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Comments on European Commission Draft Notice on the Appraisal of Horizontal Mergers

Commission on Competition, 30 April 2003

1. Introduction

ICC welcomes the Draft Notice on the Appraisal of Horizontal Mergers ("Draft Notice"), which provides the long-awaited Commission response to calls for more detailed guidance as to the analytical framework that will be used by the Commission to assess notified horizontal mergers. That mergers can raise competitive concerns, even without creating a single market leader had been clear for some time (high-profile precedents include *Nestlé/Perrier, Gencor/Lonrho* and *Price Waterhouse/Coopers & Lybrand*). However the controversial *Airtours/First Choice* prohibition of 1999, and the subsequent expansive use by the Commission of the concept of 'collective dominance' to condemn certain mergers in concentrated markets (for instance, *Time Warner/EMI* and *Alcan/Pechiney*), have created a strong need for clarification on the scope of 'dominance', the analytical framework being employed by the Commission, and the nature of the evidence upon which the Commission will rely in such cases.

ICC considers the Draft Notice a positive effort to bring needed transparency to the analytical process and clarification on the economic rationale underlying the Commission's approach to assessing mergers of competing assets (ICC also looks forward to a similar exercise being performed for mergers of complements, as in vertical and conglomerate deals, where there is still considerable and undesirable uncertainty). The approach adopted in the Draft Notice is, for the most part, broadly sensible and consistent with mainstream economic thinking, as well as broadly in line with the US approach. As discussed below, however, ICC remains highly concerned with certain conceptual aspects of the Draft Notice. ICC also believes that there are still *unresolved issues of resource constraints and consistency of implementation at the MTF, that need to be resolved as a threshold matter to ensure consistent and meaningful decision-making, and to provide business with greater certainty in the future.*

2. General Issues

The Draft Notice provides important and valuable clarification on a number of important points. At the same time, the Draft Notice would benefit from improved organization and overall clarification as to the applicability of the principles described therein. For instance, a number of topics that may be of general or broad-ranging applicability are discussed within the confines of a specific section, suggesting limited applicability. One example is the discussion of "Reaction of Outsiders" (paragraph 69), which apparently falls under the "Increased risk of co-ordination" section of the Draft Notice, suggesting some special applicability of that concept to coordination models. This problem is propagated throughout the Draft Notice where discussion of competitive effects or countervailing forces of importance to a broad range of scenarios are tied to a specific "model" of competitive harm.

In addition, the Draft Notice discusses three categories of effects as able to create or strengthen a dominant position and labels them as "Paramount Marke t Position," "Non-collusive Oligopoly," and "Co-ordinated Behaviour." There are significant dangers, however, inherent in the Draft Notice's extensive reliance on the labels attached to these categories of effects. ICC is concerned that if one of the merging firms is identified as occupying a "paramount market position" or if the market was identified as an "oligopoly," then the outcome of the Commission review would turn on these nominal designations, rather than assessing whether the concentration itself would result in adverse competitive effects on consumers in light of all relevant market dynamics. For example, there is no economic support for the proposition that that the mere creation of an entity with greater than a 50 percent market share likely will result in adverse competitive consequences. Likewise, neither unilateral nor coordinated effects necessarily will occur simply because an industry becomes more oligopolisticaly structured. Detailed analysis is required to determine whether, in fact, something likely

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will change in the competitive interactions to give rise to a substantial competitive concern. The Commission thus should ensure that these labels do not replace detailed analysis, as this could lead to the disapproval of competitively neutral or beneficial mergers - depriving consumers of potential efficiencies - based on superficial competitive criteria.

Lastly, ICC applauds the Draft Notice's use of the HHI as a measure of industry concentration. The HHI provides a useful starting point for establishing baseline conditions of competition in an industry. While the Draft Notice utilizes HHI levels to identify transactions that may adversely affect competition, it does not take full advantage of the opportunity to establish "safe harbours" for transactions that fall below certain concentration thresholds. ICC would urge the Commission to institute safe harbours within the framework of the Draft Notice, identifying circumstances within all three categories of effects under which the Commission would presume that no competitive effects are likely to arise.

3. Importance of proof and evidence

The Draft Notice is a significant step forward in the adoption of economics-based standards in merger control. Nonetheless, ICC is conscious of the risk that reliance on theoretical economics may lead to improper decisions in individual cases unless great care is taken to ensure that all aspects of the theory reflect factual reality in the precise circumstances of the case. This concern extends beyond merger control by the Commission itself: ICC recognizes that the Commission's guidelines may be adopted or followed by a large number of other authorities in Europe and elsewhere, many of which will not be as experienced as the Commission in the practical application of economic theory.

