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ICN Subgroup Analytical Framework for Merger Review
Contribution by the Bundeskartellamt, Germany

1. Institutional Framework

The Bundeskartellamt (Federal Cartel Office) is an independent higher Federal authority which is responsible to the Federal Ministry of Economics and Technology. Its main task is to apply the Act against Restraints of Competition (ARC). This was enacted for the protection of competition and came into force on 1 January 1958. Merger control was introduced with the second revision of the ARC in 1973. The Bundeskartellamt bases its decisions solely on competitive criteria. It receives no instructions from the Ministry of Economics and Technology. There is a right of appeal to the Higher Regional Court in Düsseldorf against prohibitory decisions of the Bundeskartellamt. Appeals on points of law can be lodged with the Federal Supreme Court against decisions of the Higher Regional Court.

In exceptional cases the Federal Ministry of Economics and Technology also acts as a competition authority: If in individual cases restraints of competition are outweighed by advantages to the economy as a whole, or are justified by an overriding public interest, they can be given exceptional approval by the Federal Ministry of Economics and Technology. This applies to special cartels and merger control. Grounds for giving ministerial authorisation can be e.g. rationalisation advantages, the wish to preserve jobs or secure the supply of energy or raw materials. In doing so the market economy system of the economy as a whole may not be jeopardized.

For this reason the examination of mergers is organized in two stages: The Bundeskartellamt is responsible for exclusively examining a merger under competition law. Any political grounds for its justification can only be taken into consideration in the second stage, in the form of a ministerial authorisation. Only 18 applications for a ministerial authorisation have been filed in over 20 years, and ministerial authorisations were granted in only 6 cases. Two requests for ministerial authorisation are still pending at the economics ministry.

2. Substantive Test

a. Effect on competition in relevant markets

Single-firm dominance

Under Section 36 (1) of the ARC, a merger is to be prohibited by the Bundeskartellamt “if it is expected to create or strengthen a dominant position.” The concept of market dominance is put into concrete terms in Section 19 (2) of the ARC, where an undertaking, which either has <u>no competitors</u> (first option) or is <u>not exposed to any substantial competition</u> (second option) or has a paramount <u>market position</u> in relation to its competitors (third option), is presumed to be dominant. The first variant is of practically no great significance because the complete absence of competition can only be presumed in the most exceptional cases. Whilst the first and second variants determine the certain absence of (substantial) competition, the expectation that the restraint of competition will most probably lead to a standstill in competition in the further course of developments is enough to determine a paramount market position.[1] The third variant is thus the most significant in merger control.

A paramount market position exists if an undertaking’s <u>scope of action is not sufficiently controlled by its competitors</u> due to market or company-related structural criteria. Company mergers strengthen a paramount market position if the competitive conditions on the affected market become even worse as a result.

Section 19 (2) sentence no. 1 (2) of the ARC stipulates the major factors which should be taken into account when examining a paramount market position. The market share always forms the basis for assessing market power. A dominant position is presumed to exist within the meaning of Section 19 (3) of the ARC if <u>one undertaking</u> has a <u>market share of at least one third</u>. Apart from market share the law stipulates the following assessment criteria: financial power, access to supply or sales markets, links with other undertakings, legal or factual barriers to market entry by other undertakings, actual or potential competition by undertakings established

[1] Cf. Mestmäcker/Veelken in Immenga/Mestmäcker, GWB Kommentar zum Kartellrecht, 3rd ed., § 36, marginal note 137.

within or outside the area of application of this Act, the ability to shift supply or demand to other goods or commercial services, as well as the ability of the opposite market side to resort to other undertakings. This list is not conclusive. In examining a merger the Bundeskartellamt has to make an overall appraisal of all the criteria. A more exact analysis of the individual criteria is given under point 3.

