

Christiansen, Arndt

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THE “MORE ECONOMIC APPROACH” IN EU MERGER CONTROL

ARNDT CHRISTIANSEN*

EU Merger Control, which was introduced as recently as 1990, has since become an important element of the regulatory framework for international mergers and acquisitions. It is currently undergoing its most profound reform, central to which is the “more economic approach”. This article traces the main elements of the new approach and gives a preliminary assessment, thereby highlighting remaining problems and open questions.

Outline of EU merger control

If certain turnover thresholds are met, then EU merger rules apply to cross-border concentrations irrespective of the companies’ seats or their major areas of activity. Pre-merger notification is obligatory with the European Commission, i.e. its Competition Directorate General (DG Comp). Most cases are dealt with in Phase I, that is within six weeks. Only complex transactions, which amount to roughly five percent, enter Phase II proceedings that take up to four additional months. Final decisions are subject to judicial review by the Court of First Instance (CFI) and ultimately the European Court of Justice (ECJ).

Almost 3,000 cases were handled from early 1990 until the end of 2005. As Figure 1 shows, the annual caseload rose steadily until 2000. Interestingly, there have only been 19 outright prohibitions to date with a maximum

* Economic Policy Unit, Department of Economics, Philipps-University of Marburg.

of five in 2001. Since then there has only been one additional prohibition in 2004.¹ These are, however, complemented by 95 withdrawn transactions and, most importantly, 210 approval decisions coupled with conditions and obligations ranging from comprehensive divestitures to specific behavioural commitments.

Main elements of the “more economic approach”

The “more economic approach” is the most important result of the ongoing reform process. It implies increased reliance on theoretical concepts from industrial economics and quantitative methods of analysis, firstly in case investigations and, secondly, in formulating legislation and defining the relevant criteria (Christiansen 2006; Röller 2005). This is widely seen as a reaction to the harsh criticisms of the Commission’s previous decision-making and, in particular, to the heightened standard of proof resulting from the threefold annulment of prohibition decisions by the CFI in 2002.

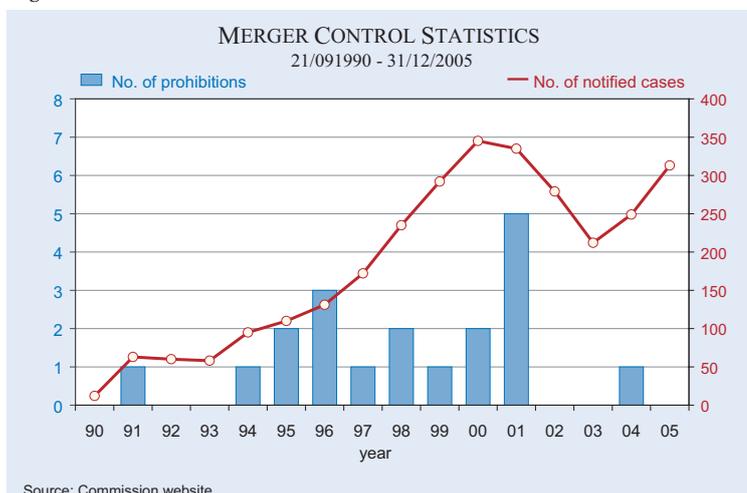
The new approach has had a tangible influence on the amended EC Merger Regulation (ECMR)², the likewise redrafted Implementing Regulation and the

¹ All cited decisions are available at the Commission’s website at <http://europa.eu.int/comm/competition/mergers/cases>.

² All cited legal documents are available at the Commission’s website at <http://europa.eu.int/comm/competition/mergers/legislation>.

The “more economic approach” relies increasingly on concepts from industrial economics

Figure 1



new Horizontal Merger Guidelines (HMG), all of May 2004, as well as subsequent decision practice. The most striking change is the new prohibition criterion. Article 2 (3) of the ECMR now reads:

“A concentration which would significantly impede effective competition in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market.”

This is referred to as the “significant impediment to effective competition” or simply SIEC test. The previous criterion of market dominance is still embodied in the rule, but it now merely constitutes a primary example.

The new test is given concrete form in the accompanying Guidelines. Accordingly, the overall aim continues to be the prevention of (significantly increased) market power, which denotes the ability to increase prices, to reduce output, choice or quality, or to diminish innovation at the expense of consumers (HMG, para 8). The Commission compares, within the “competitive analysis in a particular case”, the foreseeable impact of the merger with the situation that would have prevailed otherwise (HMG, para 13). While, at this level, there is no fundamental change, the Guidelines subsequently introduce a number of new concepts from contemporary industrial economics.