ICC would therefore welcome the inclusion in the guidelines of an express recognition that economic theories and models will be carefully applied to reflect the facts of each case. The guidelines should explain clearly that economic theory provides no more than a working tool that may help it better to understand observations of how particular markets work in practice. It is not a substitute for the facts. Thus, ICC recommends that the guidelines acknowledge that it is the Commission's burden to establish that a given transaction creates or strengthens a dominant position and that this showing should be based upon the specific facts of the concentration at issue. Notifying parties should not be called upon to disprove the relevance of a theory advanced by the Commission or a complainant. Moreover, paragraph 9 of the Draft Notice should make clear that the Commission will only seek to prevent concentrations that are likely to result in harm to consumers, rather than suggesting that the Commission will only approve concentrations that result in demonstrable consumer benefits. ICC would welcome an express commitment by the Commission, if it seeks to support a prohibition by the invocation of economic theory, to use the theory only as a framework within which to organise factual evidence of the creation or strengthening of dominance.

ICC would also welcome clarification on the standard of proof on which merger review decisions are based. In this respect, ICC believes that the burden should be on the Commission to provide evidence as to why possible anti-competitive effects will arise in any given merger. If only a possibility that such effects might arise is shown, the presumption should be that the case has not been proven, and the merger should be allowed to proceed. Alternatively, if evidence is found of a possible anticompetitive consequence of the merger, the Commission should consider the possibility of the imposition of a compliance regime and a monitoring obligation, which could be a more proportionate response to the potential problem than a decision to block the merger which overall might produce innovation or efficiency enhancing benefits. Clarification of the standard required to prove factors which the Commission would consider favourable to the approval of a merger would also be welcome. Equal weight should be given to the positive and negative competitive effects of a proposed merger to ensure a balanced perspective of its possible effects as a whole on competition.

4. The adoption of explicit concentration thresholds

ICC welcomes the introduction of explicit concentration 'thresholds', as indicated in the Draft Notice, if the intention is to provide a consistent framework for the initial screening of mergers, and to identify with greater certainty those that are deemed to pose no concerns. At the same time, ICC believes it would be highly undesirable for the Commission to adopt a more 'structural' approach to the

assessment of mergers. Indeed, as explained below, one of ICC's concerns is that the Draft Notice appears to focus on a structural approach to single-firm dominance rather than on an economic analysis addressing the competitive effects of the transaction in the context of the relevant market circumstances.

The thresholds proposed in the Draft Notice are:

- a post-merger HHI below 1,000 for mergers that pose no concerns, or alternatively a post-merger market share of less than 25% for differentiated product markets;
- a post-merger HHI of more than 2000 with an increase of 150 points for mergers that raise "likely" concerns in homogenous product markets'.

It would appear that the upper threshold is intended to apply only to mergers where the concern is not coordinated effects, but non-coordinated effects in homogeneous product markets. While an explicit recognition that HHIs below 1,000 should not generate concerns of any sort is welcome, ICC believes that there should be no positive presumption of serious concerns above 2,000. Both modern economic theory and practical experience has taught that there is precious little basis for any such presumption. Other parts of the document suggest that the Commission is aware of the dangers of placing too much emphasis on 'short-hand' and 'structural' measures, and this approach should be strengthened.

In particular, ICC would welcome an indication that the Commission will be cautious as to the significance of relatively high HHIs in a small geographic territory, even where that territory may qualify as a distinct market, where the sector concerned is characterised by actual or developing competition on a broader basis.

5. Possible Anticompetitive Effects of Horizontal Mergers

The single most significant change introduced by the Draft Notice is an explicit taxonomy of problematic mergers, with a three-way distinction being drawn between mergers creating a 'paramount market position', a 'non-collusive oligopoly' and a 'increased risk of coordination'. ICC understands that this represents the Commission's attempt to draw a line under the post-Airtours debate - intensified after the CFI's annulment of the Commission's Decision last June - that the twin concepts of 'single-firm' and 'collective' dominance were inadequate to cover all possible instances of potentially harmful mergers, in particular if 'collective' dominance was to be understood (as the CFI concluded) as 'coordinated behaviour' (or 'tacit collusion' in economic terms).

