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DECEMBER 2002

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THE CHOICE OF REGIME FOR EUROPEAN MERGERS

Following the highly publicised over-turn by the Court of First Instance of three of its merger prohibition decisions, the European Commission has announced a number of proposed changes to its decision-making process. These reforms aim to address the priority areas of the merger control procedure employed by the Commission and the resources available to it. However, no change is envisaged to the substantive 'dominance' test - the Commission has decided that it does not propose to replace it by one seeking to establish whether the effect of a merger will be a 'substantial lessening of competition'. This bulletin explores some of the implications.

NO CHANGE OF TEST

A year ago the European Commission issued a Green Paper exploring options for reform of the EC Merger Regulation (ECMR). Amongst the many issues raised was the desirability of a move from the current 'dominance' standard to the 'substantial lessening of competition' (SLC) test adopted in the US and the UK. →

Advocates of the SLC test have suggested that it would allow for the economic issues to be better reflected in the competitive assessment of mergers. Meanwhile defendants of the dominance standard maintain that it is able to capture all possible competition concerns.

Since then the Court of First Instance (CFI) has annulled, on appeal, three of the Commission's recent merger prohibition decisions – Airtours/First Choice, Schneider/Legrand and Tetra Laval/Sidel – on the basis that the Commission had failed to provide sufficient economic and factual evidence to prove its theories of competitive harm. Attention therefore appropriately turned to the more pressing issue of improving the Commission's application of the ECMR and, on 11th December 2002, a number of proposed reforms were announced to its investigative practice and decision-making process¹. This reform package includes management measures to improve the way investigations are conducted, enhancing the Commission's economic capabilities, introducing an internal peer review system, improving the parties' ability to defend their points of view, strengthening of the Hearing Officers role, more flexibility with regard to the timeframe for notifications and investigations, and enhancing the fact-finding powers of the Commission.

The Commission has also confirmed that it considers the dominance test enshrined in Article 2 of the ECMR to be capable of dealing with the full range of anti-competitive scenarios that mergers may engender. It is therefore to remain, and will not be replaced by the SLC test. However, the Commission proposes to amend Article 2 of the ECMR effectively to redefine the dominance test to include non-collusive oligopolies. The main argument for changing to SLC would be the clarity provided by the test in these cases. This article explains the nature of the perceived 'gap' that the Commission is seeking to fill.

UNILATERAL EFFECTS

From a competition perspective, a merger may give rise to economic concerns if it results in an increase in 'market power'; that is, if it increases a firm's ability to raise prices profitably above the competitive level. The debate over the most appropriate test hinges on the effectiveness of each in assessing three different ways in which this increased market power may come about.

Firstly, a merger may have 'unilateral effects' – that is to say, a firm may be able to raise prices above the competitive level without the co-operation of, or co-ordination with, its rivals. Most obviously, a merger may have unilateral effects if it results in one large firm facing a number of smaller competitors that are unable to provide an effective competitive constraint. More generally, concerns about unilateral effects can arise in oligopolistic markets. But there is no general, robust relationship between market structure and market power. Simple measures of market concentration, such as market share or the number of firms, are insufficient to provide an unambiguous guide as to the effects of a merger. There is no simple rule to determine whether a reduction in the number of firms will result in an increase in market power, and so in a rise in prices. This will vary greatly, depending on the nature of competition and the characteristics of the market.

So a variety of different economic models of oligopoly have been developed to capture the method of competition in particular industries, each of which will deliver different predictions as to the relationship between market power, market share, and the number of firms. The three that follow are amongst the most important:

- **The Cournot model:** Cournot competition describes a situation in which full competition on price for each and every customer is not possible. This may arise, for example, if firms compete on investment as well as price, so that capacity constraints limit the number of customers each firm can serve. In such a situation, the strength of competition, as measured by the price-cost mark-up, increases with the number of firms. Any merger will result in some increase in market power for

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all firms, which will be greater the fewer they are in number and the higher the capacity shares of the merging firms.