The first one is the Herfindahl-Hirschman Index (HHI), i.e. the summed squares of the market shares of all firms, as an additional indicator of market structure (HMG, paras 16–21). Even more important is the differentiation – originating in US practice – between coordinated and non-coordinated effects as possible anti-competitive consequences of horizontal mergers, which will be dealt with more extensively below. While the remarks on coordinated effects largely represent a restatement of the traditional collective dominance concept, the inclusion of unilateral effects was explicitly meant to extend the scope of the ECMR and thereby cover anti-competitive mergers in oligopolistic markets “below” the old market dominance threshold.

Conversely, efficiencies are for the first time acknowledged as a “countervailing factor”, which can result in approval despite a

dominant market position (HMG, paras 76-88; Schwalbe 2005). The Guidelines set out three cumulative conditions for acceptance. In detail, the efficiencies must be merger-specific and verifiable. They must also – at least partly – be passed on to consumers, which conforms to the so-called consumer welfare standard. Moreover, the burden of proof lies with the firms in contrast to the normal merger control procedure. In this connection, the expected efficiency gains must be weighed quantitatively against merger-related welfare losses on a case-by-case basis. A similar concept known as “efficiency defence” is already established practice in US merger control. Taken together these concepts constitute the substantive core of the “more economic approach”. In addition, the Guidelines mention the other well established factors of buyer power, entry and the “failing firm defence” (HMG, paras 64–75; 89–91).

The substantive issues are complemented by a number of important procedural changes in the amended ECMR itself and in the Implementing Regulation. These include the extension of the time limits in complex cases, the increase of the Commission’s investigative powers and sanctions as well as firms’ extended duties to furnish information upon notification. The “more economic approach” is also closely related to a number of organisational changes within DG Comp. One is the appointment of Prof. L.-H. Röller as the first Chief Economist who heads up a team of – at present ten – industrial economists.³ In addition, the European Advisory Group on Competition Policy (EAGCP) has been set up as an academic advisory body.

Finally, the new approach is already visible in the merger control practice, although its implementation is far from completed. In particular, there has been no prohibition decision on the basis of the new SIEC

³ More details can be found at the DG Comp website at http://europa.eu.int/comm/dgs/competition/cce_en.htm respectively <http://europa.eu.int/comm/dgs/competition/eagcp.htm>.

The Horizontal Merger Guidelines consider “efficiencies” to offset a “dominant market position”

Figure 2
MAIN ELEMENTS OF THE “MORE ECONOMIC APPROACH”

- New prohibition criterion “significant impediment to effective competition” (SIEC)
- New substantive concepts in the Horizontal Merger Guidelines: Herfindahl-Hirschman Index, coordinated and unilateral effects analysis, “efficiency defence”
- Procedural changes: extended time limits, increased investigative powers, greater information requirements
- Appointment of Chief Economist, establishment of advisory body EAGCP
- Strengthened use of quantitative analysis in case practice

test to date, nor has a merger been approved on the grounds of efficiency. There is, however, evidence of greater recourse to statistical and econometric analyses (Weitbrecht 2006). As a corollary, economic experts are involved more regularly in proceedings, both within the Commission and on behalf of the companies. Recent examples include the cases of Oracle/PeopleSoft (2004) and Blackstone/Acetex (2005). These changes further contribute to an alignment with US practice.

Unilateral versus coordinated effects

A few more words are due on the newly introduced pair of possible anti-competitive effects of horizontal mergers. Together with the novel “efficiency defence”, they constitute the substantive core of the “more economic approach”, but are of a much greater practical significance. They are typical of the new approach in that they both reflect recent theoretical developments in industrial economics and, in addition, closely resemble US merger control practice (Vickers 2004, 463). They further contribute to the overall tendency towards more differentiated treatment of and, consequently, deeper inquiries into individual cases (Christiansen and Kerber 2005, 3–4). Apparently, this is deemed to be the logical consequence of incorporating more economics into competition law and its application.