The policy concern with which the Commission has been faced - expressed inter alia by the heads of the UK and Irish Competition Authorities and a number of commentators - was that there can be instances (particularly in differentiated product markets) where a merger can lead to material incentives for price increases without creating a single leading player, and at the same time without significantly increasing the feasibility of tacit collusion. And yet it may appear difficult - at least semantically - to apply the notion of 'single firm' dominance to mergers that do not create a clear market leader. The Draft Notice is the product of a balancing act between - on the one hand - arguments that a 'Substantial Lessening of Competition' test should replace 'dominance', as it more clearly covers all possible permutations of increased market power; and - on the other hand - arguments that 'dominance' is sufficiently flexible as a test to encompass such possibilities.

ICC views the Draft Notice as a statement that debate over 'SLC vs. dominance' was ultimately semantic, and that 'dominance' is nothing more than a 'placeholder' for 'market power' (in the sense that mergers that create or strengthen a dominant position are all mergers that create or increase significant market power). At the same time, and for the avoidance of doubt, the Draft Notice spells out that the Commission will be concerned with the change induced by the merger in market structure in three possible cases:

- when the merger creates a market leader ('paramount position'), indicatively with a market share of over 50%, particularly if rivals have a much smaller position;
- when the elimination of competition between the merging parties creates the incentives for, and likelihood of market-wide price increases without however increasing the feasibility of coordinated conduct ('non-collusive oligopoly'); and
- when the merger creates opportunities that did not exist before and the likelihood for coordinated market behaviour.

Each of these situations is discussed below.

Pa ramount Market Position

ICC seriously questions the desirability of introducing new terminology - the concept of a "paramount market position" - in the Draft Notice. The introduction of the concept of a 'paramount market position' violates the overall approach introduced by the Draft Notice, which is to introduce accepted and well-grounded economic theory to merger analysis and enforcement. It is unclear from the Draft Notice whether a "paramount market position" is intended by the Commission to be the same as a "dominant" position or is a narrower concept applying only to a subset of "dominant" firms that possess many of the "strategic advantage" factors set forth in paragraph 21 of the proposed guidelines. ICC believes that the concept of single-firm dominance is already properly defined in the case law as a "position of economic strength enjoyed by an undertaking which enables it to hinder the maintenance of effective competition on the relevant markets by allowing it to behave to an appreciable extent independently of its competitors and customers and ultimately consumers." (Case 322/81, Michelin v. Commission, [1983] ECR 3461, section 30). In contrast, a presumption of competitive concern based on the fact of an acquisition by a firm with a 50% or greater market share, or that creates a firm with a 50% or greater market share - or less in some cases - is without basis in the jurisprudence of the Community or fundamental and sound economic theory. The application of this principle seemingly suggests that most or all transactions involving firms with moderately large market shares are anticompetitive, regardless of the impact on consumer welfare. All emphasis should be on the effect of the concentration on the market, rather than on the pre-existing competitive posture of the parties involved. As Commissioner Monti noted in a speech last November, one of the main advantages of retaining the dominance test is the ability to "preserv[e] the jurisprudence that the Courts have developed all these years in interpreting its meaning and, therefore, in maintaining a high degree of legal certainty." The introduction of new "paramount market position" terminology in the Draft Notice undermines that purpose and the otherwise sensible economic underpinning of the analytical framework that is created.

More important than the issue of terminology are substantive concerns presented by the "paramount market position" portion of the Draft Notice. First, unlike other portions of the Draft Notice, the "paramount market position" section appears to focus primarily on structural considerations such as historical market share and a list of "strategic advantages" rather than on the effect of the proposed transaction on competition in the relevant market[s].

ICC believes that it is critical for the Commission, in each case, to apply meaningful economic analysis to establish whether a 'snapshot' share above 50% is informative about the actual likelihood that market power will be created or enhanced going forward.

To address this deficiency, in part, the discussion of market shares in paragraph 14 of the Draft Notice, including the acknowledgement of the limited role of market shares in assessing dominance in bidding markets, should be incorporated into the "paramount market position" section. In light of the discussion in paragraph 14, and the lack of empirical support for the underlying assumption, paragraph 20 of the Draft Notice should be modified to state that a market share in excess of 50% "may be" evidence of a dominant position and qualified by reference to the touchstone in the case law of the ability of the firm to hinder effective competition on the relevant market by acting to an appreciable extent independently of competitors and customers. In sum, in each case the Commission should apply a meaningful factual and economic analysis to determine whether the share above 50%

is informative about market power going forward. The Commission should not seek to replace the all-important detailed case-by-case economic analysis with a "strong presumption" based on a 50%+ market share. The result will be a competition enforcement regime divorced from the realities of the market.

