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**The New European Regulation of Horizontal Mergers: Did it Have Any  
Practical Effect?**

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## 1. Introduction

On the 1 May, 2004, the new EC Merger Regulation<sup>1</sup> came into force and was expected to make the European system of Merger control more economically based and efficient. The former Merger Regulation<sup>2</sup>, although regarded as an advanced piece of legislation providing an effective tool to deal with the growing number of cross boarder mergers, during the last years of its life faced increasing criticism from academic and business society, which indicated the drawbacks of the merger control system. Finally, after the well publicized defeats of the European Commission before the Court of First Instance (the CFI), these drawbacks were seen as intolerable and requiring the reform of the Merger Control System.

In this paper, the practical impact of the merger reform will be analyzed. The attention will be focused on the horizontal mergers, i.e. mergers of the companies producing similar goods in the same level of production in the same industry. Further, the term “merger” will be used as a synonym of “concentration” within the meaning of the article 3 of the Council Regulation (EC) No 139/2004, the characterizing feature being a permanent change in control. Thus, in this paper no distinction will be made between mergers (fusions of two independent companies), acquisitions and creations of joint ventures performing on a lasting basis all the functions of an autonomous economic entity.

In order to assess the practical effect of the New Merger Regulation, the following preparatory steps shall be taken. In the next part of this paper the insight of the economic

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<sup>1</sup> Council Regulation (EC) No. 139/2004 on the Control of Concentrations between Undertakings, 2004 O.J. (L 24) 1;

<sup>2</sup> Council Regulation (EEC) No. 4064/89/EEC (21 December 1989) OJ 1989 L 395;

theory on the welfare effects of mergers will be presented. This will help to understand the rationale behind the regulation of horizontal mergers and serve as a useful background to the discussion of the reform. Next, the former Merger Regulation will be presented briefly and its main drawbacks will be discussed with the focus on the substantive issues. Then the reform will be discussed and the main changes brought by the New Merger Regulation will be outlined. Finally, the practical impact of the New Regulation will be assessed, providing the examples from the Commission's case law under the new Regulation. The conclusion will summarize the findings of this paper.

## **2. Economic reasoning of merger control**

There is extensive economic literature, dedicated to the analysis of the economic effects of horizontal mergers. Despite the variety of the approaches taken by the authors, most of the economists agree, that in certain circumstances horizontal mergers may be harmful to the social welfare. Economic theory distinguishes two main groups of the detrimental effects of horizontal mergers: so-called *unilateral* (non-coordinated) effects and *coordinated* effects.

The unilateral effects of mergers comprise the situations, whereby a merged firm can find it profitable to raise the price unilaterally after the merger as a result of increase in its market power<sup>3</sup>. A merger is said to result in coordinated effects when it is likely to facilitate the collusion in the market. In the latter case, a merger affects the conditions in the market in such way, the incentives of the market players to collude increase, and, as a

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<sup>3</sup> Motta, M., (2000), p. 231;

result, the prices rise to the higher level than the merged firm would be able to attain unilaterally<sup>4</sup>.

Although sometimes it is hard to distinguish between the two mentioned types of mergers' impact<sup>5</sup>, and the distinction might seem to be only of theoretical, rather than practical, significance, it is important to understand the difference between them, since, as discussed later in this paper, such understanding might be crucial in dealing with real world cases and determine the outcome of the case. As summarized by Van den Bergh and Camesasca, the difference between the mentioned two types of oligopolistic behavior (i.e. unilateral effects and coordinated effects) lies "in the way the firms involved take into account their competitors' behavior. Non-coordinated effects are the form of individual rivalry, implying that firms will take their competitors' behavior as a given. <...> Coordinated effects have as a necessary condition that firms act with the intention of influencing the future actions of their competitors."<sup>6</sup>

Both coordinated and not coordinated effects manifest themselves in likely reduction of consumers' surplus as well as total social welfare, and it is the main reason why the regulators on the national and on European Union level are concerned with merger activity of private firms<sup>7</sup>. In what follows, the mechanism of the unilateral and coordinated effects will be discussed briefly.

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<sup>4</sup> *Ibid.*;

<sup>5</sup> Van den Bergh, R. J., Camesasca, P., (2006), p. 365;

<sup>6</sup> *Ibid.*, p. 365;

<sup>7</sup> Promotion of allocative efficiency and protection of the consumer's welfare are seen as the main goals of European competition policy and law. For overview see Van den Bergh, R. J., Camesasca P. (2006), p. 29-53;

## 2.1. Unilateral Effects of Horizontal Mergers

The ability of a merged firm to unilaterally increase the market price is explained through the changes in the market structure and the market power of the incumbent firms after the merger. When there are several independent and competing firms in the market, the ability of each of them to exercise increase in price is limited, because any such increase would usually induce their customers to switch to the products of the competitors, which offer lower price. A horizontal merger changes the market structure, since it by definition reduces the number of competing firms at least by one. As a result, the market power of the insiders, i.e. merging firms, increases after the merger<sup>8</sup>, which leads to the price increase by the newly created firm.

It should be noted, that some economic models assume price to be decision variable of the firms (Bertrand competition), while the other assume that the firms react to the output of their competitors (Cournot competition)<sup>9</sup>. When the firms in the market react to the price of their competitors, presence of a close substitute to the merging firm's product will be the crucial factor in evaluating the competitive conditions in the market. When the firms choose output, number of the competitors will be important in addition to the substitutability of the products. Despite the difference of these two models, their common prediction is that absent efficiency gains, mergers reduce the consumer surplus<sup>10</sup>.

As regards producers, the theory largely agrees that the insiders' (i.e. merging firms') profits will increase as result of the merger. That is, the profit of the newly created

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<sup>8</sup> Motta, M. (2004) illustrates this effect by example of merging grocery stores: "A contemporaneous increase in the price of each product by the merged stores would be profitable, because the number of rival stores is reduced. Consumers would have to travel higher distances to find a store with lower prices, and many of them would shop at their usual store despite higher prices";

<sup>9</sup> Van den Bergh, R. J., Camesasca, P., (2006), p. 366;

<sup>10</sup>Motta, M., (2000), p. 3;

firm will be higher than the sum of the profits of the merging firms before the merger<sup>11</sup>. The mechanism is quite intuitive: if two products are substitutes, raising the price of one product induces consumers to buy more of the other product. If after the merger both products are produced by one firm, the threat of losing customers to the rival due to increase in price is reduced, and, as a result, the new firm has higher incentives to increase the price (or reduce the output) than the firms before the merger<sup>12</sup>.

It is interesting to note, that in the absence of the efficiency gains from mergers, mergers are beneficial not only to the insiders, but also to the outsiders, i.e. the firms not participating in the merger. The impact on the outsiders will depend on the type of the competition (Bertrand or Cournot). If the firms react to the price set by their competitor, the price increase by the newly created firm will lead the outsiders to increase their price. If the firms react to the output choice of their competitors, reduction of output by the merged firm will cause an increase of output by the non-cooperating outsiders<sup>13</sup>. In both cases the outsiders benefit from the merger, and their gain might be even higher than that of the insiders<sup>14</sup>.

The increase of the market power due to the merger depends on number of factors:

**Concentration:** the higher is the market concentration, the greater will be the ability of the merged firm to increase the price<sup>15</sup>.

**Market Shares:** the lower is the market share of the insiders and the higher is the market share of the outsiders, the less negative effect the merger will have on social welfare<sup>16</sup>.

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<sup>11</sup> However, as described by Stephen Salant, Sheldon Switzer and Robert J. Reynolds (1983), under number of restrictive assumptions, a merger may result in lower profit by insiders;

<sup>12</sup> Van den Bergh, R. J., Camesasca, P., (2006), p. 367;

<sup>13</sup> Ivaldi *et al.*, (2003), p.48; Salant S., Switzer, S., Reynolds, R. J., (1983), p.189;

<sup>14</sup> Motta, M. (2004), p. 234;

<sup>15</sup> *Ibid.*, p. 236;

**Potential Entry:** the higher mark-ups resulting from the merger may attract potential entrants into the industry, which found it unprofitable to enter before the merger. Potential entry will reduce the ability of the merged firm to exercise market power and increase price. Existence of potential entrants, entry barriers, as well as the time needed to accomplish the entry, will be important in assessing the possibility of the entry by new competitors<sup>17</sup>.

Among the other factors affecting the impact of the merger on the social welfare, the following should be mentioned: **demand elasticity** (low demand elasticity implies higher market power), **buyer power** (strong buyers limit the freedom of sellers to increase the price), **presence of a failing firm** between the merging parties (in the latter case the gravity of the negative effects of the merger is compared with the situation where the merger would not take place and the failing firm would be allowed to fall.).

To sum up, as the result of unilateral effects described above, mergers cause decrease in consumer surplus, but increase producer surplus. However, the harm to the consumers exceeds gain to the producer, because due to the prices higher than marginal costs, some socially beneficial transactions do not take place. Therefore, the overall social effect of such mergers is detrimental.

It is important to note here, that for mergers to have negative social welfare effect, the merging firms do not need to be dominant neither pre merger, nor post merger. Although, as mentioned above, big market share of the insiders might exacerbate the loss brought by merger, the merged firm will have incentives to increase its price even if the merger does not result in dominant position.<sup>18</sup>

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<sup>16</sup> Farrell, J., Shapiro, C.,(1990), p. 119;

<sup>17</sup> Motta, M., (2004),p. 237;

<sup>18</sup> Motta, M., (2000), p. 4;

## 2.2. Coordinated Effects.

The concept of coordinated effects refers to the changes in the industry, caused by a merger, facilitating a collusion of market players, which would not take place without the merger<sup>19</sup>. In this case, the merged firm would not be able to increase the price unilaterally, but the price increase is caused through collusion with the outsiders<sup>20</sup>.

The collusion is facilitated by the merger's intrinsic impact on the structure of the industry, i.e. reducing of the number of competitors. It is recognized in economic theory, that the collusion is more likely in the industry with low number of players<sup>21</sup>. Another structural change, which can be caused by merger – increase in the symmetry of market shares is also a facilitating factor for collusion<sup>22</sup>.

However, mergers will not necessarily lead to collusion, even in concentrated markets. For collusion to be sustainable, adhering to the collusive strategy for individual players should be more profitable than deviating from it<sup>23</sup>. In many cases, for individual firms, at least in a short run, it may be more profitable to deviate from collusive behavior (e.g. pricing higher than marginal costs) thus reaping more profit for the detriment of the other (colluding) market players.

In the terminology of game theory, firms, taking decision whether to choose competitive or collusive course of actions face “prisoners’ dilemma”. The following example demonstrates the fragility of the collusive outcome. Assume there are two competing firms in the market (let’s call them “A” and “B”) and each of them has to decide independently whether to cooperate with their competitor or not. Assume further, that there

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<sup>19</sup> Green, J., Staffiero, G., (2007), p. 8;

<sup>20</sup> Stirati, G., (2004), p. 257;

<sup>21</sup> Motta, M., (2004), p. 251;

<sup>22</sup> *Ibid*, p. 251;

<sup>23</sup> Van den Bergh, R. J., Camesasca P., (2006), p. 367;

is no mechanism available to the firms to make their commitment credible. The payoffs from the alternative courses of action are illustrated in table 1. If the firms do not cooperate – each of them will earn 2 and their joint profit will be equal 4. If they decide to cooperate, their individual and joint payoffs will be higher than in competitive strategy: each of them will earn 3 and total profit will be 6. However, it is even more profitable for each of them individually to deviate from the cooperative behavior (e.g. decrease price or increase outcome) given that the other player sticks to cooperative strategy (in this case the cheating firm earns 4, and the “victim” of cheating – only 1).

**Table 1.**

		<b>Firm B</b>	
		Cooperate	Cheat
<b>Firm A</b>	Cooperate	3;3	1;4
	Not cooperate	4;1	2;2

In such game non-cooperation is a dominant strategy: given the behavior of the other player it yields a higher payoff for both firms. Thus, in the equilibrium both firms will not cooperate (the bottom right cell of the table). As mentioned above, such outcome on overall is less profitable than the cooperative outcome, but for reaching the latter, additional conditions are needed in order to provide incentives for the individual firms to cooperate<sup>24</sup>.

