rising because the merger also leads to cost efficiencies that flow through to prices. The intellectual argument for such an efficiency defence is clear. To the extent that cost savings flowing from a merger result in lower prices to consumers post-merger than pre-merger, they should clearly be considered pro-competitive. Even so, the Guidelines impose various restrictions on the scope for an efficiency defence.

The most important restriction is that efficiency claims will only be considered to the extent that they are passed on to consumers. Thus a merger that leads to significant fixed cost savings, but no variable cost efficiencies, is unlikely to benefit from an efficiencies defence since economic theory holds that it is variable costs that primarily affect pricing rather than fixed costs.

The Guidelines state (paragraph 84) that it is 'highly unlikely' that the efficiency defence will be enough to convince the Commission to allow a merger to monopoly. We believe, however, that there are cases where mergers to monopoly should be passed on efficiency grounds, for example in industries that are declining due to falling demand. In industries of this type mergers may be a very efficient means of allowing firms to exit the market.

The Guidelines also state that efficiencies will only be considered if they are 'merger specific', which is taken to mean they could not be achieved by a less anti-competitive alternative, such as a licence or a cooperative joint venture.<sup>3</sup> By choosing an alternative contractual arrangement rather than the current situation as the relevant counterfactual, the Commission is requiring an assessment of the likely alternative mechanism that the market would bring in the absence of the merger. This has the potential to become a very difficult and largely arbitrary exercise. Joe Farrell and Carl Shapiro, both ex-chief economists at the US Department of Justice Antitrust Division, one of the two federal merger control agencies, argue that this requirement significantly reduces the usefulness of the efficiency defence to parties.<sup>4</sup> They argue that those cases where efficiencies are most likely to be important and 'merger specific' are also cases where there are likely to be real competitive concerns. The result is that arguing for an efficiency defence in a case may be a double-edged sword.

### **Efficiency offence**

On a number of occasions in the recent past the Commission has treated cost efficiencies arising from a merger as anti-competitive. The Guinness/Grand Metropolitan and GE/Honeywell mergers are good examples of this. The original draft Guidelines included a discussion that looked very much like a discussion of an efficiency offence. The draft Guidelines discussed economies of scale and scope as leading to a 'strategic advantage' over smaller competitors and worried about a merger enhancing a firm's distribution network in ways that would be difficult for its rivals to replicate.<sup>5</sup> None of this text, or the theory underlying it, has survived to the final version of the Guidelines. This is to be welcomed.

### **Coordinated effects**

Coordinated effects are said to arise when a merger reduces the number of firms to the point at which it becomes likely that the remaining firms will not compete strongly against each other, with the result that prices rise. The discussion of coordinated effects in the Guidelines represents a significant improvement on past Commission practice. The

Commission discusses four necessary conditions for coordinated effects to occur:

- It must be possible to reach a common understanding on the terms of coordination (i.e. price, quality, etc.)
- Coordinating firms must be able to monitor each other to ensure that they are all adhering to the terms of coordination
- There must be a credible deterrent mechanism that is activated if a firm does deviate
- Those not participating in the coordination (other competitors, potential competitors and customers) must be unable to undermine the coordination.

This approach is the economically correct one and is a substantial improvement on the Commission's previous approach. There are two points that should be noted here. First, the four conditions above are all necessary conditions, not sufficient conditions. If any one of them does not hold, then coordination is not plausible.

Second, there has been a great deal of confusion over the 'credible deterrent mechanism' condition. The Guidelines state that 'Some deterrent mechanisms, such as punishing the deviator by temporarily engaging in a price war or increasing output significantly, may entail a short-term economic loss for the firms carrying out the retaliation.'<sup>6</sup> Where this is true, there must always be considerable doubt over whether the 'punishing' firms will actually carry out the threat of punishment, or whether they will succumb to the temptation to choose the short-run profit maximising option of 'forgiving this time'. However, the most common form of punishment mechanism is self-enforcing. If a firm deviates by lowering its prices and raising its output, the other firms will find that maximising their short-run profits involves lowering their prices. This in turn will then lower the profits of the deviating firm and so reduce the incentive to deviate in the first place. Coordinated behaviour will be most easily sustainable when the short-run profit maximising response of non-deviators leads to the deviation being unprofitable. Equally, when punishment requires firms to take decisions that are not profit maximising in the short-run, there must be serious doubt over the credibility of the punishment mechanism.

### **Notes:**

<sup>1</sup> "Council Regulation (EC) No 139/2004 of January 20, 2004 on the control of concentrations between undertakings (the EC Merger Regulation)" and "Commission Notice: Guidelines on the assessment of horizontal

mergers under the Council Regulation on the control of concentrations between undertakings” (30/1/2004).

<sup>2</sup> This is explicit in the Commission’s recent new telecoms regulatory regime and in the UK’s competition regime. See the Commission’s “Guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services” (2002) and the UK Office of Fair Trading’s “Assessment of Market Power”, OFT 415 (1999).

<sup>3</sup> Paragraph 85.

<sup>4</sup> Joseph Farrell and Carl Shapiro: “Scale Economies and Synergies in Horizontal Merger Analysis,” in: Antitrust Law Journal, vol. 68, no. 3, 2001.

<sup>5</sup> Paragraph 21 of the “Draft Commission Notice on the appraisal of horizontal mergers under the

Council Regulation on the control of concentrations between undertakings.” (11/12/2002).

<sup>6</sup> Paragraph 54

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