Second, the listing of "strategic advantages" in paragraph 21 of the Draft Notice may confuse rather than clarify the analysis of horizontal mergers. Many of the listed factors are likely to be possessed by numerous successful firms, even those with a relatively modest market share. Indeed, most of these factors are equally consistent with dynamic competition as with dominance, particularly in that the development of these "advantages" even by a leading firm may drive competitors to innovate in these areas, thereby expanding overall output and enhancing competition. In addition, a number of the factors are of dubious economic significance. The Commission should avoid an approach that entails a perfunctory box-ticking exercise using a list of "strategic advantages" and focus on whether the transaction in question will lead to the creation or strengthening of market power that "may significantly impede effective competition." (Draft Notice, paragraph 11). ICC is particularly concerned about the identification of access to "financial capital" as a basis for evaluating competitive effects. The Draft Notice provides no guidance as to whether the financial strength will be assessed on a product basis, division basis, firm-wide basis, or otherwise. Moreover, this provision could unduly taint mergers involving large firms, which often have gained that status by operating more efficiently than their counterparts. As the Commission itself rightly acknowledges (e.g. in the reference to bidding markets), there may well be circumstances in which a firm with a substantial market share is not in a position to exercise any significant market power. The same applies to 'strategic advantages' as defined by the Commission.

Third, the discussion of "paramount market position" fails to address the role of the merger in the creation or strengthening of single firm dominance. The discussion in the Draft Notice focuses exclusively on the market share and strategic advantages of the combined firm post-merger and does not explain the extent to which the transaction under review must contribute to the risk of the exercise of market power in order for the transaction to violate the test in the merger regulation. Unless the transaction itself adds appreciably to the risk of harm to competition through the combination of horizontal competitors, the merger should not be viewed as problematic simply because one of the parties on its own may possess market power. The key issue is whether the proposed concentration changes the competitive dynamics in a manner that harms consumers.

Non-collusive oligopolies

ICC believes this is an area open to considerable future controversy. Conceptually, there is no problem with a reference to 'non-collusive oligopolies' as a way of making clear that mergers can be problematic not only when they create a single leader, or when they facilitate coordinated behaviour. The legitimate economic issue is that in eliminating competition between the parties, the merger will provide the incentives for the merged firm to raise its prices, and that other firms in the market will be unable or unwilling to constrain the increase, allowing for generalised price increases. These are the classic price effects that do not depend on coordination, but result from individual firms unilaterally setting the prices that maximise their profit (given what they expect others to do).

A significant concern is one of implementation. There are already developed empirical tests available to measure with some confidence at least the order of magnitude of the likely price increase arising from a merger (which - as the Draft Notice recognises - will depend in practice on the degree of product differentiation in the market, how closely substitutable are competitors' products to those of the merging parties, the ability of competitors to reposition their brands, their capacity constraints and so on). But the concern is that in practice, the Commission will not be able to carry out these more rigorous empirical analyses to the required standard, because of its constraints in the availability of economically trained staff to collect the right data and perform the right tests, and will rely - much as in the past - on a subjective assessment of the potential for post-merger price increases.

The danger in this case is that we would have replaced one type of uncertainty - on the scope and meaning of 'collective dominance' concerns in oligopolistic markets - with another - the circumstances where a 'non collusive oligopoly' raises material dangers of price increases. Or in other words, we would be swapping a subjective and uncertain judgement on 'collective dominance' with an equally subjective and not well-reasoned judgment on 'non-collusive oligopoly'. To put it bluntly, the concern is that 'non-collusive oligopolies' may become a 'catch all' for mergers in concentrated markets where there is no single leader being created, and at the same time where it is difficult to make a case that coordination will become easier (e.g. because the product is highly differentiated). The uncertainty created by this new category of mergers which the Commission would consider to be a priori problematic is of great concern to ICC.

ICC believes that in order to allay this concern, the Commission needs to improve as a matter of urgency the quality of its economic assessment. While the Draft Notice makes a number of useful clarifications on principles, and the appointment of a Chief Economist will be an important signal, the real priority is to increase the quota of its economically-trained staff (in industrial organisation theory, business studies, and empirical techniques). The creation of a highly-trained, substantial 'economics bureau' will be essential to raise the level of the debate with all interested parties in a merger, to sift more efficiently through the arguments put forward by the various parties, and ultimately to reduce the risk (significant at present) of weak decisions and 'capture' by complainants. The mandate of the economics bureau should be clear to ensure that there is more than mere theory justifying interventions in mergers.