For the cooperation to be sustainable, it is crucial, that the market players are able to monitor the behavior of their competitors and react promptly to any detected deviation

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<sup>24</sup> Van den Bergh, R. J., Camesasca P., (2006), p. 158-159;

from the cooperative behavior. In addition, the retaliation measures have to be severe enough to effectively discourage such deviations<sup>25</sup>.

A popular example of a device for monitoring adherence to collusive behavior, often mentioned in economic literature, is so-called “meeting competition” clause<sup>26</sup>. This clause guarantees, that if a buyer finds a price which is lower than the one offered by the seller, the seller will match such a price. Such a clause helps the firms to detect any price reductions by their competitors and retaliate against the deviator.

Another factor, which facilitates detecting deviations from cooperative behavior, is repeated interaction. It is understandable, since the larger is the number of contacts with the competitor, the easier is the monitoring and understanding of his strategy.

Retaliation would usually take form of underpricing and increasing the output, so that the non-cooperating firm loses his collusive profits in the long run<sup>27</sup>. It is important that the expected loss from the “punishment” for the deviator is greater than his profits from the deviation. Therefore, timely reaction is crucial, since if the deviation is undetected and unpunished for a long period of time, the available punishment will less likely to be severe enough to secure cooperation. Another problem with punishment is that often punishment is costly also for the retaliating firms<sup>28</sup>. Indeed, they will have to deviate from collusive pricing and/or output themselves, thus losing part of their collusive profits.

Nevertheless, if determination to punish the deviators severely is demonstrated in convincing way, coordination may be achieved. Multi – market contacts are often cited as a device making securing of the collusion (and even enforcing of cartels) easier. For

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<sup>25</sup> Van den Bergh, R. J., Camesasca P., (2006), p. 161; Recently these conditions were explicitly recognized as necessary for collective dominance to take place by the CFI and the Commission;

<sup>26</sup> *Ibid.*, p. 166;

<sup>27</sup> *Ibid.*, p. 167;.

<sup>28</sup> *Ibid.*, p. 167;

example<sup>29</sup>, if there are very two similar firms (A and B), active in two distinct markets, A holding 30 % share at the first market and 70% of the second market and B holding 70 % share at the first market and 30 % at the second market, the fact that the firms contact in several markets facilitates collusion. In the isolated market the collusion would be unlikely occur, since the asymmetry is too strong, but the asymmetry is removed through multi-market contacts, and firms, planning their actions will take into account reaction of their competitors in the both markets.

In the extensive study, conducted for the European Commission, a group of well-known economists summarized the necessary condition as follows: “Tacit collusion can arise when firms interact repeatedly. They may then be able to maintain higher prices by tacitly agreeing that any deviation from the collusive path would trigger some retaliation. For being sustainable, retaliation must be sufficiently likely and costly to outweigh the short-term benefits from “cheating” on the collusive path. These short-term benefits, as well as the magnitude and likelihood of retaliation, depend in turn on the characteristics of the industry”<sup>30</sup>.

The study provides a broad exemplary list of market characteristics, which may affect the likelihood of collusion:

- a) number of competitors;
- b) entry barriers;
- c) frequency of interaction;
- d) market shares;
- e) market transparency;
- f) demand growth;

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<sup>29</sup> The example is provided in Motta, M., (2004), p. 149;

<sup>30</sup> Ivaldi *et al.*, (2003a),. p. 5;

- g) importance of innovation;
- h) costs asymmetries;
- i) product differentiation;
- j) multi-market contact;
- k) demand elasticity.

The mentioned factors represent the different ways in which the collusion will be affected – through increasing or reducing expected payoff from collusion and deviation, effectiveness of monitoring and speed of detection. For instance, low entry barriers make collusion less sustainable, since the outsiders, attracted by increased margin caused by the coordinated behavior, will engage in hit-and run strategy and reap away the benefits of the collusion from the cooperating firms<sup>31</sup>. Symmetry of the firms, i.e. similar cost functions, product characteristics and market shares, facilitate coordination among rival firms. Therefore, the mergers leading to increased symmetry raise more concern about potential collusion<sup>32</sup>.

In addition, when assessing sustainability of collusion, it is important to evaluate how much value the firms involved attach to the present earnings versus the future earnings<sup>33</sup>. If the discount factor is not high enough, i.e. if the present earnings are much more valuable than the future profits of the firm, the threat of punishment will be unlikely to deter the firm from cheating in order to get higher short-term profits, which will make cooperation unstable<sup>34</sup>.

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<sup>31</sup> Ivaldi *et al.*, (2003a), p. 16;

<sup>32</sup> *Ibid.*, p. 35-45;

<sup>33</sup> *Ibid.*, p. 8;

<sup>34</sup> Simple example will help to understand the role of discounting: if the discount factor  $(1/1+R)$  is low enough, i.e.  $R$  (interest rate) is high, the firm would find it more profitable to get higher profit today and invest it, rather than wait for higher profit in the future from adhering to the cooperative strategy.

The analysis above demonstrates, that the factors which determine, whether the merger will lead to tacit collusion or not, are numerous. Therefore, it is important to take into account all of them when predicting the effects of a merger. Only if the factors are likely to induce firms to collude (e.g. by increasing the transparency of the market, providing effective punishment mechanism), and thus overcome inherent instability of collusive outcome, could the merger be seen as raising concerns of collective dominance<sup>35</sup>.

### **2.3. Economic Benefits Brought by Horizontal Mergers**

Horizontal mergers can result not only in welfare losses. Economic theory points out, that mergers can bring also economic gains to the society. Indeed, it would be premature to think that harming consumers and transferring the welfare from consumers to the producers is the only aim of merging firms. Frequently, and probably most often, there are also other motives behind the decision to merge two or more competing firms.

First of all, economic literature suggests, that mergers can make the production of the insiders more efficient by reducing their unit costs<sup>36</sup>. This is so, because the merged unit will often enjoy economies of scale and economies of scope. For example, the merger can allow the insiders to save on transportation costs or organize their production more efficiently<sup>37</sup>.

Another source of efficiency improvements is the greater ability of the merged, and hence bigger, firm to invest in expensive R&D, which, in turn, can lead to creating a

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<sup>35</sup> For more detailed description of how the described factors affect cooperation, see Ivaldi *et. al.*,(2003a), pp. 11-67, also Motta, M. (2004), pp. 142-166;

<sup>36</sup> Motta M., (2004), p. 238;

<sup>37</sup> *Ibid.*, p. 240;

product of better quality or drastic reduction in costs of creating the same product<sup>38</sup>. Further, mergers can result in learning effects, due to accumulated experience of the merging firms or diffusion of know-how within a newly created firm<sup>39</sup>.

Finally, merger might reduce cost of capital of the merging firms. This effect is likely where the capital markets are imperfect and smaller firms have to pay higher costs for financing (for example banks charge higher interest rates for small firms assuming their higher risk of default)<sup>40</sup>.

The beneficial effects of a merger sometimes can outweigh its anticompetitive effects. Oliver Williamson in 1969 published a very influential paper, where he drew the attention to the trade-offs of the merger effects<sup>41</sup>. In this paper, he described two usual effects of a merger: price increase due to increased market power, and decrease in costs due to economies of scale. Increase in price leads to deadweight loss, because some part of the consumers will not buy the product anymore<sup>42</sup>. However, there are also costs savings from the merger, which should also be taken into account when appraising the welfare effects of the merger. According to Williamson, “for the net allocative effects to be negative, a merger which yields non-trivial economies must produce substantial market power and result in relatively large price increases”<sup>43</sup>. Williamson’s model, despite the difficulties in its straightforward application in practice<sup>44</sup>, clearly demonstrates the task lying before the antitrust authorities in their exercise of appraisal the merger’s economic effects: both

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<sup>38</sup> Green, J., Staffiero, G., (2007), p. 9;

<sup>39</sup> Stirati, G., (2004), p. 265;

<sup>40</sup> *Ibid.*, p. 266;

<sup>41</sup> Williamson, O. E., (1968);

<sup>42</sup> See graph 1 (Annex 1);

<sup>43</sup> Van den Bergh, R. J., Camesasca P., (2006), p.33;

<sup>44</sup> Van den Bergh, R. J. and Camesasca., P., (2006) summarize the main practical problems with this model, which are: 1) difficulties in determining the elasticity of demand and quantifying internal costs savings of the merging firms, 2) ignoring the dynamic character of the competition; 3) assuming increase in price as a prerequisite for opposing a concentration.;

positive and negative effects of the merger should be taken into account in order to get the full picture of the merger's impact.

After Williamson, there has been a number of works analyzing efficiencies brought by mergers and under which circumstances the efficiencies should allow the merger to go on. Most of the papers took account of "consumer standard" usually applied by antitrust authorities and analyzed under which conditions merger can satisfy this standard.<sup>45</sup> Although applicability of the models in real life is still problematic, for example due to restrictive assumptions or informational problems, some of them provided very important insights into merger analysis.

For example, Farrell and Shapiro in their model show, that merger will result in the increase in price, if it does not bring synergies. For merger to reduce price, "impressive synergies" are needed if the market share of the insiders is high. The analysis of Farrell and Shapiro is interesting, because they focus their attention on the external effect of the merger, i.e. the impact on the welfare of the consumers and non-merging firms. This is more convenient way of analysis, because it requires much less information than assessing the overall effect. The model of Farrell and Shapiro does not require to evaluate the cost savings of the insiders which are "easy to promise, yet, maybe difficult to deliver"<sup>46</sup>. Analyzing the reaction of the competitors to the merger, the authors draw predictions on when the merger will increase or decrease social welfare. If, as a result of the merger, the competitors reduce their output, the social welfare will most probably be

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<sup>45</sup>Consumer standard requires that the merger does not make consumers worse off, i.e. does not cause price increase or quality reduction;

<sup>46</sup> Farrell, J., Shapiro, C.,(1990), p. 109;

lowered. If, instead, the reaction of the outsiders will be to increase their output, the merger will be welfare-enhancing<sup>47</sup>.

Werden analyzed the consequences of mergers in the markets with differentiated goods under Bertrand price competition<sup>48</sup>. He provided a robust method to determine if the consumer welfare is decreased by merger<sup>49</sup> and found that the cost reduction needed to offset the anticompetitive effects of such mergers will depend on pre-merger prices, diversion ratios among products and profit margins. He concluded, that “if the products are highly differentiated and the merging firms compete intensively large, typically implausible cost reductions are necessary to restore pre-merger prices”<sup>50</sup>.

A more detailed discussion of the studies dedicated to efficiency gains brought by mergers would go beyond the scope of this paper<sup>51</sup>. Here, however, it would be appropriate to note several points which should be kept in mind when thinking about the effects of a particular merger:

1) First of all, one should clearly understand the welfare standard we are weighting the effects of the merger against, i.e. whether we are aiming to avoid reduction in overall social welfare or reduction of consumer welfare<sup>52</sup>. While economic theory suggests that total welfare standard can often be satisfied if the merger results in efficiency gains<sup>53</sup>, it

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<sup>47</sup> Farrell, J., Shapiro, C., (1990), p. 111-119;

<sup>48</sup> G.J. Werden, (1996), cited in Van den Bergh, R. J., Camesasca P., (2006), p. 35;

<sup>49</sup> Under this model needed cost reductions are calculated without making any assumptions about demand.

<sup>50</sup> G.J. Werden, (1996), cited in Van den Bergh, R. J., Camesasca P., (2006), p. 35; See also Van den Bergh, R. J., Camesasca P., (2006), p. 374.

<sup>51</sup> A compact overview of the most influential models and their findings is provided in Lin Bian, McFetridge D. G., (2000), pp.302-304;

<sup>52</sup> Besides the two mentioned standards, one can apply so-called weighted surplus standard, where more weight is attributed to consumer surplus than to producer profits. Formally, this standard is satisfied if:  $\Delta CS \leq \Delta \Pi \times \mu$ , where  $0 < \mu < 1$ ; Lin Bian, McFetridge D. G., (2000) also describe an alternative standard, so-called Hillsdown standard, which is satisfied if the sum of cost savings realized by the producers (including both insiders and outsiders) is equal to or greater than the absolute value of change in consumer surplus (see Lin Bian, McFetridge D. G., (2000), pp. 309-312);

<sup>53</sup> See, for example, Williamson, O. E., (1968), Lin Bian, D.G. Lin Bian, McFetridge D. G., (2000);

also tells us that if the consumer welfare (Pareto efficiency) standard is taken as a standpoint, majority of mergers will not meet it despite efficiency savings<sup>54</sup>.