Oligopolistic dominance

According to Section 19 (2) sentence 2 of the ARC, two or more undertakings are dominant insofar as they jointly satisfy the conditions of market dominance and no substantial competition exists between them. Therefore, in assessing an oligopolistic situation it is first examined whether the conditions of **internal competition** favour anti-competitive parallel conduct. The presumption thresholds for oligopolistic dominance lie at a combined market share of 50 per cent in the case of a maximum of three companies or two-thirds for a maximum of five companies. Advantages in market share and resources as well as interlocks or economic interdependence between the oligopolists and outsiders are of particular significance as regards **external competition.** Additional criteria applied in the assessment of oligopolistic dominance include the level of market transparency, the homogeneity of the products and actual competitive activity in the market. A comprehensive appraisal of all the significant conditions of competition should also be made and considered in assessing collective dominance.

b. Public interest issues

In examining mergers the Bundeskartellamt applies solely competitive criteria. After a merger has been prohibited by the Bundeskartellamt any considerations of public interest in it can only be made by the Federal Minister of Economics in the form of a ministerial authorisation.

c. Efficiency gains

The Bundeskartellamt is of the opinion that, at least in cases of clear market dominance, mergers cannot be cleared solely on the basis of efficiency gains. However like that of public interest, this criterion is applied as a competition-unrelated criterion in the ministerial authorisation.

Based on the conviction that in the long term free competition also increases welfare, the emphasis in merger control lies in protecting this competition. Its objective is to combat any risks to competition arising from dominant positions.[2] The aim here is to maintain competitive market structures and ensure that the scope of action of companies is sufficiently controlled and does not impinge on the substantive <u>freedom of action</u> of other firms and consumers. Merger control should therefore combat any risk to competition that may arise from a change in market structure resulting from a concentration. It is essential because a code of conduct and abuse control are not considered as effective substitutes for competition.[3]

The emergence of a dominant position can indeed lead ad hoc to increases in efficiency. However, in the case of market dominance the freedom of action of other market participants is excessively and probably permanently restricted with the result that competition loses its effect as a <u>steering and control mechanism.</u> Without this consumers would not be able to simply switch to another supplier in the event of a change of their preferences or of a deterioration in services. The sanction mechanism, which ensures selection and thus progress, would ultimately be affected. Moreover as a result of the appreciable restraint on competition increasing inefficiencies on the part of the merged company would be likely in the long term as the competitive pressure on improving services would be lacking.

Merger control on its own <u>does not provide for a welfare-based examination</u> of a merger. The ARC does not generally empower the competition authorities to use the protection of competition to achieve economic policy aims such as overcoming economic or structural crises, promoting growth or reducing unemployment.[4] A merger is therefore not examined with the direct aim to increase public welfare but with regard to protecting competition. The view already mentioned that competition free of power positions leads to an optimum in welfare in the long term forms the basis for this concept. In this respect, a pluralistic definition of welfare applies. In this sense, welfare results from the sum of individual expectations and activities which

[2] Cf. Mestmäcker in Immenga/Mestmäcker, GWB Kommentar zum Kartellrecht, 3rd ed., preliminary note on Section 35 (*Vor § 35*), marginal note 27.
[3] Cf. Mestmäcker in Immenga/Mestmäcker, GWB Kommentar zum Kartellrecht, 3rd ed., preliminary note on Section 35 (*Vor § 35*), marginal note 27.
[4] Cf. Mestmäcker in Immenga/Mestmäcker, GWB Kommentar zum Kartellgesetz, 3rd ed., Introduction, marginal note 4.

can be realized in free competition. Maintaining free competition is therefore tantamount to achieving an optimum in welfare. No specific overriding social welfare function is assumed. In this way competition can be regarded as the economic equivalent of the democratic principle. This is laid down in the legislative intent of the government draft of 1952.[5]

From this we can conclude that the Bundeskartellamt would also have to prohibit a merger which leads to efficiency gains and at the same time a dominant position. It is theoretically conceivable that a merger leading to a dominant position could, due to extraordinarily high merger-related efficiency gains, force down the cost curves of the merging parties to such a low level that this would ultimately result in a lower profit-maximizing price for the merging parties than before for the individual companies. The Bundeskartellamt does not take a likely reduction in the price following a merger as sufficient proof of the future functioning of competition. In such a situation the companies would be free to make commitments which would reduce the expected restraint of competition and maintain the efficiency gain. If the competitive concerns of the Bundeskartellamt could be dispelled in this way, this would render a prohibition unnecessary.