The Draft Notice defines an "oligopoly," in paragraph 7, as "a limited number of sizeable firms." This definition risks the exclusion of fringe competitors from the relevant competitive analysis. Fringe competition may include players whose current market share is small, but whose ability to affect the competitive dynamic of the market may be substantially in excess of their market share, due to factors such as idle or under-utilised capacity, the ability to expand output with minimal cost, or maverick pricing behaviour. Thus, the Draft Notice should note that fringe competition, even in an oligopolistic market structure, should be fully analysed. The draft section is further complicated by the alternating discussion of differentiated and homogenous product markets versus markets characterized by price or output competition. As discussed further below, ICC believes that the level of product differentiation is the appropriate basis on which to consider competitive impacts. The Draft Notice also should expressly indicate, in paragraph 36, that in heterogeneous product markets, mergers among firms whose products are not close substitutes are not likely to result in harm to competition.

Moreover, paragraph 11(b) - which appears aimed at concentrations resulting in unilateral effects as compared to coordinated behaviour as described in paragraph 11(c) - would benefit from an explanation of the "competitive constraints" at issue, specifically that unilateral effects that may result from a merger between parties whose products are, typically, each others' closest substitute. As it currently stands, paragraphs 11(b) and 11(c) could appear to capture very similar competitive circumstances and could lead to confusion in application.

In addition, paragraph 25 of the Draft Notice states that the removal of an "important competitive constraint" would give rise to concern, yet provides no guidance of the types of constraints to be considered, or on the level of "importance" to be ascribed to such constraints. Likewise, paragraph 27 discusses the HHI level and "delta" at which a concentration is likely to raise "serious doubts." ICC is concerned about the use of the HHI index as a basis for establishing this presumption absent any reference to the dynamics of the marketplace. While the HHI threshold is a useful indicator, the final assessment should be made on a case-by-case basis taking all market characteristics into account.

In view of the above, ICC would welcome a clearer explanation in the Draft Notice of how the concept of non-collusive oligopolies will be applied.

Coordinated Behaviour

The Draft Notice devotes almost a third of its entire length to the possibility of a merger enhancing

'coordinated behaviour'. ICC welcomes the fact that following the CFI's judgement on *Airtours*, the Commission appears to be formally embracing the established economic wisdom on the analysis of tacit coordination in oligopolistic markets. Indeed the conceptual treatment of coordinated behaviour (reference to market transparency, need to establish the credibility of a punishment mechanism, etc.) is consistent with modern economic thinking. The Draft Notice is less helpful in explaining how specific empirical evidence will be used to assess whether a merger will enhance opportunities for coordinated behaviour.

For instance, the Commission states that in assessing how much a merger contributes to the enhanced risk of coordination, it will look at the "structural features of the markets concerned and the past behaviour of firms in these markets." As to the 'structural features', the Airtours judgement makes clear that the Commission needs to go beyond a mechanical application of the 'collective dominance checklist' - which has been its default approach in the past. ICC hopes that the Commission will make a positive effort to replace the use of checklists and the application of subjective judgements of the past with an empirical and analytical approach that evaluates how the merger changes these 'structural features' in a manner likely to make coordination more likely or successful. Further, while analysis of historical market coordination, particularly tacit coordination, may be useful in analysing post-concentration competitive effects, the Commission should further develop its discussion of the factors that will cause it to conclude that post-merger coordination is likely where there was none before (this was arguably the case in *Airtours*, where the Commission did not sufficiently explain why the merger would have 'tipped' an otherwise competitive market towards coordination).

In particular, paragraph 43 correctly notes that coordination is more likely where the terms of coordination are simple and where it is easy to identify acts that would be considered cheating or punishment. It should however note, in analysing whether past coordination has occurred, it may be difficult to distinguish between a supposed pattern of cheating and punishment and actual competition.

Paragraph 48 states that evidence of past co-ordination in similar product or geographic markets may indicate that conditions for coordination are likely to be fulfilled in the markets relevant to the merger. This "guilt by association" concept undermines what should be a bedrock principle of the guidelines: that each concentration should be analysed according to the particular facts and circumstances of the market(s) at issue. The statement is particularly problematic in that it appears to suggest that other markets should be used as a barometer where the evidence in the actual market under review is inconclusive. ICC would strongly discourage the Commission from reaching conclusions in difficult cases based on evidence that, by definition, is less probative on the market at issue than the evidence adduced by the Commission on the specific market at issue.

