

ECONOMICS OF MERGER CONTROL

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The last year witnessed a lively debate, still ongoing, on the merits of allowing or blocking mergers in the EU which would substantially modify the competitive landscape, most notably in terms of the nationality of big and powerful firms. In such a context it comes as no surprise that economic arguments interact with politics – where the latter acquires importance when national governments are eager to see the creation of ‘champions’ of their own, able to compete effectively in global markets, and at the same time seem wary of allowing the control of strategic goods and services supplied in their territories, particularly those in regulated sectors, to end up in foreign hands. The past year has provided some classic case studies in this area of policy.

Economics of merger control

The economics of merger control relate to the rationale of ex ante policy interventions fostering competition. By ex ante we mean that preventing a merger is typically based on the idea that competition would be hampered, to the detriment of consumers and overall social welfare, if the market structure were changed in the way resulting from the merger. Such interventions are a complement to remedies which, regarding the presence of an existing market structure, are based on the observation that competition is not taking place in ways which would benefit society. In lay terms the philosophy of merger control is that prevention is better than cure. That puts great weight on the quality of the assessment of future economic developments.

The economic literature distinguishes between unilateral and coordinated effects of mergers. Unilateral effects stem from the direct impact on market structures: the merger reduces the number of players, overall quantity falls and prices increase. While taking into account the distributive aspect (more profits at the expense of consumers) is contentious, there is an inefficiency effect linked to the fact that some mutually advantageous transactions do not take place when prices are set at a higher

level than marginal costs. These effects are referred to as the deadweight loss from market power and reduction in social welfare and may be reinforced by mergers affecting prices and quantities in the way described. Avoiding or limiting these economic effects provides legitimacy for policy interventions.

‘Cournot’ competition is one of the descriptions of the market most commonly used when highlighting unilateral effects of mergers. The idea is that firms decide upon the quantities to bring to the market and then prices are set so that, with the existing demand function, the market clears – that is all goods are sold at the same price. The higher the number of firms, the higher the quantity and the lower the market price. The appeal of the Cournot model is based on its simplicity and was further reinforced by the Kreps and Scheinkman proof that competition where firms set capacities first and then compete on prices leads (under appropriate assumptions) to the same results as under the Cournot model. (See D Kreps and J Scheinkman, ‘Quantity Precommitment and Bertrand Competition Yield Cournot Outcomes’, *Bell Journal of Economics*, 14 (1983) 326-37.)

Coordinated effects relate to the increased likelihood of collusion following the merger. In this case the analysis relies on how the reduction in number of players facilitates practices (information exchange on pricing policies, reciprocal control and punishment and so forth), which would allow sustained collusion. Analysis of coordinated effects in mergers has been a contentious area of EC merger policy. Commission decision taking has been strongly criticised by the Court of First Instance, most notably in the *Airtours* judgment in 2002 but again in 2006 in the judgment in the *Sony/Bertelsmann* case.

Those effects need to be put into the appropriate context in which the merger would, if allowed, take place. For instance, the analysis of both unilateral and coordinated effects would be incomplete if it did not include the degree of “market contestability”, that is, the possibility

of new entry in the presence of high profits for existing market participants. In the absence of barriers to entry there is limited benefit from collusion and from the temporary reduction of market participants.

The assessment of those effects only constitutes one of the two pillars of the economics of merger control. Mergers may also lead to enhanced firm value via increased efficiency. This can come from different sources. The main potential for efficiency improvements lies in economies of scale and of scope by which the new, bigger firm may be more efficient in bringing goods and services into the market than the previous firms operating separately. Another aspect is linked to the ability of the new firm to engage in costly R&D activity leading to innovation, which obviously constitutes a paramount force behind economic progress and hence has an appealing flavour in building up arguments against blocking a merger.