- **The differentiated Bertrand model:** This models a situation in which rivals' product offerings are imperfect substitutes (e.g. branded goods, or firms located in different areas). The greater the degree of product differentiation, the higher the price-cost mark-ups. The impact of a merger is increased by the degree of substitutability between the products of the merging firms, but decreased by the degree of substitutability between these products and those of the other firms in the market.
- **The pure Bertrand model:** This describes a situation in which rivalry between firms is intense. Where products are close substitutes, and there are no impediments – such as capacity constraints or customer switching costs – to firms serving every consumer, price competition will be tough. The existence of a second firm is sufficient to create full competition, and to drive prices down to marginal cost. Mergers that result in two or more firms remaining in the market will therefore result in no increase in market power.

Further models of oligopolistic competition have been developed, for example, for markets characterised by customer switching costs, where firms compete on product innovation and R&D investment, or where customers enjoy buyer power. However, it is rare for a single economic model to capture all the salient features of a market. Rather than being "correct" or "incorrect" for the circumstances, different models will typically be more or less appropriate.

CO-ORDINATED EFFECTS

Secondly, a merger may give rise to economic concerns if it enhances the prospect of co-ordinated behaviour between the remaining firms in the market. Co-ordinated behaviour refers to situations in which firms, recognising their long-term mutual interdependence, cease to act unilaterally and in their short-term private interests, but instead act collectively to increase industry profits above the competitive level. This need not necessarily take the form of explicit cartel agreements; a tacit recognition by firms that it is in none of their long-term interests to "rock the boat" may be enough.

The analysis of whether a merger makes such tacit agreements more likely generally proceeds in two stages. The first is concentrated on the characteristics of the industry, in order to determine whether it is susceptible to tacit collusion. Do firms have the incentives and ability to collude tacitly, and would such arrangements be sustainable? The second stage proceeds from this understanding of the context to examine the extent to which changes in the market structure, following from the merger, alter the likelihood of tacit collusion. In general, reducing the number of firms enhances the prospects of co-ordinated behaviour. However, for reasons explained in a previous Frontier bulletin, increases in asymmetry between firms could offset this effect².

VERTICAL AND CONGLOMERATE EFFECTS

Thirdly, a merger may give rise to economic concerns with respect to foreclosure effects. The merging parties need not compete in the same product markets for such concerns to arise. Essentially, the issue is whether market power might be 'leveraged' from one market to another, through actions that link markets, either horizontally or vertically - such as bundling, tying, refusing to supply, or exclusive dealing.

These examples are perhaps the most obvious causes of a potential loss of competition, since they are predicated on the possibility of exit by rival firms. However, they are often also the most controversial. They frequently engender arguments, drawing on theoretical economics, about the rationality, and feasibility, of exclusionary strategies. The results can be highly sensitive to the specific assumptions made.

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THE CFI'S JUDGMENT IN AIRTOURS

From an economic perspective, a merger control regime should seek to address the competition concerns raised by each of the three mechanisms described above. The current ECMR, based around the dominance standard of Article 82, has proven sufficiently flexible to capture most of these and to produce broadly convergent outcomes to the SLC test employed by the US and UK competition authorities. As such, the practical importance of the dominance versus SLC debate should not be overstated. Nevertheless, for the reasons explained below, a perceived gap remains in that certain types of unilateral effects concerns in oligopolistic settings may not be readily caught by either the single firm dominance or the collective dominance tests under the ECMR. Hence the Commission's desire to clarify the situation by amending Article 2 of the ECMR.

An important potential limitation of the dominance test for the purposes of merger control was the ability to address concerns over co-ordinated behaviour. This has changed with the rapid development of the concept of 'collective dominance'. It is now established that the Commission can apply the concept of collective dominance in order to prohibit a concentration if it is able to show that this would create or strengthen the ability of the merged firm to benefit from tacit co-ordination with other firms in the market.