Paragraph 51 suggests that reducing the number of pricing points in a complex economic environment, or developing relative price points that move in tandem, may facilitate collusion. The Draft Notice should also take account of the fact that a reduction in the number of pricing points may have an important pro-competitive purpose in reducing the transaction costs involved in purchasing in such a complex environment.

Paragraph 52 states that structural links such as, inter alia, participation in joint ventures may help to align incentives of oligopolists. The Commission should take caution not to discourage efficient joint ventures between erstwhile competitors and should note that many if not most joint ventures will not result in anticompetitive coordination. Moreover, the blanket suggestion that public statements concerning expected demand increases can be used to establish common terms of coordination could conflict with corporate disclosure requirements or efforts to promote output-enhancing investment that could significantly benefit competition. The Commission should take care not to discourage such statements without a view as to their potential benefit.

The suggestion in paragraph 53 that symmetrical firms are more likely to reach terms of coordination should be qualified substantially to indicate that the conditions of the marketplace are determinative of this likelihood. The suggestion in paragraph 54 that a concentration resulting in increased symmetry

will be of particular concern to the Commission also needs qualification: think for instance of a case when the transaction involves the combination of two smaller firms that may, as a r esult of the transaction, gain the scope and scale to better compete with larger rivals precisely because they become more symmetrical, i.e., competitive, in the eyes of customers.

6. The distinction between 'types of competition'

The Draft Notice discusses at some length the importance for merger assessment of distinguishing between 'modes' of competition, and in particular on whether competition takes place primarily over 'prices' or 'quantities'. ICC finds the emphasis on this distinction, and in particular the reference to text-book analytical tools such as 'Cournot' and 'Bertrand' models of competition, unnecessary and confusing in its current form.

ICC believes the only meaningful distinction for purposes of merger analysis is between 'homogeneous' and 'differentiated' goods markets. In homogeneous goods markets, prices are determined by the degree of capacity utilisation, and the effects of a merger depend on its impact on the distribution of capacity between the remaining firms. In differentiated markets the main assets are brands, and there the effect of a merger will depend on how it changes the distribution of brands between the remaining competitors. It is not particularly useful (as well as impenetrable to non-economists) to couch this distinction in terms of 'Cournot' and 'Bertrand' competition. The notion that firms compete in 'quantities' is indeed rather peculiar from a business perspective: firms compete always in 'price', and it is known that the 'Cournot' model only makes sense as a simplified model for a situation in which there is a sequence of capacity and pricing decisions.

The distinction between competition in 'prices' and 'quantities' is thus not a desirable or indeed relevant reference: what matters are the types of assets that are being consolidated as a result of the merger. In homogeneous goods markets, where the assets that are transferred are essentially capacities, it makes sense to use a framework where capacity plays a role; while if consolidation is on brands, then those considerations should lie at the heart of the analysis (how close are the merging parties' brands, how easily can brand portfolios of the parties and their rivals be shifted, etc.).

7. Treatment of efficiencies

An area of major interest for business and advisors has been how the Commission would revise its approach to the assessment of merger efficiencies. The Commission's past reluctance to give explicit weight to efficiency arguments has led to an unfortunate general perception that such arguments tend to count against a merger. The whole way that mergers are presented to the Commission has been affected by the concern that the creation of major efficiencies through a merger had to be concealed, lest the Commission concluded that it would put at a competitive disadvantage rivals that are unable to achieve similar synergies (the 'efficiency offence'). This has led to perverse outcomes where, as in a number of recent cases, the Commission's staff has made the argument that they were more inclined to prohibit because the parties had not explained what efficiencies would be realised from the merger.

In the Draft Notice, the Commission cautiously states that it will take efficiencies into account providing that they are "to consumers' advantage" and do not form an "obstacle to competition". The onus is on the merging parties to provide the Commission with credible evidence that the efficiencies arising from the merger will be &qu ot;of direct benefit to consumers" and can be shown to be "merger-specific, substantial, timely and verifiable". The Commission explicitly states it is interested in seeing estimates of how marginal/variable costs will be reduced by the merger (stemming from the prediction that such costs are likely to be passed on to consumers, while reductions in fixed costs (overheads, HQ costs, etc.) are more likely to be retained by the firm as additional profits).