Up to the point where a dominant position is reached the companies are generally free to realize all their merger projects and to aim for efficiencies, irrespective of their nature. As competition is to be understood as a dynamic and open process resulting from the progressive and imitative actions of companies, it must of necessity produce temporary imbalances of power. With the criterion market dominance the lawmaker only sets an absolute limit for the individual scope of action producing such imbalances. Once this limit has been reached competition as such is likely to be eliminated.

[5] „The ‚Act against Restraints of Competition' constitutes one of the major foundations for supporting and maintaining market economy. Its purpose is to safeguard freedom of competition and to eliminate economic power where it impedes the effectiveness of competition and puts into question its inherent tendencies to increase economic performance and secure the best possible availability of supplies to consumers. The Act is based on the experience made in economic policy and confirmed by economic research that an economy based on competition is the most economically efficient, and at the same time the most democratic economic system. The Act is also based on the experience that regulatory intervention in market processes should only be undertaken by the state to such an extent as is necessary to maintain the market mechanism or to supervise those markets where the market concept of complete competition cannot be achieved …An economic system set up in this way is the economic-policy counterpart of political democracy." (Explanatory statement of the government with respect to the ARC, Bundestagsdrucksache II/1158, Annex 1, p. 21ff.)

d. Failing firms

A merger can only be prohibited in Germany if it is causal for the creation or strengthening of a dominant position. Causality is lacking when, although a concentration would lead to a worsening of market conditions, this would have happened even if the concentration had not occurred. One example of this is the so-called failing company defence. This type of merger, even if it creates or strengthens a dominant position, should be cleared if it is assumed that the acquiring company would also gain the remaining potential of the failing firm if this firm were to leave the market.

e. Benefits to consumers

Only indirect consideration is taken in merger control of benefits to the consumer. Maintaining free competition as a regulating principle is given primary consideration. It is assumed that this produces the greatest benefit for consumers.

f. Other specific issues

The Bundeskartellamt can clear a merger which fulfils the prohibition requirements if the companies can prove that the merger – in another market – will improve the conditions of competition and that these improvements will outweigh "the disadvantages of dominance" (balancing clause of Section 36 (1) of the ARC). Again, only competitive criteria are taken into consideration in such an examination.

3. Analytical steps - Assessment of market power

3.1 Single-firm dominance

a. Marktanteil

A high absolute market share suggests that the ability of the opposite side of the market to switch to other undertakings is limited and that the enterprise concerned has an increased scope of action. As a general rule a product's market share in value terms is expressed by turnover. Other methods of calculation can be a more appropriate indication in certain circumstances, e.g. volumes of orders in the construction industry and armaments sector, the number of passengers in air traffic. The threshold from which dominance can be presumed is when a market share of one third is reached.

Market share difference and the distribution of market shares are indicative of the competitors' ability to offer the other side of the market alternative choices. The greater the difference between an enterprise's market share and that of its largest competitor and the more fragmented the market shares of its other competitors, the greater the likelihood is that the market (share) leader has a scope for restrictive action. However the law gives no indication of the measures of concentration (e.g. Hirschman Herfindahl Index, HHI) and presumption thresholds applicable in this respect.

The development of market shares over time can also be indicative of the presence or absence of a paramount market position. A permanently high market share is indicative of an uncontrolled scope of action. The Bundeskartellamt therefore generally analyses the development of the market shares in the relevant market over a period of several years.

b. Resources, in particular financial strength

Superior financial strength may provide a firm with a scope of action, in particular as regards the use of parameters of competition such as price, investment, research and advertising. The same applies for example to a comprehensive production programme or range of products, or resources that are specific to a particular sector or market, in particular technological resources. Superior resources result in a paramount market position if they limit the alternatives available to buyers and if they have discouraging and deterrent effects on competitors.