A merger may give rise to so-called unilateral effects because of the removal of competitive constraints on one or more seller(s) (HMG, paras 24–38; Motta 2004, 233–250). Increased market power, especially for the merging firms, may be the result, thus widening the scope for profitably increasing prices or reducing output. This does not require an accommodating reaction on the part of the competitors nor the establishment of a dominant position in the sense of the old substantive test. Rather, the decisive factor is the intensity of competition between the merging firms relative to their competitors. Unilateral effects are therefore likely to occur primarily in differentiated product markets. The Guidelines cite as conducive factors high market shares, a high degree of substitutability between the merging firms’ products, the lack of alternatives for customers and capacity constraints faced by the competitors.

In practice, an assessment of unilateral effects requires a quantitative projection of the (short-term) price and quantity effects of the merger. This is done increasingly by means of so-called “merger simula-

tion models”. These models incorporate assumptions on the form or structure of the given market and the primary competitive parameters such as price or quantity. Moreover, the relevant price elasticities must be estimated and any cost savings as well as reactions by competitors to the merger need to be forecasted. Both the underlying theoretical concept and the empirical simulation models have been in use in US merger control for some time. The theoretical background is provided by industrial economics models on incentives for mergers in oligopolistic markets developed since the 1980s.

Coordinated effects, on the other hand, are said to result from a merger if it enables the sellers to (implicitly) coordinate their behaviour or if it stabilises already practiced coordination (HMG, paras 39–57). The term tacit collusion is also used, since no explicit agreements are involved. Competition between the coordinating firms is (largely) eliminated. In contrast to unilateral effects, this is more likely to emerge in homogeneous markets. The Guidelines define four cumulative criteria. Firstly, it must be relatively simple to reach a common understanding on the terms of coordination. Secondly, the coordinating firms must also be able to monitor each other’s compliance and, thirdly, they must be capable of sanctioning any deviation, which implies the existence of a credible deterrent mechanism. Fourthly, the foreseeable reactions of customers as well as actual and potential competitors must not undermine coordinated action. In practice, a number of structural factors are examined such as the market shares and the number of firms, transparency, degree of product homogeneity and demand growth. All in all, these criteria are closely aligned with contemporary thinking in industrial economics as well as US practice (Motta 2004, 137–185).

Costs and benefits of the “more economic approach”

In order to assess the benefits and costs associated with the new approach, three aspects are worth considering, namely the administrative burden, legal certainty and decision quality. To begin with, the recent reform made the administrative burden rise especially with regard to complicated cases (Weitbrecht 2006, 44). Several factors are responsible for this. For one, the (new) Article 3 (2) of the Implementing Regulation requires the official notification form (Form CO) and all documents to be submitted in the original and in 35 copies (!) as compared with 24 and

Unilateral effects mean increased market power for the merging firms

Coordinated effects result if sellers are enabled to coordinate their behavior

19 copies previously. Furthermore, the notifying parties have to furnish more extensive information. The market share threshold for details about competitors has been lowered from ten percent to five percent. In addition, for the first time, pre-merger and post-merger HHI values have to be calculated for all the affected markets (Section 7.3 of Form CO).

Increasing quantitative analysis plays a crucial role as well. Both econometric market delineation and, above all, the new simulation models require the compilation of extensive data sets. Particularly exacting requirements are associated with the new “efficiency defence”, which is conceived as a case-by-case assessment with the burden of proof lying with the firms (Section 9.3 of Form CO). This affects not only the firms but also the Commission, which conducts its own studies and must examine those submitted by the firms. It also must make the data files and calculations accessible for inspection by the firms in a specially devised “data room”. Taken together, this results in a significant rise in administrative costs.

The “more economic approach” also has important repercussions on the degree of predictability and, hence, legal certainty for the affected parties. In the context of merger control, this refers primarily to the ability to predict the outcome of an investigation with sufficient reliability (Voigt and Schmidt 2005). Proponents of the new approach repeatedly argued that the increased application of economic concepts made the decision-making more transparent and, thus, more predictable (e.g. Röller 2005, 21). This implies that the new concepts provide a clearer benchmark for the assessment of concrete cases. However, contemporary economic knowledge cannot in fact fulfil this expectation (Christiansen 2006, 10–12).

Industrial economics, which underlies the new approach, is built primarily on game-theoretic (oligopoly) models (Motta 2004). A wide range of theoretical work is available, which often either leads to contradictory results or suffers from limited validity because of rather specific assumptions. Concurrently, a (more) general theory as well as systematic empirical work are lacking, so that the scope of validity of the individual models and, thus, the selection of the rel-

evant model remain ambiguous. This, in turn, widens the scope for discretion, thus making the Commission’s decisions more difficult to predict. Hence, legal certainty is not improved but diminished.