2) Second, to get a full picture of the impact of a merger on social welfare, one should distinguish three main groups affected by mergers: *insiders*, i.e. the merging firms, *outsiders*, i.e. rivals of the merging firms, who do not participate in the merger, and *consumers*.

3) Finally, one should understand the source of the change in welfare and the mechanism which increases or reduces the welfare of one or another group mentioned above.

For example, if a merger results in unilateral effects, i.e. increased market power of the merged firm allows it to raise price above marginal costs, the insiders clearly gain from such a merger<sup>55</sup>. At the same time, consumers suffer a loss, part of their surplus being transferred to the producers (i.e. neutral result from total welfare point of view) and another part ending up as a deadweight loss (and thus being the loss also from total welfare point of view). Outsiders usually would also gain from such a merger (absent efficiency gains), because if the firms compete in price, the outsiders would follow the price increase by insiders and increase their own price. If the market is characterized by Cournot quantity competition, the outsiders would increase their output following the subtraction of output by insiders and would also be better off. It should be noted, that in the latter case, the negative welfare effect caused by reducing of output by the insiders is attenuated through increased outsiders' output<sup>56</sup>.

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<sup>54</sup> Van den Bergh, R. J., Camesasca P., (2006), p. 35;

<sup>55</sup> However, see Salant, S., Switzer, S., Reynolds, R., (1983), p. 189, where they demonstrate the possibility of decrease in insiders' profit as result of merger;

<sup>56</sup> Van den Bergh, R. J., Camesasca P., (2006), p. 367;

If a merger results in coordinated effects, i.e. if it induces the producers to collude post merger, both insiders and outsiders gain from such a merger (thus, total producer surplus increases significantly) and the consumers are worse off (because of the increased prices or reduced output).

Mechanism of efficiency gains' impact on social welfare is interesting. First of all, efficiency gains are additional source of profits to the insiders (since their costs are reduced). Thus, in this sense efficiency gains increase social welfare. Besides, significant cost reductions may make it optimal for insiders to reduce price in order to maximize profits. In this case also consumers are better off as a result of the merger. At the same time, if the costs are reduced significantly, typically the outsiders will suffer from such a merger (and thus oppose it) – indeed, improved competitive position of the insiders will reduce outsiders' profits<sup>57</sup>. In addition, increased competitive power of the insiders due to the reduced costs make collusion less likely (which is beneficial for the society). On the other hand, the synergies which bring symmetry to the market may facilitate collusion (and thus have detrimental effects<sup>58</sup>).

Finally, some authors stress the spill-over effects of efficiency gains: the competitors of the merged firm may replicate the cost savings to some extent (this can happen, for example due to limited breadth of patent protection)<sup>59</sup>. This effect will usually reduce profits of the insiders and increase the profits of the outsiders. Consumers will usually benefit as a result of such replication because the competition will be intensified and the merged firm will be precluded from gaining large market power.

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<sup>57</sup> Motta, M., (2004), p. 251;

<sup>58</sup> *Ibid.*, p. 252;

<sup>59</sup> Lin Bian, McFetridge D. G., (2000), pp. 299-300;

To summarize, the effects of the merger are not always unambiguous. Reduction in welfare of one social group usually implies increase of other groups' welfare. The merger resulting in large efficiency gains depending on market characteristics may be beneficial to consumers and society as the whole. Thus, "big" is not always "bad" for the competition, especially if merger leads to more intensive competition thus which usually reduces price, increases quality and makes the consumers better off<sup>60</sup>. As mentioned above, one should keep in mind all the interacting (and counteracting) mechanisms launched by merger, in order to make conclusion about its social desirability. Economic theory provides valuable insights and tools to perform such analysis.

#### **2.4. Limits of the Economic Models**

As described above, economic theory provides arguments for regulatory intervention into merger activity. It also provides numerous tools to appraise the social effects of mergers. However, we should not be too optimistic about economists' ability to perfectly predict the effects of a particular merger. Things become much more complicated when likely effects of a real-life merger have to be assessed.

For example, if we look at the basic Williamsonian model, mentioned above, despite its analytical elegance and simplicity, numerous difficulties of its practical application were acknowledged in economic literature<sup>61</sup>. Williamsonian tradeoff depends on elasticity of demand which is usually hard to estimate precisely in practice. Besides, the costs savings claimed by parties to a merger are usually impossible to quantify ex-ante. Thus, exact volume of the changes in the welfare of consumers or producers will usually

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<sup>60</sup> Green, J., Staffiero, G., (2007);

<sup>61</sup> Van den Bergh, R. J., Camesasca P., (2006), p. 33;

not be determined in real life cases. Similarly, most of the other models are based on assumptions which most often do not fully hold in real life cases<sup>62</sup>.

As regards coordinated effects, things are even more complicated. Above we listed a number of factors which affect the likelihood of collusion. However, it is very difficult to assess, to which extent these factors will lead to collusion in a particular case. Despite the problem of measuring each of the factors in a robust way, it is not clear how these factors will interact in a particular case. There exist no clear-cut rule on how to weight these factors, and it is clear that in most of the real life cases not all of them will act in one direction.<sup>63</sup> As Ivaldi *et al.* summarized in their study of coordinated effects: “While economic theory provides many insights on the nature of tacitly collusive conducts, it says little on how a particular industry will or will not coordinate on a collusive equilibrium, and on which one”<sup>64</sup>.

Finally, though it is agreed that mergers often will result in efficiency gains, there is no clear way how these efficiencies can be quantified in order to compare them with welfare losses (precise magnitude of which will be usually also vague). This is especially true, when the efficiencies which are had in mind arise not from simple economies of scale, but from increased R&D activity, or learning effects of the merger.

The problem is escalated by ex-ante character of merger control. That is, when taking the decision whether to allow a merger, an antitrust authority has to predict the effects of a merger which has not taken place yet. Thus, in practice we might never find out with certainty whether a decision to allow or block a merger was absolutely right: the fact

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<sup>62</sup> Van den Bergh, R. J., Camesasca P., (2006), p. 372;

<sup>63</sup> Motta, M., (2004), p. 251;

<sup>64</sup>Ivaldi *et al.*, (2003a),p. 6;

that merger *could* bring certain anti-competitive or pro-competitive effects does not always mean that it *will* entail such effects<sup>65</sup>.

The decision will often be largely based on the information provided by the interested parties, which further aggravates informational problems. The insiders will usually tend to exaggerate the competitive effects of the merger. On the other hand, the competitors may try to create obstacles to a merger which will decrease their profits, although it increases consumer surplus, therefore, they will tend to exaggerate detrimental effects of the merger<sup>66</sup>.

These theoretical difficulties naturally cause many problems in practice, especially having in mind that a decision on whether to allow a merger or not is a binding legal decision, which affects rights and duties of numerous parties. Consequently, standard of proof in merger cases requires at least clear-cut criteria on which the decision should be based. Therefore, when assessing a merger, one should be cautious about his or her conclusions and account for imperfections of the economic models.

### **3. Council Regulation (EEC) No 4064/89**

#### **3.1. Main Features of the Former System of Merger Control.**

Council Regulation (EEC) No 4064/89<sup>67</sup> introduced a centralized system of merger control in the European Union. One of the most important features of the merger control, as envisaged under the Regulation, which distinguished it from the enforcement under article

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<sup>65</sup> *Ibid.*, p. 63;

<sup>66</sup> Motta, M., (2004), p. 242; Massimo Motta points out, that the rivals' complaints about the merger might signal that there might be significant efficiency gains and thus increase in welfare (see. Motta, Motta, M., (2004), p. 240);

<sup>67</sup> Council Regulation (EEC) No. 4064/89/EEC (21 December 1989) OJ 1989 L 395;

81 and 82 of the EC Treaty was its forward-looking character. In particular, all the concentrations, which fell into the scope of the Regulation, could be executed only upon authorization by the European Commission<sup>68</sup>.

Such ex-ante review was envisaged for efficiency reasons<sup>69</sup>. Indeed, if all the large mergers would be allowed to proceed without prior authorization, ex-post spin-offs in case the merger was found detrimental, would involve huge costs (especially if considerable time passed after the merger took its effect)<sup>70</sup>. From a legal standpoint, ex-ante authorization also contributes to legal certainty, otherwise, firms would be reluctant (at least in not clear-cut situations) to engage in mergers which could be declared illegal and undone forcefully ex-post.

Being expedient for the reasons stated above, the forward looking character of European merger control is probably the main source of difficulties arising in merger cases and faced by the Commission and the parties<sup>71</sup>.

According to the Article 1 (1) of the Regulation, the rules of the Regulation applied to all the concentrations within Community dimension. “Community dimension” was defined in parts 2 and 3 of the Art. 1 and meant meeting certain EC-wide and worldwide turnovers. In addition, the Community dimension was not recognized if more than two thirds of the aggregate Community-wide turnover of each of the merging firms was reached within the same Member State. Thus, the Community competence extended to sufficiently

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<sup>68</sup> Art 7 (1) of the Council Regulation 4064/89, provided that no concentration falling within the scope of the Regulation would take effect before the Commission declared it compatible with the Common Market (unless the concentration was notified and the Commission did not take a decision as to its compatibility within time limits set by the Regulation);

<sup>69</sup> Motta, M., (2004), p. 37;

<sup>70</sup> Shavell, S., (1993);

<sup>71</sup> See the analysis below.

large concentrations, which involved several Member States, which is in line with the subsidiarity principle established in article 5 of the EC Treaty<sup>72</sup>.

*All* the concentrations, satisfying the Community criteria had to be notified to the Commission not more than one week after the conclusion of the agreement, or the announcement of the public bid, or the acquisition of a controlling interest. After such notification the formal review procedure was launched, in the meanwhile the proposed merger deal had to be suspended<sup>73</sup>. It should be noted, that under the former Merger Regulation the earliest possible point of time where the concentration could be notified was conclusion of a binding agreement (or public bid), i.e. the parties could not notify the merger based on some informal preliminary agreement to merge<sup>74</sup>.

After the notification the Commission, in particular the Merger Task Force of Competition Directorate of the Commission, would had conduct an investigation which was composed of two phases. After the first phase, which, in accordance with Article 10 (1) of the Regulation was limited to one month period<sup>75</sup>, the Commission could take 3 types of decision:

- a) that the concentration notified does not fall within the scope of the Regulation<sup>76</sup>;
- b) not to oppose the merger if it is found not to rise serious doubts as to its compatibility with the common market<sup>77</sup>;
- c) to initiate proceedings if the concentration is found to raise serious doubts as to its compatibility with the common market<sup>78</sup>;

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<sup>72</sup> Steiner, J., Woods, L., Twigg-Fleshner, C., (2006), P. 50;

<sup>73</sup> Art. 7(1) of the Regulation;

<sup>74</sup> Green Paper on the review of Council Regulation (EEC) No. 4064/89, COM(2001), 745/6 Final, Brussels 11.12.2001., para. 185;

<sup>75</sup> The one month period can be extended to 6 weeks if the Commission receives a request for the referral from the Member States or if the undertakings concerns submit commitments aimed to address the possible anti-competitive effects of the proposed merger.

<sup>76</sup> Art 6 (1) (a) of the Regulation;

<sup>77</sup> Art 6 (1) (b) of the Regulation;

The first two types of the decision would finish the investigations and imply that the parties were free to proceed with the deal, whereas the third type of decision entailed opening of the second phase investigation which would last up to four additional months<sup>79</sup>. At the end of the second phase the Commission could take one of the decisions specified in Art 8 of the regulation, namely:

- a) to allow the merger unconditionally;
- b) to allow the merger subject to certain conditions and/or obligations (remedies), meant to render the concentration compatible with the common market;
- c) to prohibit the concentration by declaring it incompatible with the common market.