In order to assess the financial strength of an enterprise, the Bundeskartellamt applies numerous criteria such as turnover, cash flow, profits, liquid funds, annual surplus or access to national and international capital markets. The financial strength of an enterprise can be of particular importance in markets that are subject to strong cyclical fluctuations, or require high research expenses. However, it is not the increase in financial strength as such that leads to the deterioration of market structures. The likelihood of an anti-competitive impact should be examined, i.e. whether resources are likely to be of relevance for predatory and disciplinary strategies or as barriers to market entry.

A similar examination is conducted to establish any other possible resource advantages. These gain in significance in conjunction with an existing market dominance which is further strengthened by product range extensions and technological improvements.

c. Access to supply or sales markets

A firm's easier access to the supply or sales markets in relation to its competitors may give it a paramount market position. This is particularly so if a powerful firm (in terms of its market share) can make access to such markets difficult or even impossible for its rivals on account of its own excellent access to the supply or sales markets (raising the barriers to entry).

A market foreclosure effect can, for example, be of relevance in the case of vertical integration, when a company can supply a full line of products or complete systems, or in the case of other resource-based competitive advantages (e.g. superior distribution system). Such offers often involve efficiency advantages. However, the supply of full product ranges or complete systems can contribute to the creation or strengthening of a dominant market position if it results in advantages relating to sales market access that cannot be matched by competitors and predatory strategies to the disadvantage of less diversified firms. Furthermore, having to offer a complete system or full range of products can deter potential rivals from entering the market.

d. Interlocks

The interlocking arrangements of a firm, in particular with its competitors, customers or suppliers, may be contributing factors to a paramount market position, but cannot in themselves lead to its creation. Interlocks can be of a social, personal, economic or legal nature (e.g. reciprocal patent licensing agreements, (exclusive) supply contracts). Such interlocking arrangements may in principle strengthen a firm's dominant position if it gains resources or influence as a result. Interlocks with current or potential competitors as well as with suppliers of imperfect substitutes are particularly significant here, as competition among those competitors is usually restrained as a result.

e. Barriers to market entry / potential competition

Just as market share gives an indication of the relationship between the firms involved in a merger and their current competitors, the barriers to entry provide information on the significance of potential competitors for competition on the market concerned. As long as a powerful firm cannot quote excessive prices as otherwise potential competitors would be likely to enter the market, it is unlikely to have an unlimited scope of action. However, if barriers to entry are high, this may be an important indication that a dominant firm has a paramount market position as it is able to secure its market position against new entrants. In evaluating a potential competitor, it should be examined whether an effective entry which is of relevance to competition is possible and probable. It must also be possible to express in sufficiently concrete terms.

Barriers to entry can be roughly divided into three categories:

- *statutory* barriers to entry are those set up in the context of the state's monopoly on power in the form of laws, regulations and administrative practice (for example national individual procedures for the clearance of medicaments or protection of patents).
- *structural* barriers to market entry usually arise from certain technological or demand-related market characteristics, but may also lie in the resource-based strength of a company. They are not generally created intentionally to prevent entry. These include, for example: deterrent potential of large resources of the market leader, transport costs, economies of scale, high sunk costs, economies of scope, technical barriers to entry.
- *strategic* barriers to entry are intentionally set up by incumbents in a market in order to deter potential suppliers from entry. These can include for example long-term supply contracts, exclusive contracts, industrial standards and technical access systems

f. Counterbalancing market power

A high level of concentration of firms on the buyer side of the market is not in itself sufficient evidence to disprove the market dominance of a supplier, since any buying power initially affects all suppliers to an equal extent.

Instead of this, a prerequisite for counterbalancing market power is that a powerful buyer awards its contracts according to market-strategic considerations, so as not to become dependent on (dominant) suppliers. In order to do this he must have high cost transparency and the competence to develop the products concerned. Here the question arises of whether the factors contributing to effective competition – for example effective price and cost limitation or the incentive to make technical progress – can be equivalently replaced by buyer power and strategic purchasing behaviour in individual cases.

g. Market phase

On markets which are just beginning to develop and where the speed of innovation is high, a large market share or even a sole position is not necessarily to be seen as a dominant position. In such a situation conditions of competition are exposed to rapid change. There is no danger of paramount positions being cemented in the long term. If, however, it is likely that the market concerned will be sealed off permanently as a result of the concentration already at the time when the firm is set up, the concentration concerned is to be prohibited (examples: digital television services, Internet platforms).