The CFI's recent judgment in *Airtours* has helped to clarify somewhat the interpretation of collective dominance:

*"collectively dominant position significantly impeding effective competition in the common market or a substantial part of it may thus arise as the result of a concentration where, in view of the actual characteristics of the relevant market and of the alteration in its structure that the transaction would entail, the latter would make each member of the dominant oligopoly, as it becomes aware of common interests, consider it possible, economically rational, and hence preferable, to adopt on a lasting basis a common policy on a market with the aim of selling at above competitive prices."*³

In particular:

"three conditions are necessary for a finding of collective dominance as defined:

- *first, each member of the dominant oligopoly must have the ability to know how the other members are behaving in order to monitor whether or not they are adopting the common policy;*
- *second, the situation of tacit coordination must be sustainable over time, that is to say, there must be an incentive not to depart from the common policy on the market;*
- *third... the Commission must also establish that the foreseeable reaction of current and future competitors, as well as of consumers, would not jeopardise the results expected from the common policy."*⁴

These economic considerations are relevant to the ability and the incentive for firms to develop a sustainable tacitly collusive arrangement, and hence to concerns about co-ordinated behaviour. They are not relevant to an assessment of unilateral effects.

The CFI would thereby appear to have confirmed that the concept of collective dominance cannot be used to make an assessment of the general competitive effects of mergers in oligopolistic markets, confined its application to those where there is a real risk of the merger facilitating co-ordinated behaviour. However, this is not a view shared by all. The CFI only ruled on the specifics of the case before it, and did not explicitly rule on the possibility of addressing the effect of mergers in non-collusive oligopolies. It could therefore be argued not to have more generally limited the scope of application of the ECMR in oligopolistic markets.

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IS THERE A GAP?

The CFI's judgment in *Airtours* could mean that the single firm dominance standard would need to be applied to all concerns about unilateral effects. Single firm dominance arises in a situation in which a firm is sufficiently large to act independently of its competitors and its customers – for example, if one large firm confronts a fringe of smaller competitors. The European Court has held that, in the absence of exception circumstances, there is generally a presumption that a company has a dominant position if it has more than a 50% share of a particular market. However, the conventional wisdom has traditionally been that a merger would not typically fall foul of the single firm dominance test unless the new entity's market share was over 40% and it faced no other sizeable competitor.

Although the Commission has stated that the possibility of a company being dominant cannot be discounted where it has a market share of less than 40%, in practice this has been rare. We are aware of only one case under Article 82 where a firm has been found dominant at below 40% market share (39.7%)⁵. More recently, though, the Commission has subjected to careful scrutiny a number of mergers involving shares below 40%⁶.

This leaves two potential gaps in the regulation of mergers that give rise to concerns about unilateral effects. The first potential gap occurs where a merger results in the creation of one large firm, but with a market share of less than 40%. As discussed above, the key constraint on the behaviour of a merged firm is its rivals' ability to expand output and undermine the profitability of any price increase the merged firm attempts to introduce. There is no reason to expect that this will necessarily exist in all situations where the merged firm's market share is below 40%.

The second - and perhaps more important - potential gap occurs where a merged firm faces one or more large rivals rather than a plethora of smaller competitors. Such a situation might give rise to an increase in the market power of each large firm in the market. Each of them, acting independently, may rationally take the actions and likely responses of other large firms into account in making their own decisions. To do so, they may not need actually to co-ordinate their behaviour, and hence inspection through the lens of collective dominance may not adequately deal with the issues.

In short, therefore, we cannot rely on a general presumption that a 40% market share acts as a robust dividing line between mergers that do and do not give rise to unilateral effects concerns. Nor can we demonstrate that unilateral effects concerns will never arise in oligopolistic markets served by more than one large firm. We can illustrate the issues by use of simulated economic models, which (given the relevant assumptions about the initial market structure, method of competition, and characteristics of the market) enable us to arrive at estimates of price increases that might be expected post-merger. Specific examples of these simulations are outlined in the box below.