In sum, the Regulation provided for centralized, ex-ante merger control system, characterized by strict time limits and exclusive Commission's jurisdiction in dealing with mergers falling within the scope of the Regulation. The latter principle, referred to as "one-stop shop", is regarded as one of the central features of the merger control system. This principle is also believed to be favorable to the firms, since withdrawing the merger from jurisdiction of numerous national competition authorities and subjecting it to the scrutiny of a single administrative body – European Commission is likely to save considerable time and resources, as well as to reduce legal uncertainty resulting from potential controversy in decisions of different national authorities<sup>80</sup>.

The allocation of competence between the Commission and national authorities in merger control is based on their ability to deal with the concentrations. Thus, Commission is clearly better placed (having in mind available resources, investigation and enforcement powers) to investigate the cases involving large undertaking active in numerous national

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<sup>78</sup> Art 6 (1) (c) of the Regulation;

<sup>79</sup> Art. 10 (3) of the Regulation;

<sup>80</sup> Cook, J. Kerse, C., 2005, p. 97; Motta, M., (2004), p. 37;

markets, merger of which will can have impact in several Member States. Conversely, the Member States are in better position to deal with mergers which are national in character<sup>81</sup>.

At the same time, it should be noted, that the allocation of the cases between the Member States and the Commission, as established by the Council Regulation (EEC) No Regulation 4064/89 should not be seen as absolutely rigid, since the Regulation provided for a possibility to adjust this mechanism where it is deemed appropriate. In particular, Article 9 of the Regulation provided for a possibility to refer whole merger case or a part of it case from the Commission to the Member State concerned if the proposed merger is likely to adversely affect the competition within that Member state “which presents all the characteristics of a distinct market”<sup>82</sup>. On the other hand, Art. 22 of the Regulation allowed to refer the case from the Member States to the Commission if the Commission was deemed to be better placed to investigate the merger, even if the merger in question did not meet the “Community dimension” as defined in Art. 1 of the Regulation. In the latter case, a merger could be referred to the Commision if it was found, that, besides negative impact on the competition within one or two Member States, the concentration would affect trade between Member States<sup>83</sup>.

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<sup>81</sup> Green Paper on the review of Council Regulation (EEC) No. 4064/89, COM(2001), 745/6 Final, Brussels 11.12.2001, paras 17-20;

<sup>82</sup> Art. 9 of the Regulation;

<sup>83</sup> The criterion of affecting the trade between Member States was added when the original Regulation was amended through the Council Regulation No 1310/97. Before the amendment, Art 22 did not require impact on interstate trade in order to refer a case to the Commission. This was so, because at the time when the Regulation was adopted some Member States did not have national merger control system similar to that envisaged by the Regulation. Therefore, the initial purpose of the article was to allow such states to benefit from the EC Merger Control system before their own system was established;

### **3.2. Substantive Test Under the Former Merger Regulation.**

Having discussed the main features of the Merger Control under the Regulation No 4064/89 and the possible decisions which could be taken in the outcome of the investigation, in this section the test determining the outcome of the case will be analyzed. What was the criterion under which the European Commission would decide whether the concentration was “compatible with the common market” or not and respectively allow it to proceed or block it? The answer to this question lies in the text of Art. 2 of the Regulation, part 3 of which states the following: “A concentration which creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it shall be declared incompatible with the common market”.

The wording of the article is quite abstract and needs further interpretation, however, it can be seen immediately that the Regulation established a two-prong test for assessing concentrations. According to the test, mergers would be found incompatible with the common market if: a) they created or strengthened dominant position and b) significantly impeded the competition in the common market or in substantial part of it. Nevertheless, as noted by commentators, in practice the Commission usually focused its attention on the first part of the test, i.e. creation or reinforcing the dominant position<sup>84</sup>. If the merger was unlikely to create or strengthen dominant position – the second part of the test – i.e. impediment to the competition – was not enough to stop the merger. If the

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<sup>84</sup> Stirati, G., (2004),p. 255, Kekelekis, M., (2006), p. 45;

creation of dominant position was found, the significant impediment to competition was often considered to be an inherent consequence of such position<sup>85</sup>.

Thus, the central focus of the substantive test of the former Merger Regulation was creation or strengthening of dominant position, and therefore it is usually called “dominance test” in the literature. The contents of the concept of dominance were clarified and developed in the practice of the European Commission, CFI and ECJ.

For the first time the concept of dominance was construed by the ECJ in the *United Brands* case, where it defined a dominant firm as a firm which “can determine its policies substantially free from competitive restraint, that is, is free to act without taking into account to any substantial extent, its competitors, purchasers or suppliers”<sup>86</sup>. Although such definition was born in the case law under Article 82 of the EC treaty (abuse of dominant position), it was used by the Commission<sup>87</sup>, and later by the CFI<sup>88</sup> in the context of merger control<sup>89</sup>.

In the very early case law, the main focus in finding of dominance was the market share of the merging entities. However, gradually the Commission and European courts have developed the view, that high market share is only one of the possible indicators of the dominance, but it does not necessarily mean dominance<sup>90</sup>. For instance, the ECJ endorsed such a position in *Kali and Salz* judgment where it stated that “A market share of approximately 60 per cent <...> cannot in itself point conclusively to existence of a

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<sup>85</sup> Kekelelis, M., (2006), p. 45;

<sup>86</sup> *United Brands Co v Commission of the European Communities* [1978] E. C. R. 207; [1978] 1 C.M.L.R. 429, ECJ.; Similarly the concept of dominance was defined in *Hoffman/La Roche* case (*Hoffman La Roche & Co AG v Commission of the European Communities* [1979] E.C.R. 461; [1979] 3 C.M.L.R. 211, ECJ);

<sup>87</sup> See, e.g. Case IV/M.004 Renault/Volvo [1990], O.J. C 281/2 para. 22;

<sup>88</sup> See, e.g. *Gencor v. Commission*, Case T-102/96 [1999] ECR II-753, para.200;

<sup>89</sup> Van den Bergh, R. J., Camesasca P., (2006), p. 355; It should be noted however, that despite similar definition of dominance, the test under Art. 82 of EC treaty and the dominance test under the Merger Regulation are not identical, since the latter does not require *abuse* of dominant position which is necessary for violation of Art. 82 EC Treaty.

<sup>90</sup> Van den Bergh, R. J., Camesasca P., (2006), p.356,

collective dominant position”<sup>91</sup>. Thus, the Commission and the Court moved from mechanical reliance on market share and recognized importance of other market characteristics, thus taking into account the developments of economic theory<sup>92</sup>.

The fact that the EC institutions quite early took account of the developments of the economic analysis in the area of merger control is illustrated by the *Nestlé/Perrier*<sup>93</sup> decision, where the Commission for the first time held that the test contained in Article 2 of the Regulation can be applied not only to the single firm dominance but also to the situation of “joint dominance”. In this case, the Commission authorized the takeover of French company Perrier by Nestlé, subject to imposed conditions. The Commission found, that the merger would create a situation of joint dominance in the mineral water market. The Commission based its decision *inter alia* on the following factors: Nestlé, Perrier and BSN held together around 85 % share in the relevant market, the market was characterized by high degree of transparency, ability to monitor competitors’ behavior, entry barriers and inelastic demand. In addition, Commission took account that the commitment of Nestlé to sell part of Perrier to BSN, its largest competitor, would increase the symmetry in the market. Based on these factors, the Commission held that the merger would lead to joint dominance and allowed the merger only subject to condition that Nestlé would sell part of its mineral water brands. The factors analyzed by the Commission and the decision taken in this case demonstrate that the Commission took into account the findings of the theory of coordinated effects, discussed in Part 2 of this paper. Indeed, as noted by the commentators,

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<sup>91</sup> *Kali and Salz* ( Joint cases C-68/94 and C-30/95, France v. Commission of the European Communities; Societe Commerciale des Potasses et de l’Azote (SCPA) v Commission of the European Communities [1998] E.C.R. I-1375; [1998] 4 C.M.L.R. 829, ECJ) para 226;

<sup>92</sup> Green Paper on the review of Council Regulation (EEC) No. 4064/89, COM(2001), 745/6 Final, Brussels 11.12.2001, para. 163;

<sup>93</sup> Case IV/M.190 Nestlé/Perrier [1992], O.J. L356/1;

“the concept of joint dominance matches closely the economic concept of coordinated effects”<sup>94</sup>.

Thus, the case Nestle/Perrier was the first case where the Commission applied the notion of joint dominance. Needless to say, this was regarded as an innovative approach, since it is not obvious from the wording of the Art. 2(3), that it could be applied to collective dominance. However, such approach is in line with economic analysis, since it takes into account anticompetitive coordinated effects of mergers.

Subsequently, the view that Regulation could be extended also to collective dominance was confirmed by the CFI in *France v. Commission*<sup>95</sup>. In the analysis of the collective dominance situation the Court held that “Effective competition in the relevant market is significantly impeded by the undertakings involved in the concentration and one or more other undertakings which together, in particular because of correlative factors which exist between them, are able to adopt a common policy on the market and act to considerable extent independently of their competitors, their customers and also consumers”. These findings of the court are, again, in line with what the economic analysis of coordinated effects suggests.

Furthermore, in *Gencor v. Commission*<sup>96</sup> the CFI clarified, that the “correlative factors” mentioned in the discussed decision of ECJ do not need to be formal links between the firms, and rather mean certain characteristics of oligopolistic market<sup>97</sup>.

Hence, the substantive test established in Art. 2 of the former Merger Regulation was interpreted quite flexibly, which allowed the Commission and the Court (CFI and ECJ)

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<sup>94</sup> Motta, M., 1999 p. 25, see also Navarro, E., *et al.* (2005), p. 200;

<sup>95</sup> Joint cases C-68/94 and C-30/95, *France v. Commission of the European Communities; Societe Commerciale des Potasses et de l’Azote (SCPA) v Commission of the European Communities* [1998] E.C.R. I-1375; [1998] 4 C.M.L.R. 829, ECJ;

<sup>96</sup> *Gencor Ltd. v. Commission*, Case T-102/96 [1999] ECR II-753, CFI;

<sup>97</sup> For brief overview of evolution of the concept of joint dominance in EC case law see Motta, M., (1999), pp. 25-28;

to apply the developments of economic theory to the merger cases and focus on the likely economic effects of the merger rather than only on the market shares of the firms involved. Such economically-based approach t can be illustrated by the words of former EC Commissioner for competition, Mario Monti, stressing that the market dominance test laid down by the Regulation was not “some immovable and absolute measurement against which the future effects of a merger can be assessed”, but “a highly sophisticated tool that requires us to understand the dynamics of competition and to identify the key competitive factors in the markets concerned”<sup>98</sup>.

### **3.3. The Drawbacks of the Old System: Need for Reform**

In overall, the Council Regulation No 4064/89 was regarded as successful piece of regulation. Indeed, one stop shop principle lowered the administrative burden of the firms. Besides, the strict deadlines set by the Regulation and ability of the Commission to adhere to them in vast majority of cases should be welcomed, since it increased the legal certainty and thus further decreased costs of concentrations. As demonstrated above, the substantive test of the former Regulation was largely applied in line with economic analysis and allowed the Commission to deal successfully with ever increasing number of concentrations<sup>99</sup>.

Nevertheless, economic and legal literature as well as the case law crystallized several drawbacks of the former Merger Regulation, which were considered serious enough to launch a reform of the merger control system. In what follows these drawbacks and main critiques of the old system will be briefly presented.

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<sup>98</sup> Levy, N. (2005), p. 114;

<sup>99</sup> Motta, M., (2004), p. 37;

### 3.3.1. The “Gap” of the Market Dominance Test

Probably the sharpest criticism of the previous system was related to the incompleteness of the old substantive test. Numerous economists agreed, that the wording of the article 2(3) of the former Merger Regulation, which required creation or strengthening of dominant position in order to block a merger, did not allow to address the group of detrimental concentrations which did not lead to dominance or reinforcing thereof<sup>100</sup>.