ICC believes the hurdle set by the Commission is too high. On a conceptual level, it is not clear that it is necessary for the full benefit of efficiencies to be passed on to consumers;there is no basis for this in welfare economics. Although the US gives greater weight to those efficiencies that will be passed onto consumers through lower prices in the near term(1) other jurisdictions recognise the distinction between transfers (between e.g. consumers and producers) and allocative losses, and apply a total

surplus standard, where policy is aimed at maximising total welfare . A more appropriate standard may require only the transfer of sufficient efficiencies to offset the effects of the lessening of competition or to prevent an increase in prices.

Further, demonstrating in practice that efficiencies will be of direct benefit to customers (i.e. that they will be fully passed on) will be difficult. It is also very difficult to retrieve reliable measures of the true economic marginal cost from accounting data. As a practical first step, the Commission should be willing to focus explicitly on the existing plans for proposed reorganisations after the merger, and use these to evaluate at the very least the question of whether it is credible that efficiencies are motivating the merger (in which case it is simply less likely that anticompetitive effects are the driving force for the transaction).

Finally, it would be helpful to clarify the definition of "consumers" (buyers on the relevant market? in downstream markets? the ultimate end-user?) and whether the efficiencies must be passed on to all consumers (however defined) or if it is sufficient that a subset of consumers receive all the benefits of the efficiencies. For example, what if all efficiencies were passed along to large purchasers? Alternatively, if only a subset of consumers were actually injured by the merger, could the efficiencies be passed along only to those consumers?

Apart from the way in which the "efficiency defence" is framed, ICC is particularly concerned that the Draft Notice leaves open the door to future applications of an "efficiency offence." The Commission's discussion of "paramount" market position includes, at paragraph 21, a list of attributes that may give the merging firms an advantage over rivals, but that are largely efficiency-enhancing and likely to benefit consumers directly. These attributes appear in the Draft Notice as a checklist of factors that will enhance the likelihood the Commission will challenge the merger. This is precisely the approach that has inhibited firms in the past from demonstrating their transactions' efficiency-enhancing aspects, and that has resulted in the deterrence or prohibition of efficiency-enhancing mergers.

Finally, the force of the efficiency provisions is additionally weakened by the inclusion of apparent pro-efficiency conduct in the negative checklist applicable to the "paramount firm" section. As noted, ICC urges that this section be deleted from the guidelines.

8. The treatment of buyer power and new entry

ICC naturally welcomes the recognition in the Draft Notice that both buyer power and market entry can in principle be important enough to provide sufficient counterweight to merger incentives to raise prices. In practice, however, the discussion is unduly brief in both cases, and there is comparatively little indication of how the assessment will be carried out in practice. Buyer power and new entry are of increasing importance in the business environment and ICC would welcome a more comprehensive coverage of these two aspects.

With respect to buyer power, the Draft Notice is correct that what matters is not the size of the buyers as such, but their ability to find credible alternatives within a reasonably short time-scale if faced with price increases (although obtaining a credible alternative is something that larger customers are more likely to be able to do than smaller customers). Further, it is undeniable that for buyer power to work as a market in favour of a merger, it must be also the case that smaller customers (assumed not to have any buyer power) will not be faced with higher prices after the merger. However, in practice the discussion of how buyer power will be assessed could be more thoughtful. For instance, the Commission should make clear that it will seek to understand the relative bargaining leverage of the customers and supplier, recognising that bargaining leverage depends on the respective effects on profits of an attempted price increase, and give examples of how this might work.

In particular, the Commission could be more explicit about the evidence that would be needed to support a particular case for buyer power. Take for instance a case where a manufacturer is seeking to raise wholesale prices, and may fail to agree with some of his retail distributors - as a result of

which they will stop stocking and selling his brand. The retailers' 'buyer power' will depends also on the way that final consumers buy the product: if they will continue to patronise the retailer, and purchase instead a different brand, the retailer does not have much to lose from failing to carry the manufacturer's brand; but he would have more to lose if this led customers to go and buy the product at another outlet. In practice, information on consumer purchasing patterns, and on the way that bargaining unfolds between manufacturer and retailers can be critical for assessing the significance of buyer power.