During the reform process, improved decision quality became more and more important (e.g. Röller 2005; Vickers 2004). The new concepts and analytical methods, according to the argument, made it possible to identify more reliably any anti-competitive mergers, on the one hand, and welfare-enhancing transactions, on the other. Compared to the practice before the reform, decision errors of both types would be reduced, thus increasing social welfare. Figure 3 serves to illustrate the possible cases and ensuing welfare effects.

Regarding the actual reforms, the incorporation of unilateral effects analysis was explicitly meant to close a gap under the old ECMR and, thus, to eliminate a systematic source of type I-errors. There are some indications of the theoretical relevance of such a gap in respect of certain welfare-reducing mergers in heterogeneous oligopolistic markets “below” the market dominance threshold. However, evidence of a significant number of false approvals by the Commission is widely lacking. The only case cited in this connection is Airtours/FirstChoice (1999). Even more importantly, the Commission had already examined unilateral effects before the reform and had thereby also resorted to econometric methods, for example in the cases Philips/Agilent (2001), GE/Instrumentarium (2003) and Oracle/PeopleSoft (2004). Although this list does not claim to be exhaustive, it reduces the scope of the potential gap.

As to the analysis of coordinated effects, no reduction in errors can be expected simply for the reason that it is closely aligned to the previous collective dominance concept. Like the inclusion of unilateral

The new approach is said to render decision-making more transparent, but ...

Figure 3

ERROR TYPES AND WELFARE EFFECTS

		Welfare effect of the merger	
		Negative	Positive
Decision by the authority	Approval	Error Type I (direct welfare loss)	Correct decision (direct welfare gain)
	Prohibition	Correct decision (avoided welfare loss)	Error Type II (foregone welfare gain)

Adapted from Christiansen and Kerber (2005, 9).

effects, however, the “efficiency defence” was meant to correct a certain type of decision errors. It was claimed that efficiency had been falsely used as an argument against mergers (“efficiency offence”) and that type II-errors had therefore been committed. However, the empirical evidence for this claim is fairly weak. Moreover, the specific conditions set out in the Guidelines are presumably impossible to fulfil in practice (Schwalbe 2005). The US experience points in the same direction. In conclusion, a significant improvement in decision quality is unlikely.

All in all, the effects of the “more economic approach” on decision quality remain ambiguous for the time being. The coordinated effects analysis as well as the newly adopted “efficiency defence” are unlikely to reduce errors. For unilateral effects analysis, which will probably have the greatest practical relevance, the outcome is more positive. All the same, the extent of the alleged gap and the ensuing reduction of type I-errors must be put into perspective. At present, it is still unclear, however, what the relative weights of these effects will be. However, any assessment of the new approach must also take account of the rise in administrative costs and the reduction in legal certainty. Even without precise quantification, there is every indication that the costs associated with the “more economic approach” outweigh the benefits.

... the effects on decision quality remain ambiguous

Important institutional implications

A comprehensive assessment of the new approach must also include institutional considerations. Two points are particularly important, namely the scope for non-competition factors to interfere with the decision-making process and the related aspect of separation of functions. Regarding the former, EU Merger Control has suffered from a fundamental institutional flaw ever since it was introduced. With the European Commission, responsibility for final decision-making lies with a primarily political body whose members are particularly exposed to influence from firms and from (governments of) the EU member states (Murray 2004, Schmidt 1999). Political interventions constitute another source of welfare loss due to erroneous decisions. Indeed, a number of questionable decisions could be observed. These include the cases of Boeing/McDonnell-Douglas (1997), Kali&Salz/MdK/Treuhand (1994) and Manesmann/Vallourec/Ilva (1994).