As can be recalled from the discussion in Part 2 of this paper, mergers may adversely affect social welfare through the coordinated or non –coordinated effects. While the concept of joint dominance developed in the case law of the Commission and the Court can be seen as coinciding with the economic concept of coordinated effects, the concept of unilateral effects is not covered by the market dominance test to full extent<sup>101</sup>. As it was mentioned in the Part 2 of this paper, the unilateral effects can take place even if the merged firm does not become dominant. The example often given by the literature to illustrate the latter situation is that of a merger between number 2 and number 3 firms in the market. It may happen, that after such merger the newly created firm will still not obtain dominant position and be much smaller than the leader of the industry in question. If the market characteristics are such that collusion is unlikely to occur, such merger will not lead to joint dominance. However, economic analysis suggests, that absent efficiency gains, the merging firm will be able and willing to raise prices unilaterally, thus the merger will be detrimental to the consumers (and the society as a whole). Nevertheless, despite the possible negative economic effects of such merger, it could not be prohibited under the old

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<sup>100</sup> See, e.g., Motta, M., (1999) p. 22; Lindsay, A., (2006), pp. 44-45; Levy, N. (2005), p. 116; Röller, L., De la Mano, M., (2006), p. 7-8, Monti’s legacy, p. 116. , Lindsay, p.44 – 45;

<sup>101</sup> Motta, M., (2000), p. 6-7;

Merger Regulation, according to which, dominant position was regarded necessary to block a concentration (*conditio sine qua non*)<sup>102</sup>.

### 3.3.2. Efficiency considerations

Another strong criticism of the former substantive test was its alleged failure to take account of the efficiency gains which may be brought by mergers. As mentioned in the Part 2 of this paper, mergers often results in economic gains coming, e.g. form economies of scope and scale, learning effects, improved R&D activities, optimized use of human resources etc. Such gains under certain circumstances might be larger than welfare losses brought by merger. Without going into detailed discussion on the topic of the applied welfare standard and the weight attributed to the consumer surplus in relation to the producer surplus, it is clear that economic analysis requires to include efficiencies into appraisal of the mergers' competitive effects<sup>103</sup>.

Still, the former system failed to provide appropriate framework which would allow to systematically include efficiency arguments in the assessment of mergers. It should be noted, that the position of the former Regulation towards the efficiency defense was not absolutely clear, since it neither explicitly allow it, nor expressly excluded possibility of such defense. Therefore, there was a discussion in the literature about extent to which the efficiency defense could be used under former Merger Regulation.

The Commission's position also was not absolutely clear, but, as noted in the literature, it was not sympathetic to efficiency arguments<sup>104</sup>. Anyway, there were no cases

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<sup>102</sup> *Ibid.*, p. 6-7;

<sup>103</sup> Stirati, G., (2004), p 269;

<sup>104</sup> *Ibid.*, p. 272;

under the old system, where the Commission would allow detrimental mergers to proceed due to the efficiency savings. On the contrary, the cases, where efficiency arguments were raised, such as *Aerospatiale-Alenia/DeHavilland*<sup>105</sup>, *Accor/Wagon-Lits*<sup>106</sup>, the Commission usually dismissed them<sup>107</sup>.

In addition, it was noted, that the Commission tended to use efficiency considerations in the opposite direction, i.e. for “efficiency offence”. In other words, the Commission sometimes held that efficiency savings, brought by merger, would foster the competitive power of the merged company versus its competitors<sup>108</sup> and further strengthen its market power<sup>109</sup>.

To sum up, the status of efficiency arguments in the appraisal of horizontal mergers under the old Regulation was ambiguous. Therefore, numerous commentators pointed out that the position of the Commission towards efficiency arguments should be clarified for the sake of transparency and in order to put the assessment of mergers in line with economic analysis.

### **3.3.3. Procedural and jurisdictional defects**

Besides the criticisms of the substantive test and application thereof by the Commission, a number of jurisdictional and procedural drawbacks were identified<sup>110</sup>.

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<sup>105</sup> *Aerospatiale-Alenia/DeHavilland*, Case IV/M.053 (October 1991), O.J. L334/42;

<sup>106</sup> *Accor/Wagon-Lits*, Case IV/M53 (1991), O.J. L204/1;

<sup>107</sup> Stirati, G., (2004), p. 272;

<sup>108</sup> See, e.g., *Mitsui/CVRD/Caemi*, Case IV/ [M.2420](#) [2001], O.J. C167; where the Commission used efficiencies and cost saving as arguments against the merger;

<sup>109</sup> Cook, J. Kerse, C., (2005), p. 275;

<sup>110</sup> A detailed discussion of procedural and jurisdictional problems, as well as the effect of the changes in the referrals and the procedure, would require lengthy discussion which would exceed the scope of this paper, therefore, in this paper the procedural and jurisdictional issues will be mentioned only briefly, to complete the description of the reform in merger control;

These criticisms, added with the drawbacks of the substantive test, increased the need to change the Merger Regulation.

As regards the jurisdictional issues, it was noted, that despite the thresholds set in the article 1 of the Regulation, there still existed a problem of multiple filing, i.e. the cases of Community interest were still notified and scrutinized in a number of national jurisdictions. In addition, there were some concerns about the operation of the referral system. In particular, it was argued, that the referral system should be made more flexible, for example by allowing the Commission to refer *on its own initiative* a case to the Member State, and, conversely, the from the Member State to the Commission.

The criticisms of the merger procedure involved several issues. First, it was claimed, that the parties should be allowed to notify the merger before the binding agreement is concluded, since signing an agreement implies considerable investment, which is wasted if the merger is not allowed. Further, the calculation of the time limits was said to be inflexible under the former Regulation, which often led to limiting parties' and Commission's ability to get prepared appropriately to the case. Finally, there was seen a scope for improvement of the internal and external "checks and balances" in the Commission's decision making process<sup>111</sup>.

### **3.4. The Reform**

Naturally, the Commission was aware of the criticisms of the old system, and was ready to discuss the possible ways to improve it. Thus, in 2001 it published a Green Paper

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<sup>111</sup> Green Paper on the review of Council Regulation (EEC) No. 4064/89, COM(2001) pp. 6-8;

on the Review of Council Regulation 4064/89<sup>112</sup> (Green Paper) where it outlined the arguments concerning the drawbacks of the former system, including the arguments discussed above, and invited the comments from the interested parties as to desirability of amendments of the Merger Regulation.

The discussion in the Green Paper concerned possible amendment of the substantive test, improvement of the referral system and improvements of the procedure. Interestingly, the Commission expressed quite conservative view towards amendments of the Market Dominance test. Therefore, in the discussion it focused in more detail on the procedural and jurisdictional issues, dedicating rather modest part of the Green Paper to the substantive test.

In the Green Paper, the Commission weighed market dominance test against Substantive Lessening of Competition (SLC) test, which is used in some national jurisdictions, including the USA. The Commission recognized validity of the arguments in favor of switching to the SLC test such as the following:

- 1) The SLC test is closer to economically-based analysis of concentrations;
- 2) SLC test is more flexible than market dominance test
- 3) In particular, SLC would cover the “gap” present in the market dominance test (i.e. unilateral effects of a merger not creating or strengthening dominance);
- 4) SLC is better suited to deal with merger-specific efficiencies;

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<sup>112</sup> Green Paper on the Review of Council Regulation (EEC) No. 4064/89, COM (2001) 745/6;

- 5) Switching to SLC would lead to increased harmonization in merger control worldwide, since SLC is used in several jurisdictions outside the EC (most importantly, the US) <sup>113</sup>.

Nevertheless, the Commission pointed out also the arguments in favor of keeping the substantive test unchanged<sup>114</sup>:

- 1) Keeping the market dominance test will allow to make further use of the case law of the Commission and the jurisprudence of the Court, which were developed under this test;
- 2) SLC is more open-ended than market dominance test, thus switching to it may result in increased uncertainty;
- 3) Switching to SLC may result in divergence of practice within EU, since most of the Member states had recently adopted market dominance test;
- 4) Market dominance test had evolved over years and took account of developments of economic theory and in most of the cases it results in the same outcome as SLC test.

There were also arguments which demonstrated skepticism about efficiency defenses. Firstly, it was claimed, that explicit introduction of efficiency defense into the merger control regime might not bring significant changes, since in the jurisdictions where such defense is allowed it almost never changes outcome of the case.<sup>115</sup> Secondly, it was argued that allowing efficiency defense would increase length and costs of proceedings,

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<sup>113</sup> Green Paper on the Review of Council Regulation 4064/89, COM (2001) 745/6, paras 160-172;

<sup>114</sup> And, to be fair, these arguments seem quite well-founded.

<sup>115</sup> Green Paper on the Review of Council Regulation (EEC) No. 4064/89, COM (2001) 745/6, para 170;

since much more information would be proceeded and analyzed in depth. Next, information asymmetry in efficiency defense was stressed: it was claimed that the parties to the concentration, who are in the best position to present data about the efficiencies, are biased towards exaggerating of the efficiencies, while for the Commission it will be harder to calculate likely efficiencies, since it is not an insider of a particular business. The third parties, i.e. other firms in the industry, were also argued to be biased in providing information, since if the efficiencies are likely to be significant, merger would probably harm them. Hence, they would be inclined to exaggerate anti competitive effects of merger and underestimate efficiencies. Finally, efficiency defense was believed to result in dissipation of resources in rent-seeking (e.g. investing resources in order to present efficiency arguments in persuasive way, lobbying)<sup>116</sup>.

Thus, the Commission demonstrated in the Green Paper that its position towards the reform was rather moderate and that in overall it was satisfied with its merger control practice. However, very soon the Commission got a new impetus which made it to rethink the intensiveness of the reform – in 2002, during a period of just 5 months the CFI overruled 3 Commissions decisions to block mergers.

The first of the three judgments, delivered 6 June 2002, in the *Airtours*<sup>117</sup> case is remarkable, because it was the first decision of the CFI where it overruled Commission's decision to block a merger<sup>118</sup>. This decision demonstrated the serious flaws of the former Merger Regulation and in Commission's analysis of merger effects. In this case, the Commission prohibited a merger between Airtours and First Choice, two companies operating in UK short – haul packaged holidays market. After the merger, the number of

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<sup>116</sup> Stirati, G., (2004), p. 268;

<sup>117</sup> *Airtours Plc. v. Commission of the European Communities* Case, T-342/99, [2002], All E.R. (EC) 783; [2002] E.C.R. II-2585, CFI;

major market players would be reduced from four to three, but the merged entity would not enjoy dominant position individually, because it would be still smaller than the market leader (Thomas Cook). Thus, Commission could not base its prohibition decision on single firm dominance, and therefore, needed to show that the concentration would lead to collusion in order to block the merger.

However, the characteristics of the industry in question were such, that it was difficult to make an unambiguous prediction about probability of collective dominance. For example, such factors as high degree of product heterogeneity, high volatility of market shares over time and difficulties in detecting deviations from collusive pattern made collusion in this case unlikely. The Commission, nevertheless, argued that the collusion could occur through capacity reduction during the planning season and the firms would be able to punish the deviating firm by increasing their capacity in next period (according to the Commission, this could be feasible, because in the discussed industry firms make capacity decisions for relatively short periods, therefore they could react promptly enough). Although such analysis of the Commission is not inconsistent with economic analysis<sup>119</sup> its arguments were not strong enough to prove the collective dominance. This point was confirmed by the CFI, which stated that Commission's reasoning contained "errors, omissions and inconsistencies of utmost gravity"<sup>120</sup>.

In its decision, the CFI further developed the doctrine of joint dominance and set down three criteria which must be established to prove coordinated effects:

"1) each member must have means of knowing whether the other operators are adopting the same strategy and whether they are maintaining it. There must, therefore, be sufficient

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<sup>119</sup> See Motta, M., (2000), p. 14;

<sup>120</sup> *Airtours Plc. v. Commission of the European Communities* Case, T-342/99, para 404;.

market transparency for all members of the dominant oligopoly to be aware, sufficiently precisely and quickly, of the way in which the other members' market conduct is evolving;

2) tacit coordination must be sustainable over time, therefore, there must be adequate deterrents to ensure that there is a long-term incentive for not departing from the common policy;

3) the Commission must also establish that the foreseeable reaction of current and future competitors, as well as of consumers, would not jeopardize the results expected from the common policy.”<sup>121</sup>

The Court found, that the Commission had made wrong conclusions about all the three indicated conditions, and therefore made erroneous decision to block the merger. Besides, the Court drew attention, that Commission's evidentiary practice was unsatisfactory, and stressed, that “it is incumbent on the Commission to produce convincing evidence<sup>122</sup>” and to “prove conclusively” that the merger would result in joint dominance<sup>123</sup>. Thus, the CFI clarified the burden of proof and the standard of proof and demonstrated that the Commission failed to adhere to it.