Non-horizontal mergers are linked to other effects with respect to the vigour of competition. On one hand they can be seen as pro-competitive. Vertical mergers avoid the ‘double marginalisation’ phenomenon occurring when two separate firms operate at different stages in the supply chain. When they unite, complementarities are taken into account: the more one product is sold, the greater the demand for the other. However, there is a danger of competition foreclosure when the merged firm tries to extend market power at one level in the supply chain on the other level, for instance by limiting the availability of a necessary input to competing firms in the next level in the supply chain.

Similar reasoning applies to conglomerate mergers when they involve complementary products: the merged firm tends to expand production as it takes into account the positive externality effects linked to the demand for complements. Controversy surrounds the possibility that competition may be limited by creating, via non-horizontal mergers, financially powerful firms and the possibility of tying products. Both aspects came into the spotlight in the GE-Honeywell attempted merger, which was cleared by US authorities and later blocked by the EU Commission.

That ‘big is bad’ for competition is in most cases contentious, especially when not directly

linked to the possibility of abusive practices but rather to a higher ability to engage in fierce competition, which in general tends to benefit consumers. Predatory pricing, on the other hand, is based on the idea that consumers are going to be harmed later by prices set at a higher level than before the merger. That predation would come as a consequence of a merger is often dubious. The same holds for tying and bundling as a means to increase profits. The Court of First Instance, while upholding the Commission’s decision to block the GE-Honeywell merger mainly on the grounds of horizontal effects, found that bundling arguments issued by the Commission were vitiated by manifest errors.

EU competition rules

Articles 81 and 82 of the EC Treaty forbid collusion restricting competition and the abuse of a dominant position, respectively. As mentioned above, they constitute rules to be applied *ex post*, ie, to make corrections when markets are not operating in conditions of effective competition (keeping in mind the exception of temporary market power being allowed, eg, via patents, in order to reward innovation). The need to establish *ex ante* remedies to block mergers likely to result in hampering competition brought about the 1989 Merger Regulation 4064/89.

The 1989 Regulation stated that a concentration which would “create or strengthen a dominant position as a result of which competition would be significantly impeded” would be incompatible with the common market and hence should not be allowed. The new Regulation 139/2004 brought about a change in the formulation, where article 2.3 states that “a concentration which would significantly impede effective competition [...] in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market”. Hence the dominant position ceased to be a necessary element of a merger for it to be blocked, giving more latitude to the Commission in blocking mergers even though dominance does not appear; this is especially relevant for cases where unilateral effects are likely to reduce social welfare, while coordinated effects are typically related to the objective of sustaining joint dominance.

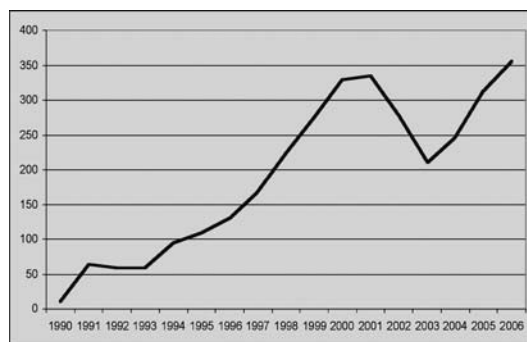
This change brought the test used in assessing EU level mergers more closely into line with

the test now used in both the US and the UK of significantly lessening competition.

Recent wave of cross-border mergers

This past year has seen a much increased wave of cross-border mergers within the European Union. In 2006, the European Commission received a record 356 cross-border merger notifications.

Figure 1: Number of notifications under Council Regulation 139/2004 (1990-2006)



Source: DG Competition, European Commission.

As shown in Figure 1, above, the number of notifications under the EC Merger Regulation has increased significantly from a recent low in 2003 and has now exceeded the previous peak in 2001.

The recent wave was spurred, among other factors, by unprecedented technological change in the realm of trading cost reduction, leading to market integration and the consequent need to be in a position to compete in a global arena.

Stronger competitive pressure from such integration has changed the fundamental features in banking, one of the sectors most affected by the recent merger waves. The spread of interest rates between deposit and loans is not any longer the main source of profits, which instead tend to come from the provision of services for investors and customers. In that respect, the ability to reach a critical mass of customers to sustain a well developed network of branches and the ability to invest in human capital has led to M&A processes leading to higher concentration in the banking sector.