SIMULATION EXAMPLES

Suppose, for illustration, that firms are differentiated by means of retail location. (Such a market has characteristics most similar to those of the differentiated Bertrand model.) The extent to which there are changes in market power, and hence price increases post-merger, will depend on the locations of the merging firms and the other firms in the market. The higher the degree of overlap between the merging firms, and the lower the degree of overlap between the merged firm and its rivals, the more the merged firm will be able to increase prices.

Suppose also that the firms are randomly located throughout the market, and hence the level of overlap between one firm and another depends upon their market shares. Now we need to make assumptions about the level of pre-merger gross margins (the mark-

up of price over marginal cost) for all firms in the industry (which in this model is equal to the reciprocal of the firm-specific price elasticity of demand). We further assume that no firm repositions its product, that the merger results in no efficiency savings, and that there is no entry of new firms post-merger. (In any real piece of analysis of post-merger price changes, such factors would all need to be taken into consideration, as they could have an offsetting - or more than offsetting - effect on price.)



Example 1: Let us consider a market structure involving eight firms whereby the shares are 20%, 15%, 10%, 10%, 10%, 10%, 10% and 5% respectively, and a merger between the top largest firms. The merged firm would have a share of 35%. In this simple model, the predicted price increases for the two firms, post-merger, are shown in Table 1. Higher price increases are predicted for higher gross margins (reflecting a lower value of the elasticity of demand).

Table 1 also presents the predicted price increases for a merger that would result in a share of 40% for the merged firm, where the pre-merger market structure is 20%, 20%, 10%, 10%, 10%, 10% and 10%. These are marginally higher, but show that there is no dramatic 'threshold' effect at 40%. Moreover, under these assumptions, the competition implications for a post-merger market share of 35% and a gross margin of 0.6 are greater than those for a post-merger market share of 40% and a gross margin of 0.4.

Gross margin	Elasticity of demand	Predicted price increase (merged firm has 35% share)	Predicted price increase (merged firm has 40% share)
0.2	5	0.8%	1.0%
0.4	2.5	1.6%	2.0%
0.6	1.7	2.4%	3.0%

Table 1: Merged firm with 35%-40% market share and small competitors

Source: Frontier Economics modelling



Example 2: Suppose instead that there are three unequally sized firms in the market, with market shares of 50%, 25% and 25% respectively, and that the two smaller firms merge. Let the other assumptions about the nature of competition and the market characteristics remain as in Example 1. As Table 2 shows, the predicted price increase at each level of gross margin is greater than for the merged firm with a 40% market share facing a fringe of smaller competitors, as reported in Table 1.

Gross margin	Elasticity of demand	Predicted price increase
0.2	5	1.4%
0.4	2.5	2.8%
0.6	1.7	4.2%

Table 2: Merged firm with 50% market share and one large competitor

Source: Frontier Economics modelling

A GAP WORTH FILLING?

At least in theory, therefore, the traditional interpretation of the dominance standard suffers from an inability adequately to capture certain types of unilateral effects concerns. From the perspective of a merger control regime, however, this theoretical weakness is only of practical interest if such effects can be identified and investigated. The CFI's recent judgments in *Airtours/First Choice* and *Tetra Laval/Sidel* confirm that it is insufficient for the Commission to develop a theory of potential economic harm without also substantiating its applicability to the market in question.

The evidence needed to support an investigation of cases in the two perceived gaps is the same as would be collected by the Commission for analysis of other unilateral effects cases (i.e. where the merged firm has a market share of over 40% and is the only large firm). There would be a need to explore the nature of competition and the characteristics of the market - including the price elasticity of demand, the nature and extent of barriers to entry and expansion on behalf of rivals, the degree of buyer power and the size of any efficiencies that would affect marginal costs.