Another important implication of the *Airtours* case is that it demonstrated the relevance of the “gap” of the former Merger Regulation discussed above, i.e. inability of the Commission to block a merger on the grounds of unilateral effects if it did not create or reinforce dominant position. As noted by commentators, although the merger of Airtours and The First Choice would not lead to single firm dominance and it was unclear if joint

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<sup>121</sup> *Ibid*, para. 52;

<sup>122</sup> *Ibid.*, para 63,

<sup>123</sup> *Ibid.*, Para 210;

dominance would arise, “one should have strong liberalist views to exclude that such merger could have anticompetitive effects”<sup>124</sup>. Indeed, given the characteristics of the market the merger was likely to lead to increase in price, and the efficiencies brought by merger were minimal<sup>125</sup>. Thus, this case clearly demonstrated that the “gap” of the old substantive test was not just “interesting as a hypothetical discussion”<sup>126</sup>, as referred to by the Commission in the Green Paper, but a serious practical problem.

The Court’s two subsequent judgments in *Shneider*<sup>127</sup> and *Tetra Laval*<sup>128</sup>, which followed shortly after the *Airtours* decision, further criticized the economic analysis performed by the Commission in merger cases and showed that Commission did not meet the standard of proof required to block mergers<sup>129</sup>. Thus, in *Tetra Laval* case, the CFI stressed, that it is not sufficient to demonstrate the *possibility* of harm, but it should be showed there is *high likelihood* of such harm. The Court also held, that analysis of the Commission has to be “particularly plausible” in such cases and that the Commission failed to conduct such analysis<sup>130</sup>. Similarly, in *Shneider*, the CFI found that Commissions arguments were “insufficiently demonstrated in law”<sup>131</sup>.

These three decisions, as acknowledged by former EC competition Commissioner<sup>132</sup>, added to the critiques from the academic and business society and forced the Commission to take more radical steps towards the reform. Thus, in December 2002 the

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<sup>124</sup> Denicolo, V., (2003);

<sup>125</sup> Motta, M., (2000), p. 17.

<sup>126</sup> Green Paper on the Review of Council Regulation (EEC) No. 4064/89, COM (2001) 745/6, para 166;

<sup>127</sup> *Schneider Electric SA v. Commission of the European Communities*, Case T-310/01, [2004], All E.R. (EC) 314; [2002] E.C.R. II-4071, CFI;

<sup>128</sup> *Tetra Laval BV v. Commission of the European Communities*, Case T-5/02, [2003], All E.R. (EC) 762; [2002] E.C.R. II-4381, CFI;

<sup>129</sup> In these two cases the problem of conglomerate was raised. More detailed discussion of these cases would require extensive description of the theory of conglomerate effects, and therefore cannot be included into this paper. Therefore, these cases will be discussed here only in the light of their overall effect on the reform.

<sup>130</sup> Lindsay, A., (2006);

<sup>131</sup> *Schneider Electric SA v. Commission of the European Communities*, Case T-310/01, para 209, cited at Levy, N., (2005), p. 112;

<sup>132</sup> Monti, M., 2002;

Commission approved a merger control package, which consisted not only of a revision of the Merger Regulation, but also of accompanying instruments, such as Draft Horizontal Merger Notice<sup>133</sup>, and draft Best Practice Notice<sup>134</sup>, the scope of which was to improve the Commission's practice and provide the comprehensive guide for the parties in Merger cases<sup>135</sup>.

## **4. The New Regulation of Horizontal Mergers**

### **4.1. The New Merger Regulation and Accompanying Instruments: Brief Overview of the Envisaged Changes.**

On 1 May 2004, Council Regulation 139/2004 ("New Merger Regulation")<sup>136</sup> came into force and replaced the Council Regulation 4064/89. The revised Merger Regulation is a central part of the "far reaching package of reforms"<sup>137</sup> on the subject of mergers. The main changes brought by it concern the substantive test for assessment of mergers, referral of the cases between the Commission and Member States and procedural issues.

The new substantive test is formulated in the Art 2(3) on the New Merger Regulation: "A concentration which would significantly impede effective competition in the common market or in a substantial part of it, in particular by the creation or strengthening of a dominant position shall be declared incompatible with the common market." Although it can seem a plain paraphrasing of the old dominance test, it is not dominance test anymore, since the central question for the new test is whether a

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<sup>133</sup> Draft Commission Notice on the Appraisal of Horizontal Mergers Under the Council Regulation on the Control of Concentrations between Undertakings, 2002 O.J. (C 331) 3;

<sup>134</sup> DG Competition Best Practices Guidelines on the Conduct of EC Merger Control Proceedings;

<sup>135</sup> Levy, N., (2005), p. 109;

<sup>136</sup> Council Regulation (EEC) No. 139/2004 on the Control of Concentrations between Undertakings, 2004 O.J. (L 24) 1;

<sup>137</sup> European Commission, DG Competition, (2004), Merger control: Merger Review Package in a Nutshell , p. 1;

“significant impediment of effective competition” will occur after the merger. Dominance, although recognized the main scenario of such impediment is not necessary condition for blocking a merger under this test<sup>138</sup> (“SIEC test”).

Thus, the main focus of the SIEC test, in contrast to the former market dominance test, is the impact of the merger on the competition, rather than on market structure<sup>139</sup>. Thus, this test is close to the “Significant Lessening of Competition” (SLC) test used in the USA. Without going into discussion whether the SIEC and SLC tests are synonymous or there are slight differences between them<sup>140</sup>, it is clear that it SIEC was intended to extend the former Market Dominance test in order to cover the “gap cases” and allow efficiency considerations. Such a conclusion can be drawn from the preamble of the New Merger Regulation, recital 25 of which explicitly states: "The notion of significant impediment to effective competition should be interpreted as extending, beyond the concept of dominance, only to the anti-competitive effects of a concentration resulting from the non coordinated behavior of undertakings which would not have a dominant position on the market concerned"<sup>141</sup>. In addition, recital 29 of the preamble to the New Merger Regulation states that “In order to determine the impact of a concentration on competition in the common market it is appropriate to take account of any substantiated and likely efficiencies put forward by the undertakings concerned”<sup>142</sup>.

Besides the change of the substantive test, the New Merger Regulation is said to reinforce the “one stop shop principle”, because it added flexibility to the referral system. In particular, under the New Merger Regulation, the merging parties are allowed to request

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<sup>138</sup> European Commission, DG Competition, New Merger Regulation: Frequently Asked Questions, 20-01-2004, MEMO/04/9, p. 3;

<sup>139</sup> Stirati, G., (2004), p. 254;

<sup>140</sup> *Ibid.*, p. 254;

<sup>141</sup> Council Regulation (EEC) No 139/2004;

<sup>142</sup> *Ibid.*.

the referral of a case to the Member State prior to notification. In addition merging parties may request referral of the case to the Commission if the merger would have to be notified in at least three member states. It should be noted, that in the case the referral is requested by the merging parties, the Member States concerned have a veto power. Finally, according to the Art. 22(5) of the New Merger Regulation, the Commission itself may initiate a referral from a Member State to the Commission.

As regards the procedural issues, the New Merger Regulation is regarded as adding flexibility and effectiveness into the merger procedure. For example, it allows notification of the concentration before the binding agreement is signed, if “a good faith intention to conclude agreement” can be demonstrated<sup>143</sup>. Besides it removed the one week deadline for the notification, and allowed extension of procedural deadlines if the parties deem it necessary. The new Regulation also increased the sanctions for failing to comply with the Regulation which is regarded as enhancement of the investigative powers of the Commission<sup>144</sup>.

Besides the New Merger Regulation, other two documents were adopted, which constitute an important part of the merger control system. One of them is so called Best Practice Guidelines<sup>145</sup>, which codify informal practice of the Commission in conducting investigations under the merger Regulation. These Guidelines are aimed to improve procedure and refine the checks and balances system in the merger procedure. For example, the Guidelines envisage pre-notification contacts, state-of play meetings to keep the parties informed about the progress of the investigation, “triangular meetings” between the

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<sup>143</sup> Art. 4(1) of the New Merger Regulation;

<sup>144</sup> Van Zutven, A., Urlus, H., (2004);

<sup>145</sup> DG Competition Best Practices Guidelines on the Conduct of EC Merger Control Proceedings;

Commission, merging parties and the interested third parties<sup>146</sup>. Finally, the Guidelines lay down the conditions under which the parties are granted access to the key documents<sup>147</sup>.

The other important document accompanying the New Merger Regulation is Horizontal Merger Guidelines<sup>148</sup>, which can be seen as analytical manual for the application of the New Merger Regulation. In other words, the Horizontal Merger Guidelines provide an analytical guidance on the factors which should be analyzed in the merger procedure. The Guidelines outline the economic insights on the mergers' effect and "elaborate on the Commission's evolving experience with the appraisal of horizontal mergers [...] as well as the Court of Justice and the Court of First Instance of the European Communities"<sup>149</sup>. For example, they provide a guidance on the importance of HHI index in the industry, factors influencing non-coordinated effects and coordinated effects, as well how to deal with efficiencies and other factors countervailing anticompetitive effects of mergers. The Guidelines are believed to increase "transparency and clarity" of the Commission's decisions<sup>150</sup>, and provide a clear analytical framework for assessment of concentrations, which takes account of the modern economic theory and case law in the field of mergers.

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<sup>146</sup> European Commission, DG Competition, (2004), Merger control: Merger review package in a nutshell, p. 2;

<sup>147</sup>DG Competition Best Practices Guidelines on the Conduct of EC Merger Control Proceedings, paras 45-46;

<sup>148</sup> Commission Notice on Guidelines on the Assessment of Horizontal Mergers Under the Council Regulation on the Control of Concentrations between Undertakings, 2004 O.J. (C 31) 5;

<sup>149</sup> Commission Notice on Guidelines on the Assessment of Horizontal Mergers Under the Council Regulation on the Control of Concentrations between Undertakings, 2004 O.J. (C 31) 5, para 6;

<sup>150</sup> Levy, N., (2005), p.113;

## 4.2. Practical Changes Brought by the Reform of the Merger Control System

### 4.2.1. “The First Gap Case” – T-Mobile/Tele.ring

The most representative example of how the change in the substantive test from Market Dominance to SIEC addressed the problem of the “gap”, is provided by the Commission’s Decision in T-Mobile/Tele.ring case<sup>151</sup>, issued on 26 April 2006. In this case, the Commission analyzed the competitive effects of a proposed merger between number 2 player in Austrian mobile telephony market, T-Mobile, with number 4 player, Tele.ring.

Having defined the relevant product market as a market for the provision of mobile telephony services to end customers<sup>152</sup> and relevant geographic market as Austrian national territory<sup>153</sup>, the Commission found that there are four firms active in this market: Mobilkom (the largest player), T-Mobile (number 2), ONE (number 3) and Tele.ring (number 4)<sup>154</sup>. In addition to these four biggest firms operating on both GSM technology and UMTS technology, the fifth firm, H3G entered the market in May 2003 and provides services only on the basis of a UMTS network.<sup>155</sup> However, in time of the notification H3G network covered only 50% of the Austrian population and even less in geographical terms, therefore, in order provide services throughout Austria, H3G was buying airtime access to Mobilkom GSM network under the terms of national roaming agreement<sup>156</sup>. Another service provider, YESS!, which provided limited range of services, such as prepaid

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<sup>151</sup> Case COMP/M.3916 T-Mobile Austria/tele.ring, [2006], O.J. L 088;

<sup>152</sup> *Ibid.*, Para 18;

<sup>153</sup> *Ibid.*, Para 19;

<sup>154</sup> *Ibid.*, Para 29;

<sup>155</sup> *Ibid.*, Para 130;

<sup>156</sup> *Ibid.*, Para 30;

packages through discount food stores and internet, was found not to be independent market player, since it is a subsidiary of network operator ONE.

After analyzing the market data, the Commission concluded, that “elimination of Tele.ring as an independent network operator and the emergence of a market structure with two large network operators of similar size (Mobikom and T-Mobile), a far smaller operator (ONE), and a very small operator (H3G) will give rise to *non coordinated effects even though T-Mobile will not have the largest market share after the merger* (emphasis added)<sup>157</sup>. Thus, the Commission focused on the anticompetitive effects of the proposed concentration and found such effects to be sufficient, not concerning itself with proof of dominant position.