Technological developments and market restructuring have been important drivers of mergers in the energy sector. The past few years have witnessed a process of convergence between gas and electricity, as the former is increasingly

used for electricity generation. Liberalisation of national markets and the prospect (not yet realised) of market integration across the EU have provided a spur for cross-border mergers. This has led to tensions between EU and national political objectives. Below we highlight how these tensions present themselves in the practice of merger control, with special focus on two recent cases.

ECONOMICS AND POLITICS: MERGER CONTROL IN PRACTICE

Merger control in the UK

In 2003 the UK introduced a new merger control system when the Enterprise Act 2002 came into effect. As commented on by Peter Freeman, then the deputy chairman of the UK Competition Commission:

The new regime sought to take politics out of merger control. The Government aimed to achieve this by enhancing the independence and status of the competition authorities and by giving them decision-making power subject to more specific judicial control. Building on the 1998 reforms, the aim was to provide powerful competition authorities, free from political interference, armed with a full range of powers. In merger control, the practice of the previous decade was made explicit with the adoption of a substantial lessening of competition (SLC) test. (See www.competition-commission.org.uk/our_role/speeches/pdf/freeman_nera_021004.pdf.)

Merger control in continental Europe

However, political issues have been very much at the forefront in some merger cases in other EU member states. It has also seen a number of cases in which national governments have tried to take protectionist measures, resulting in action by the European Commission.

Energy

The energy sector has provided the most high profile examples. However the same potential conflict between national and EU policies arises in other sectors. See, for example, the acquisition of the Italian toll road operator Autostrada by the Spanish company Abertis. This was cleared by the EC but was subject to subsequent conditions imposed by the Italian government.

The subject of national restrictions on the takeover of domestic firms came to the fore in the acquisition by E.ON, a large energy company

based in Germany, of the Spanish electricity operator Endesa.

E.ON's bid was launched in February 2006, in competition with an earlier bid for Endesa from the Spanish energy company Gas Natural. E.ON's proposed transaction was notified to the Commission in March, and in the following month the Commission approved the acquisition under the EU Merger Regulation on the grounds that the relevant gas and electricity markets are predominantly national in scope and the two parties had limited overlapping activities.

A few days after the Commission had approved the transaction, the Spanish Council of Ministers adopted an urgent legislative measure (Royal Decree Law 4/2006 of 24 February) which increased the supervisory powers of CNE, the Spanish energy regulatory. In particular, this law required CNE authorisation for the acquisition of over 10 per cent of share capital, or any other percentage giving significant influence, in a company that engages in regulated activities or activities subject to special administrative control. In July 2006, the CNE made use of these new powers to lay down a number of conditions for the *E.ON/Endesa* operation, including the divestiture of important assets.

The Commission responded to these developments by opening infringement proceedings, beginning with a "letter of formal notice" in May 2006 which requested Spain to provide information on the new law. The Commission took the view that the Spanish law granted the CNE wide discretionary powers and could unduly restrict the free movement of capital and the right of establishment under EU law.

Neelie Kroes, the European Commissioner in charge of competition policy, set out the Commission's position on cross-border mergers in a speech in September 2006. She stated that:

The reality of the Internal Market – not to mention the single currency – has [...] encouraged European undertakings to grow across national borders [...]

This is a welcome development, as cross-border mergers tend to be better for customers [...] than mergers between national players that would otherwise compete in the same national markets.

The vast majority of cross-border mergers have gone ahead without any interference from national governments. But in a small number of

well-publicised instances, direct or indirect steps have been taken by member states to prevent or frustrate cross-border mergers [...]

The EU's single market rules as well as article 21 of the EC Merger Regulation clearly ban unjustified measures taken by member states to prevent cross-border mergers of a European dimension. The Commission is determined to ensure that these rules are observed and respected in all cases.
(Speech/06/480 on cross-border mergers and energy markets.)