In light of these principles, the Draft Notice provisions on buyer power should be modified in several respects. First, it suggests in paragraph 76 that a firm with buyer power may not wish to sponsor new entry if the benefits of such entry "could also be reaped by its competitors."This would only be true, however, if a competitor was likely to reap greater benefits from the entry than the sponsoring firm, leading to a competitive disadvantage for the sponsoring firm. If the benefits were merely shared equally by the competitors of the sponsoring firm, it would nonetheless have the incentive to sponsor entry because such entry would result in a lower cost for its product, and presumably a lower price than would otherwise be the case. All other things being equal, such a lower price will result in higher overall demand for the product of the sponsoring firm, as well as the products of other firms able to take advantage of the new entry.

Similarly for entry, the principle is relatively uncontroversial: for the Commission to accept that new entry eff ectively prevents price increases, it will have to find evidence that new entry is 'likely, timely and sufficient in its magnitude'. While this is reasonable in principle, the interpretation of these standards could vary significantly, allowing entry defences in either a wide variety of situations or only in very rare cases. ICC believes the use of the term "very easy entry" in paragraph 8 is misguided and the language therein should be precise and made consistent with the standard as set forth in Part V of the Draft Notice. It would be desirable for the Commission to give further guidance on the circumstances under which, in practice, such arguments are likely to be successful.

The Entry section makes repeated use of the phrase "magnitude and scope" in describing the necessary sufficiency of the entry. The terms, however, are not defined and are vague in the context in which they are used. For example, in paragraph 79, the Draft Notice states that "entry must be shown to be likely, timely and sufficient in its magnitude and scope to prevent the potential anticompetitive effects of the merger." It is not clear what "magnitude and scope" mean in this context and, indeed, the description would benefit from their omission. The real issue is whether the entry is "sufficient to prevent the potential anticompetitive effects of the merger," as would be made clear from striking those terms.

Although ICC recognizes that what could constitute a reasonable period for entry may vary based on the nature of the market, clarification of the requirement for "timely" entry would help ensure that considerations of entry into a market are meaningful. The focus on entry should not necessarily be on whether entry is successful or whether it covers the entire market, but rather on the potential for entry and the likely effects of that on pricing. Even unsuccessful entry - particularly where barriers are low - can discipline pricing.

In addition, the section on bidding markets would benefit from further elaboration to provide clearer guidance.

9. The introduction of a failing firm defence

ICC also welcomes the Commission's consideration of a 'failing firm defence', which had not been explicitly covered previously by European legislation (as it is in the United States Horizontal Merger Guidelines).

The stated requirements for a 'failing firm defence' to be considered are fairly standard (that the failing firm would be forced out the market in the near future, that there is no less anti-competitive purchase

to the proposed merger, and that the assets of the failing firm would inevitably exit the market if the merger does not take place). However, ICC hopes that the Commission will adopt a pragmatic approach to this assessment in specific cases, carefully considering the counterfactual: what exactly is likely to happen to the assets of the failing firm if the merger does not go through? Would they be dispersed or could they be used to facilitate entry? In the recent Andersen case, the Commission has indeed demonstrated that it is willing to consider what the market would have looked like if the merger did not take place (and not merely what it looked like pre-merger), and has explicitly taken into account that Andersen could not survive as a stand-alone presence.

10. Conclusions

The Draft Notice makes a useful contr ibution to clarifying how the Commission will treat horizontal mergers. It contains a useful exposition of the underlying principles, and adopts, with the very notable exception of the section concerning "paramount market position", a mainstream, uncontroversial economic approach to most of the issues being discussed. An important concept added is the framework by which the Commission will examine "unilateral effects" (that otherwise might not to be captured under the established notion of "single firm dominance"). It also usefully spells out in some detail the mechanisms underlying concerns of coordinated behaviour.

However, while the conceptual approach generally is sound, the Draft Notice is still somewhat short of practical answers on the appropriate use of evidence in such cases (as highlighted most dramatically by the CFI's recent analysis of a number of few Commission decisions). The real issue is how these principles should be made operational, and the quality of future implementation. ICC hopes that the consultation process can garner further guidance in this area.

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Footnote
(1) However, see the following extract from address of Deputy Assistant Attorney General William Kolasky , May 17, 2002:
"There is a widespread perception, for example, that in the United States we apply a so-called 'consumer welfare' test, which takes into account only those efficiencies that are likely to be passed on to consumers in the form of lower prices. . . In practice, our test is less of a pure 'consumer welfare' test than is generally thought. While we give greater weight to those efficiencies that will be passed on to consumers through lower prices in the near term, footnote 37 to the Guidelines, which was added as part of the 1997 revisions, makes it clear that we 'also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices' where we think those efficiencies will ultimately redound to society's benefit."