The evidence base required is thus no more onerous or difficult than for unilateral effects cases where the single firm dominance standard is more obviously applicable. For example, a review of mergers considered by the UK Competition Commission (formerly the Monopolies and Mergers Commission) over the last decade would reveal that a considerable number of its cases have fallen into one of these two categories. The UK Director General of Fair Trading therefore considers that:

"The threshold of market power that triggers intervention to maintain competitive incentives by preventing anti-competitive structural changes in markets ought to be lower than that which triggers liability for the breach of competition law prohibitions on firms that have become dominant."⁷

Commissioner Monti would seem to concur:

"with a view to enhancing transparency regarding the scope of our current test, I will be proposing a clarification of the notion of dominance contained in the current substantive test ... so as to make clear that the test also applies where a merger results in so-called "unilateral effects" in situations of oligopoly, a potential "gap" to which some commentators have pointed. The clarification which I will be proposing is consistent with how the ECJ has defined dominance in merger cases, but the approach has – I think – the advantage of not linking the definition of dominance under the Merger Regulation to any future interpretations given by the European Court of Justice to the concept of dominance under Article 82 of the Treaty."⁸

The disagreement between the advocates of the SLC test and the dominance standard is therefore not over the economic concerns the merger control regime should be seeking to address, but over the best means of so doing. The Commission's proposed solution is to insert a new Article 2(2) into the ECMR:

"For the purpose of this Regulation, one or more undertakings shall be deemed to be in a dominant position if, with or without coordinating, they hold the economic power to influence appreciably and sustainably the parameters of competition, in particular, prices, production, quality of output, distribution or innovation, or appreciably to foreclose competition."⁹

This is to be accompanied by the following explanation:


"Irrespective of the structure of the relevant markets affected by a concentration or of the manner in which economic power is manifested or exercised, dominance should be defined in such a way as to reflect a considerable level of economic power held by one or more undertakings."¹⁰

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CONCLUSION

Most mergers that require in-depth investigation involve markets that are oligopolistic, in which the decision-making of firms is interdependent, and the rest of the industry provides some constraint on the merged firm's conduct. Whilst many such mergers may be dealt with under the existing dominance standard, this article has identified two potential gaps in its coverage. These could have been closed by switching to a different test, notably the SLC test recently adopted in the UK. The European Commission has chosen not to do so, arguing that these gaps are more apparent than real and can be filled by clarifying the ECMR without abandoning the concept of dominance.

Whether there is in fact a unilateral effects gap between the prevailing dominance standard and the SLC test depends critically on two issues. The first is the interpretation of the CFI's judgment in *Airtours*. Some believe that it would not now be possible for the Commission to extend the concept of collective dominance beyond tacit co-ordination. However, the CFI did not explicitly state whether tacit collusion is a pre-requisite for the application of the ECMR to oligopolistic markets - and so others consider this to remain an open question. The second is whether the concept of single firm dominance could be stretched beyond the conventional interpretation to cover situations where the merged firm has a market share below 40% and/or where it faces other sizeable competitors. Either way, it seems clear that the effects of mergers in non-collusive oligopolies will now be fully scrutinised by the European Commission.

<p>SOURCE</p>	<ol style="list-style-type: none"> 1. Commission press release, "Commission adopts comprehensive reform of EU merger control", IP/02/1856, 11th December 2002. 2. Frontier Economics, "Fearful asymmetry: capacity asymmetries and merger analysis", January 2002. 3. Court of First Instance, Case T-342/99, paragraph 61. 4. Court of First Instance, Case T-342/99, paragraph 62. 5. Commission Decision of 14th July 1999, IV/D-2/34.780 Virgin/British Airways, 2000 OJ L 30/1. 6. See, for example, Commission Decision of 25th January 2000, Case Comp/M.1684, Carrefour/Promodes. 7. Professor Mario Monti, "Merger Control in the European Union: a radical reform", speech of 7th November 2002 at the European Commission/IBA Conference on EU Merger Control. 8. John Vickers, "How to reform the EC merger test?" speech of 8th November 2002 at the European Commission/IBA Conference on EU Merger Control. 9. Commission press release, "Commission adopts comprehensive reform of EU merger control", IP/02/1856, 11th December 2002. 10. Commission press release, "Commission adopts comprehensive reform of EU merger control", IP/02/1856, 11th December 2002.
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