In September, the Commission formally asked Spain to modify the legislation in question. At the same time, it ruled that the CNE's decision which imposed conditions on E.ON's acquisition was in breach of article 21 of the EU Merger Regulation.

Three weeks later on 18 October, the Commission opened infringement proceedings against Spain for not lifting the conditions.

On 3 November 2006, the Spanish minister of industry, tourism and trade imposed modified conditions on the acquisition. However, on 20 December 2006, the Commission concluded that some of the modified conditions imposed still amounted to a violation of article 21 of the Merger Regulation and required that the Spanish government withdraw such conditions by 19 January 2007.

However, the Spanish government failed to inform the Commission of any measures it had taken to comply with the Commission's request of 20 December 2006. Therefore, on 31 January 2007, the Commission formally requested Spain to explain why it had not complied with the Commission's decisions (IP/07/116).

Unsatisfied with the replies from the Spanish government, in March 2007 the Commission formally requested Spain to comply with its decisions, thereby launching the second formal stage of infringement proceedings (IP/07/296).

Another high-profile example of national political involvement in the takeover of domestic firms is the proposed merger between Gaz de France (GdF), the state-owned incumbent gas operator in France which is active in other European countries, and Suez, a French utility firm operating in the gas, electricity, water, and environmental services sectors. The merger, engineered by the French government, was a response to rumours in late 2004 that Enel, an

Italian utility, might make a hostile offer for Suez.

The European Commission was concerned with the potential anti-competitive effects of the merger, especially on the gas and electricity markets in Belgium and France, and in June 2006 decided to open a detailed investigation under the EU Merger Regulation.

To address these concerns, GdF and Suez offered a package of remedies:

Most notably, Suez will divest Distrigaz (including its French activities) and relinquish control over Fluxys. GdF will in turn divest its shareholding in SPE and, to address the concerns in the district heating market, divest its subsidiary Cofathec Coriance. Furthermore, a series of investment projects will be carried out both in Belgium and in France with a view to increasing infrastructure capacities, thereby facilitating the entry of new competitors onto the market and fostering competition. Most notably, the functioning of the Zeebrugge hub will be enhanced through the creation of a single entry point linking all networks converging on Zeebrugge and through the operation of the hub by an independent operator, Fluxys, which will no longer be controlled by Suez. (IP/06/1558)

In November 2006, the Commission finally approved the proposed merger, subject to conditions. Competition Commissioner Neelie Kroes stated that:

The Commission has insisted on far-reaching remedies in this case so as to ensure effective competition in the Belgian and French energy markets. Our intervention in this case is part of our action to ensure that there is effective competition in the newly liberalised energy markets to the benefit of consumers and business. (IP/06/1558)

Energy Policy Commissioner Andris Piebalgs commented that:

This merger proves that the European Energy market is starting to become a reality. Nevertheless to make it work in an open and effective way, we still need to take concrete action, in both the competition and regulatory areas. The Commission will announce early next year a package of concrete measures to address the existing shortcomings, for the benefit of industry and consumers. (IP/06/1558)

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Europe Economics was established at the beginning of 1998 by Dermot Glynn. The current managing director is Andrew Lilico. They can be contacted on +44 (0) 20 7831 4717.

Merger activity remains high with a growing number of cross-border transactions. The EC merger regime has coped well with the high number of cases but it is still early days to assess the impact of the move to the significant impediment of competition test introduced in 2004.

Economic analysis remains at the heart of the Commission's merger policy but it continues to face challenges from the CFI. At the political level jurisdiction has been disputed between

Brussels and national governments. In some cases the Commission may be able to reach agreement based on concessions which help take forward its wider liberalisation agenda. In others protracted legal proceedings may follow. All parties appear to be willing to engage in 'economic engineering' in the name of broader aims.

The objective of increased policy certainty which led to the almost total removal of political intervention in UK merger decisions is clearly not an EU-wide aspiration.