In particular, the Commission stressed the incentives of the firms to increase the price due to lowered competitive pressure post merger. In this respect, the image of Tele.ring as active low-cost competitor was crucial. Besides, the Commission found that the merger would likely lead to lower capacities, which would further reduce firms’ incentives to reduce price, at least in the short run.

Analyzing the price effects of the proposed concentration, the Commission noted, that, according to available data, the price per minute offered by Tele.ring was significantly lower than the price offered by the other three major network operators<sup>158</sup>. Furthermore, the majority of the customers, who switched service provider during the last years preceding the merger, became customers of Tele.ring<sup>159</sup>. Therefore, removing the active competitor Tele.ring. from the market would result in lowering T-Mobile’s incentives to reduce price,

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<sup>157</sup> *Ibid.*, Para 40;

<sup>158</sup> *Ibid.*, Paras 55-56; Although the Commission found that in some cases “YESS!” was slightly cheaper than Tele.ring, it held that it could not be regarded as adequate competitive restraint to Tele.ring due to limited range of services it offered (e.g. the YESS! did not provide roaming service) and its status as subsidiary of ONE (see para. 70 of the decision).

<sup>159</sup> *Ibid.*, Paras 49-50;

or even would induce it to increase price, since it would not fear that its customers would switch to “Tele.ring”.

In addition, as noted by the Commission, aggressive pricing is usually a strategy pursued by the network operators with relatively small customer base in order to increase number of customers. The big operators, who already serve large number of customers, are less likely to choose aggressive pricing strategy and offer big discounts for the new customers, because such discounts then have to be applied also to the existing customers, and it might reduce overall profitability of the operator. This theoretic prediction was supported by the data available in the case, which showed, that “neither Mobilkom nor T-Mobile has caused any shift in market prices in the past by making particularly aggressive offers, which can be explained by their large base of existing customers”<sup>160</sup>. Absorbing Tele.ring’s customers would further increase the customer base of T-Mobile, thus lowering it’s incentives to offer lower prices.

In assessing the merger’s impact on the capacities, the Commission established, that the merger would result in reduction in spare capacity of network operators as compared to the pre-merger situation. In particular, the concentration would lead to full elimination of Tele.ring network and, presumably, to the usage of T-Mobile network to its full capacity (as a result of absorbing Tele.ring’s customers). Therefore, Commission concluded, that reduction in spare capacity ”will reduce incentives for network operators to attract new customers by offering low prices in order to use up significant spare capacity”<sup>161</sup>.

As regards the role of the competitors, remaining after the merger, the Commission found, that none of them would be likely to exercise competitive pressure comparable to the one exercised by Tele.ring before the merger: Mobilkom and One had low incentives to

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<sup>160</sup> *Ibid.*, Para 78;

<sup>161</sup> *Ibid.*, Para 98;

reduce prices due to large customer base, while H3G, although it had sometimes adopted aggressive low price strategy, was limited in capacity (as mentioned above). YESS! was also found not to be adequate substitute for tele.ring due to its limited range of offered services. Finally, the Commission found that a new entry, which could bring new competitive pressure into the market, was highly unlikely.<sup>162</sup>

As a result of the assessment of all the factors outlined above, the Commission held, that “it is likely that the planed transaction will produce non-coordinated effects and significantly impede effective competition in a substantial part of the common market”<sup>163</sup>. It was a sufficient ground for the Commission to intervene and impose the remedies on the Merging Parties to render the concentration compatible with the Common market.

It is worth noting, that the Commission even did not consider it necessary to investigate in detail, whether the joint dominance would lead to joint dominance<sup>164</sup>, which demonstrates that establishing of dominance is not anymore considered as a crucial element for the Commission to step in. Although the decision was regarded as controversial by some economists, (for example, according to CRA International use of “maverick” term is more appropriate in the analysis of coordinated effects and not in the analysis of the unilateral effects<sup>165</sup>), it provides the example of the effect of the long-expected change in the substantive test. In order to address the unilateral effects not involving single-firm dominance, the Commission does not anymore need to risk its reputation and produce

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<sup>162</sup> *Ibid.*, Paras 102-118;

<sup>163</sup> *Ibid.*, Para 125;

<sup>164</sup> *Ibid.*, Paras 127-128;

<sup>165</sup> CRA International, (2006), p. 1.; It should be noted, however that CRA provided consultancy services to T-Mobile in this case, therefore the critiques should be seen as T-Mobile’s defense rather than impartial analysis.

ambiguous arguments to demonstrate the likelihood of collusion, as was the case in the *Airtours*.<sup>166</sup>

#### 4.2.2. Efficiency Considerations

As mentioned above, one of the drawbacks of the former merger control system was absence of a comprehensive approach to efficiencies brought by mergers, although economic literature stressed importance of the efficiencies in merger analysis. Therefore, one of the results, expected from the reform, was to include efficiency considerations into the appraisal of mergers.

Besides the cited recital 29 of the preamble to the Council Regulation (EC) No 139/2004, which states that “it is appropriate to take account” of the efficiencies, there are no indications in the main text of the New Merger Regulation on how the efficiencies should be dealt with. Instead, more detailed guidance is provided in the Horizontal Merger Guidelines. It is explicitly recognized in the paragraph 76 of the Guidelines, that it is possible that “efficiencies brought about by a merger counteract the effects on competition and in particular the potential harm to consumers that it might otherwise have” and therefore, Commission is required to consider “*any substantiated efficiency claim*” (emphasis added) in the overall assessment of the merger<sup>167</sup>.

The Guidelines further set three cumulative conditions, which the claimed efficiencies have to satisfy in order to be taken into account by the Commission. First, the efficiencies must benefit consumers. Such benefit may come from reduction in prices or new or improved products or services. The Guidelines provide, that in order to benefit

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<sup>166</sup> Motta, M., (2000);

<sup>167</sup> Horizontal Merger Guidelines, para. 78;

consumers, the efficiencies “should be substantial and timely and should, in principle, benefit consumers in those relevant markets where it is otherwise likely that competition concerns would occur”<sup>168</sup>.

Second, the efficiencies have to be merger-specific, which means that they are caused by the merger and cannot be achieved by other, “less anticompetitive alternative”<sup>169</sup>.

Finally, the efficiencies have to be verifiable. Verifiability requirement means that the Commission should be “reasonably certain that efficiencies are likely to materialize and be substantial enough to counteract a merger’s potential harm to consumers”<sup>170</sup>. The Guidelines set the guidance for the parties on the standard of proof, stating that where possible, the predicted efficiencies should be quantified<sup>171</sup>.

In the outset of the reform, numerous commentators predicted<sup>172</sup>, that explicit introducing of efficiency considerations into merger control would not bring radical changes, because economic theory tells us, that under consumer welfare standard, which requires that the efficiency savings be passed on to consumers, it would be very rare that merger bring efficiencies able to outweigh anti-competitive effects.

The Commission’s practice to date supports such prediction, because there were no cases, where efficiency savings alone would be the decisive factor in allowing an otherwise anti-competitive merger. However, as will be demonstrated below, there are some indications, that efficiency arguments, if they are appropriately presented to the Commission, will play a role in the appraisal of the concentration and may even determine a positive outcome of the case.

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<sup>168</sup> *Ibid.*, Para 53;

<sup>169</sup> Para 85;

<sup>170</sup> Para 86;

<sup>171</sup> Para 86;

<sup>172</sup> Van den Bergh, R. J., Camesasca P., (2006), p. 375;

In *Piaggio/Aprilia* case<sup>173</sup>, for example, which involved a merger between two leading Italian producers of scooters, efficiencies brought by the merger were one of the important factors (together with the “failing firm defense”<sup>174</sup>) which determined the Commission’s decision to allow the merger subject to obligations<sup>175</sup>. In particular, the Commission pointed out, that acquisition of Aprilia by Piaggio will create pro-competitive effects, because it will allow Piaggio to extend its product range by entering also into the market of motorbikes, and create significant competitor to Japanese producers of motorbikes. In addition, the concentration would allow the new entity to achieve significant economies of scale<sup>176</sup>.

Another case, which is noted in the literature as a step forward in efficiency defense,<sup>177</sup> is *Procter&Gamble/Gillette*<sup>178</sup> involving a concentration of two leading suppliers of consumer products for health care, personal care and beauty care in Europe<sup>179</sup>. In this case, the merger between Procter & Gamble and Gillette, was found to bring two types of efficiencies, namely “portfolio efficiencies” and efficiencies related to “category management”.

“Portfolio efficiencies” were defined as “benefits for retailers and customers from having only one partner to negotiate with (.one-stop-shop.), suppliers having stronger innovation capacities, and economies of scale and scope (e.g. offering a full truckload of the same product or even a full truckload of products from the same factory)”<sup>180</sup>.

“Category management” is a management method used in retail business in order to optimize the retailers’ product portfolio and to enable them to better meet the customers’

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<sup>173</sup> Case COMP/M.3570, *Piaggio/Aprilia* [2004], O.J. C7/5;

<sup>174</sup> Aprilia was facing acute financial crisis accompanied by interruptions of production and was rapidly losing its market shares (*Piaggio/Aprilia* para 12);

<sup>175</sup> Cook, Kerse, p.276; the Merger was cleared after the first phase subject to obligation imposed on the new entity to supply its 50cc engine to any competitor which expressed will to acquire them.

<sup>176</sup> *Piaggio Aprilia*, para 13.

<sup>177</sup> Röller, L., De la Mano, M., (2006), p. 18;

<sup>178</sup> Case COMP/M.3732, *Procter & Gamble/Gillette*, (15 July 2005), O.J. C 239/06;

<sup>179</sup> *Ibid.*, Paras 3-4;

<sup>180</sup> *Ibid.*, Para 131;

demand.<sup>181</sup> In other words, it is some sort of advisory services provided by the major suppliers to the retailers, which is aimed to improve the sales of the supplied product, and such consulting usually regards assortment, shelving, pricing and promotion of the products. The Commission held, that category management provided by the merged firm will increase overall sales of the products, benefit consumers through better meeting their needs and expectations (e.g. through more convenient allocation of the products on the shelves). Furthermore, category management would allow retailers to achieve economies of scale through reducing stocks and optimizing shelving decisions. Finally, it would help suppliers to increase efficiency of the promotion, because as a result of the closer contact with the retailers, they would be better able to anticipate the demand. Thus, the efficiencies described above were one of the factors which determined the decision of the Commission to clear the merger after the first phase subject to certain commitments<sup>182</sup>.

Probably the most detailed analysis of the efficiencies was conducted by the Commission in *Korsnäs/AssiDomän Cartonboard* decision<sup>183</sup>. Although again in this case efficiencies were not the only factor determining the clearance of the merger (significant buyer power of Tetra Pack was the other major factor countervailing the anti-competitive effects of the concentration<sup>184</sup>), they played important role in this case. Its noteworthy, that the Commission in its analysis explicitly referred to the criteria the claimed efficiencies have to satisfy to be taken into account by the Commission, established in the EC

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<sup>181</sup> *Ibid.*, Para 134;

<sup>182</sup> The commitments contained undertaking to divest a part of battery tooth brush business and providing a two year exclusive license for several brands of oral care products.

<sup>183</sup> Case COMP/M.4057, *Korsnäs/AssiDomän Cartonboard*, (12 May 2006), O.J. C 209/05;.

<sup>184</sup> Davies, J., Schlossberg, R., Bo Jaspers, M., Scholomiti, K, (2007), p. 5;

Horizontal Merger Guidelines, i.e. that efficiencies have to be “merger specific, verifiable and benefit consumers”<sup>185</sup>.