The preferred institutional solution would be the creation of an independent competition authority along

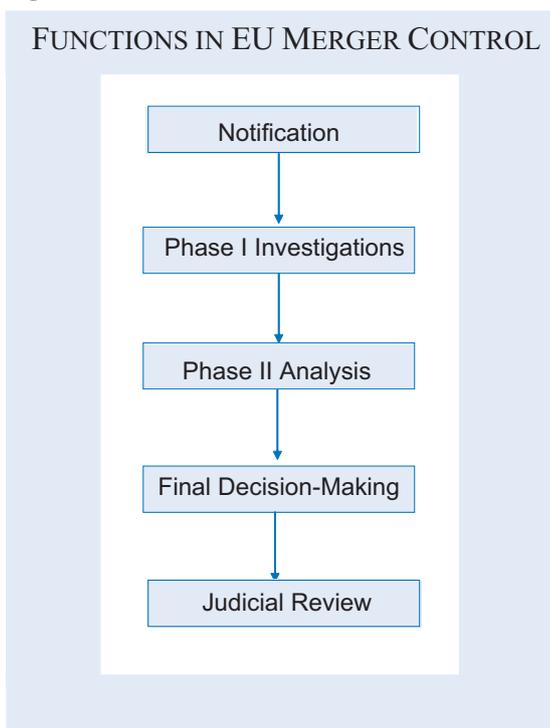
the lines of the German Federal Cartel Office. However, proposals to this effect have receded more and more into the background. Although non-competition factors have apparently played a lesser role in recent years, the issue remains important. The inclination towards political intervention will persist. This was clearly indicated by the French-German initiative for a pan-European industry policy in autumn 2004 and the parallel discussions on the competences of Günter Verheugen, the new Vice-President. Other examples are the German ministerial authorisation of the E.ON/Ruhrgas merger in 2002 and the French government’s rescue of Alstom in 2003/4.

Against this background, the increased focus on economic analysis can be interpreted as an attempt on the part of the supporters of a purely competition-oriented approach within DG Comp to shield themselves from political influence. Greater complexity of the economic argumentation already had this effect before the reform. Hence, the “more economic approach” might be a logical refinement of this strategy. It is, however, only a “second best” solution. Superior institutional solutions are available (Christiansen and Kerber 2005, 15–16). Besides an independent competition authority, this includes the formulation of more general rules so as to reduce administrative discretion and thus the potential for biased decisions. By contrast, the actual orientation towards case-by-case analysis threatens to create new possibilities for discretionary decisions and might thus raise the incentives for firms and politicians to exert influence again.

The second important criticism regarding the institutional framework of EU Merger Control concerns the concentration of functions, which also dates back to the very beginnings (Murray 2004, 41–48; Voigt and Schmidt 2005, 166–175). In principle, the merger control process consists of five analytically distinct functions (see Fig. 4). Of these, only judicial review is assigned to a separate body, while the first three functions even lie in the hands of the same case team within DG Comp. This institutional structure clearly lacks “checks and balances”, thus offering little incentive for careful investigations and decision quality.

The preferred institutional solution is greater functional separation. There are two principal ways to achieve this. Firstly, notification and analysis could be assigned to an independent institution, while the European Commission would remain responsible for the final review of the case and the ultimate deci-

Figure 4



sion. In practice, this would mean the institutional separation of DG Comp. It would resemble the institutional structure in the UK since the Enterprise Act of 2002, which divided the responsibilities for merger review between the Office of Fair Trading and the Competition Commission (Vickers 2004, 457). Secondly, the said functions could remain within the purview of the Commission, while final decision-making would be transferred to a court of lower instance like in the US (Levy 2003, 200).

In comparison, the changes in the course of the reform have not gone far enough (Levy 2003, 215–216). Of late, complex cases have been reviewed internally by so-called “peer review panels”. The Chief Economist and his team have also been increasingly involved in the decision-making process. On conceptual issues there has also been a greater exchange with academic experts, in particular through the EAGCP. More importantly, the Court of First Instance has introduced a fast-track procedure, which makes judicial review much more effective. This last change lies outside the Commission’s domain, however. So the need for institutional reform remains. If suitably structured, functional separation would also help to curtail the possibilities for political influence discussed above. All in all, the “more economic approach” should be broadened in this respect, and consideration be

given to economics-based proposals for an improved institutional framework.

Conclusion

With the “more economic approach”, the EU is taking a new tack on merger control policy. This is visible not only in the new SIEC prohibition criterion and the criteria for appraising horizontal mergers, but also in more recent decision-making practice. On closer analysis, the new approach de facto reduces legal certainty, while the upshot in terms of decision quality remains unclear. Conversely, the administrative burden has risen significantly. Moreover, institutional deficiencies remain regarding political interventions and the separation of functions. In conclusion, a broader perception of an economics-based approach that takes account especially of the institutional implications is called for. Specific recommendations are the establishment of an independent competition authority and the stronger orientation of merger control towards (more) general rules.

Greater separation of functions (like in the UK) would constitute a better institutional solution

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