The Commission agreed, that there was a scope for the merger-specific efficiencies which were likely to benefit consumers. In particular, the merger was found likely to produce substantial synergies through reducing input costs, reduction in the number of personnel and improving production efficiencies. Besides, the parties claimed that the merger would allow them to realize R&D efficiencies and benefit from implementing best practices across two production sites (learning effects). Finally, the merged entity would be in position to extend its portfolio of products, which was seen as a pro-competitive effect<sup>186</sup>. Importantly, the parties to the merger provided a detailed calculation of the efficiencies, and even some competitors confirmed that such estimations were plausible and the efficiencies could be passed to consumers<sup>187</sup>. Thus, the efficiency claims in this case seem to be convincing enough and satisfy the verifiability requirement. The quality of the efficiency defense in this case led the Commission to conclude that, although “the submission by the parties raises a lot of issues, which cannot be fully assessed within the context of a first phase investigation”<sup>188</sup>, the efficiencies claimed by the parties “are likely to enhance the ability and incentive of the merged entity to act pro-competitively for the benefit of consumers, and therefore strengthen the conclusion that the proposed transaction will not significantly impede effective competition as a result of non-coordinated effects”<sup>189</sup>.

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<sup>185</sup> Case COMP/M.4057, para 61;

<sup>186</sup> *Ibid.*, Paras 57-58;

<sup>187</sup> *Ibid.*, Para 60;

<sup>188</sup> *Ibid.*, Para 62;

<sup>189</sup> *Ibid.*, Para 64;

The analysis of the cases above demonstrates, that the reform in the EC Merger control has changed the Commission's attitude towards efficiency claims and that it is more willing to take such claims into account if they satisfy the requirements outlined in the EC Merger Guidelines. It is important, that now merging firms, as well as the Commission, have the a clear point of reference for the analysis of efficiencies brought by mergers, and if the parties to the concentration bring well-presented, quantified efficiency arguments, supported by sound analysis, Commission is obliged to deal with them, and can dismiss them only if they are not merger specific, are not verifiable and are unlikely to be passed to the consumers.

Certainly, extremely small number of cases where efficiency defense has been successful might seem to indicate, that explicit introduction of the efficiency considerations into the merger control system did not have appreciable effect. In this regard, two observations should be made.

First, as mentioned in section 2.3 of this paper, economic theory predicts that under consumer welfare standard, which is expressed in the EC Horizontal Merger Guidelines, only in very few cases efficiency gains will outweigh anticompetitive effects of a concentration. Therefore, small number of cases where efficiency defense succeeds or even is raised is in line with such prediction. It would not be consistent with the goal of the reform, if the introduction of efficiency considerations would induce parties to bring speculative efficiency arguments in each case, even if it is clear that they are unfounded.

The second observation is related to the allocation of the burden of proof in merger procedure. Unlike the duty to prove the anticompetitive effects claimed in a merger case, which is imposed on the Commission, the obligation to bring the efficiency arguments and support them by plausible evidence in order to prove them ("evidential burden" and

“persuasive burden”) is borne by the merging parties. Therefore, the Commission can not start such analysis *ex-officio*, and the small number of the cases where efficiency analysis present should not be attributed solely to the Commission’s unwillingness or failure to deal with it.

On the other hand, although unwillingness of the parties to bring efficiencies claims more often can be explained by the difficulties in satisfying consumer welfare standard and resources required to produce convincing proof, it might also be a result of the lack of a more detailed guidelines on how the efficiencies should be dealt with. Indeed, the recital of the New Merger Regulation dedicated to the efficiencies and quite abstract framework provided by the EC Horizontal Merger Guidelines, although are a great step forward compared to the situation before the reform, might be insufficient for parties to understand clearly, how the Commission will deal with their efficiency arguments. In this respect, more detailed criteria are desirable, and a special Notice of the Commission dedicated to efficiency defense would be welcome.

#### **4.2.3. The Role of Economics in Merger Cases**

The discussion of the practical changes brought by the reform of the European Merger Control would not be complete without looking at the role of economic expertise in the merger cases. As discussed at the Part 2 of this paper, the impact of the mergers on economic welfare is the main rationale for regulation of merger activity, therefore it is clear that economic analysis has to play an important role in the merger procedure.

Historically, although the European Commission recognized the importance of economic analysis in the merger procedure, its DG COMP did not have a distinct economic

unit, which would be in charge of providing economic expertise in the merger cases. Instead, when there was a need for sophisticated economic scrutiny of the merger notified to the Commission, the latter often resorted to external economic advice on an *ad hoc* basis<sup>190</sup>. However, after the judgments in *Airtours*, *Shneider* and *Tetra Laval*, in which the CFI severely criticized the economic arguments of the Commission, the need to increase economic expertise of the Commission was realized. As a result, in 2003, the Commission appointed its first Chief Economist which was charged with providing methodological guidance on economic policy as well as economic guidance in individual merger cases.<sup>191</sup> The office of the Chief Economist is staffed with highly qualified economists, who provide specialized economic support in the analysis of mergers.

Increased attention of the Commission to the economic analysis and participation of the Chief Economist's team is seen as positive development in the merger control. It has been also noted, that in several cases deep economic analysis of the facts of the case allowed to clear mergers which apparently were anti-competitive (for example, Sony/BMG<sup>192</sup> case)<sup>193</sup>.

The increased role of economics and economists in merger cases can also be seen in parties' use of economic consultancy services. It has been noted, that during the last years, parties dedicate more resources to produce economic arguments in the cases before the Commission. According to the surveys dedicated to this question, in 1995 economic consultancy amounted to about 5 per cent of total fees paid in merger cases and during the past 10 years this amount has grown to approximately 15-20 per cent (other part being legal

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<sup>190</sup> Levy N., (2005), p. 124;

<sup>191</sup> Levy, N., (2005) p. 124;

<sup>192</sup> Sony/BMG case;

<sup>193</sup> Levy, N., (2005), p.125;

and administrative expenses). Economists' participation in the merger cases is increasing and they usually provide advice in complex cases requiring sophisticated analysis<sup>194</sup>.

It is important, that the economists of the Commission and of parties do not work in isolation, but cooperate and discuss economic issues during the case. Thus, the procedural rules of the Commission allow the parties to access the file and see what methods and what data the Commission's Chief Economist's office uses to reach its conclusions. Similarly, the parties have to provide the Commission with the data and methods they used performing their own economic assessment of the merger<sup>195</sup>. Such exchange of information and discussions of economic issues increases the quality of the evidence in the merger cases and is likely to reduce the number of contradictory decisions and appeals, at least where the economic analysis of the parties and the Commission converge in majority of points in the case.

It can be argued, that strictly speaking, the increasing role is not the result of the change in the Merger Regulation, i.e. it was not necessary to adopt the new Merger Regulation in order to create a special unit for economic scrutiny in the Commission and involve more economic consultants in the merger cases. This is true, but the increasing use of the economic expertise can be seen as complementary to the merger reform, and, even more, it is indispensable given the new instruments regulating the merger procedure and requirements for the level of economic analysis to be performed in the merger cases. The provisions of the New Merger Regulation and the criteria outlined in the EC Horizontal Merger Guidelines require deep economic analysis, therefore sound implementation of these instruments could not be achieved without increase of economic analytical capacity of the Commission and the parties. As the judgments in *Airtours*, *Shneider* and *Tetra Laval*

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<sup>194</sup> Neven, D., (2007), pp. 4-5.

<sup>195</sup> Neven, D., (2007), p. 7,

demonstrated, the Court will not be satisfied by arguments, which are not based on sound and thorough economic analysis, involving the insights of the modern economic theory, and such analysis requires increased participation of economists. In this sense, the increased role of economic analysis and increased participation of the economists in the merger cases can be seen as a consequence of the merger reform.

After the three years, which have passed after the reform, it is still difficult to make a conclusive decision, if the increased presence of economists bring significant change into the merger procedure. However, it seems to have brought improvement into the quality of the analysis of the Commission, and hopefully it will further help the Commission to reduce the number of the mistakes which can appear extremely costly<sup>196</sup>.

## **5. Conclusions.**

Horizontal Mergers may bring both socially detrimental and beneficial results, which makes it desirable to control merger activity of certain scale. The former Merger Regulation on overall operated and was interpreted in line with the economic analysis, however, the gap of the old substantive test and lack of a consistent approach to efficiency gains were regarded as major drawbacks from the economic point of view.

The new Merger Regulation, in the first place addressed the mentioned drawbacks. As the discussion of the case law in this paper shows, even during the short period after the reform the Commission took advantage of the change in the Merger Regulation and started using the theory of unilateral effects and efficiency considerations more soundly in its

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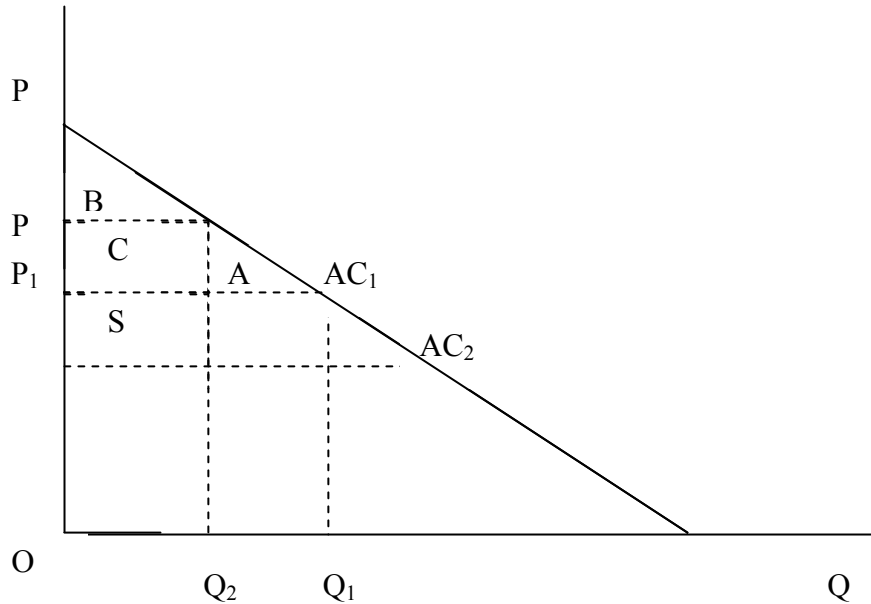
<sup>196</sup> At the time of writing, the CFI ordered the Commission to pay damages for wrongly blocking a merger between Schneider Electric and Legrand. The precise amount of the compensation is still to be determined by the experts (Schneider Electric had claimed 1,66 billion euro). For brief overview see: <http://www.ft.com/cms/s/540cda5c-2f97-11dc-a68f-0000779fd2ac.html>.

analysis. Although the number of the decisions, which can be regarded as affected by the reform, is small, one should not think that the effect of the reform is negligible, since the number of the decisions where the changes of the Regulation can be applied was not the goal of the reform. Bringing the analysis of the horizontal mergers performed by the Commission in line with the economic theory is a welcome development which is worth the effort undertaken during the reform. On the other hand, additional clarification of the requirements for efficiency defense is desirable in order to induce the parties to use it to the optimal extent.

Practical impact of the reform cannot be understood completely without seeing the change in the Merger Regulation not only as a revision of the Council Regulation, i.e. the legislative act of the EU institutions, but as a broader reform, which includes the complementary instruments such as Best Practice Guidelines and EC Horizontal Merger Guidelines, as well as institutional improvements in the Commission, strengthening its economic expertise. After the CFI stressed the defects of the Commissions evidentiary practice, the latter changes are of high importance, since the Guidelines provide a better guidance as to the standard and burden of proof in the merger cases, and the increased participation of highly qualified economists (the parties' consultants and staff of the Chief Economist's Office) helps to ensure, that the new instruments in the field of Merger Control are applied consistently and the high level of proof set by the CFI is maintained.

## Annex 1

Graph 1: The Williamsonian welfare trade-off



Source: Van den Bergh R. J. and Camesasca P., (2006), pp.32-33.

The graph demonstrates the situation where merger leads both to economies of scale and increase of the market power.  $AC_1$  depicts the average costs of the two or more firms before the merger.  $AC_2$  demonstrates the average costs after the merger.  $P_1$  shows the price before the merger which is equal to  $AC_1$ .  $P_2$  indicates the price after the merger and it is higher than  $P_1$ . The area A depicts deadweight loss which is caused by the increase of the price from  $P_1$  to  $P_2$  while costs are constant. The area S shows the costs savings achieved by the reduction of the costs.

As a result of the merger, the consumer surplus ABC is reduced to the area B, while C depicts the wealth transfer from consumers to producers.

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AUTHORSHIP DECLARATION:

I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I acknowledge the supervision and guidance I have received from Professor Vincenzo Denicolo.

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