In markets in which the technology is in an advanced stage and turnover volumes are declining or stagnating, competitive impulses through innovation and market entry tend to be rare. As a consequence high market shares are less likely to decrease in later than in earlier market phases.

3.2 Oligopolistic dominance

Oligopolistic dominance is assumed when a totality of companies refrain from competitive actions and show anti-competitive parallel conduct (**lack of internal competition).** A further condition for this is that there should be no appreciable competition between the oligopoly and other companies on the market **(lack of external competition).** This definition can be substituted by the paramount market position of an oligopoly in relation to outsiders. The examination of the competitive conditions is closely related to the question as to how much the oligopolists actually make use of possible competition parameters.

<u>Internal competition</u>

In the examination of internal competition market transparency, homogeneity of products and the actual market process are particularly relevant criteria. Furthermore the characteristics familiar from the examination of single-firm dominance will be referred to. The examination of domestic competition mainly focuses on the symmetry of oligopoly members rather than on the paramount market position. The latter will only become relevant in the assessment of external competition. The basic assumption is that with increasing symmetry of oligopolists there will be a greater likelihood for parallel behaviour without competition. In situations of strong symmetry competitive action is equally perceptible to all firms, easily detectable due to the transparency of the products, and not likely to have a very promising outcome because all the firms would have a similar retaliatory potential.

a. Market transparency

If there is a high level of market transparency suppliers can obtain information on the competitive behaviour of their competitors and thus facilitate concerted action. Relevant are not only factors that allow explicit concerted action but also market conditions that allow enterprises to signal to each other their competitive strategies.

b. Homogeneity of products

Markets where product differentiations play an important part are generally rather unfavourable for parallel behaviour within the oligopoly. In the case of homogeneous products there can be no or only very limited competition in terms of quality. In addition, it is not possible in the majority of cases to determine with reasonable certainty whether there is price competition. Thus, in such markets all forms of residual competition (such as competition in services, terms, quality and the provision of advice to customers) decide whether competition is still substantial.

c. Actual market processes

If substantial competition exists between the market leaders before the concentration and if these enterprises have made substantial investments in long-term growth strategies in a cross-border market, the absence of internal competition will become less likely if an outsider firm is acquired. The same applies if there was a dramatic drop in prices in the past, in particular if it was associated with substantial market share losses on the part of the oligopolists in favour of outsiders and if new firms have, or are expected to, enter the market.

d. Market share

The tighter the oligopoly and the fewer the outsiders, the more likely is the elimination of substantial competition. As mentioned above the presumption thresholds for oligopolistic dominance lie at a combined market share of 50 per cent in the case of a maximum of three companies or two-thirds for a maximum of five companies. Particularly the analysis of the development of market shares in the relevant market over several years may provide useful information on the competitive process taking place in the oligopoly. An indication that an oligopoly lacks competition is given when the oligopolists' market shares or the differences between their market shares are largely stable.

e. Interlocks

Interlocking directorates or capital links among the enterprises belonging to an oligopoly will increase the likelihood of anticompetitive parallel conduct. This applies both to interlocks in the market affected by the concentration and to interlocks in third markets, particularly to upstream or downstream markets.

f. Counterbalancing market power

In a highly-concentrated market, the more fragmented the opposite side of the market is, the more likely it is that there will be oligopolistic dominance. However, enterprises on the opposite side of the market that have great purchasing power may impede anticompetitive parallel conduct by suppliers.

<u>External competition</u>

When, in addition to the oligopoly, there are other firms operating in a market affected by a concentration, oligopolistic market dominance may only be assumed if substantial competition is lacking or if the oligopoly has a paramount position in relation to the outsiders. The examination of whether the oligopoly has a paramount position is similar to the assessment of single-firm dominance. Instead of one single firm the whole group of oligopoly members is subjected to a collective evaluation.

3.3 Temporal Effects

The mere possibility of market dominance alone is not sufficient; what is required is a higher level of probability. Therefore, forecasts are necessary. If there are no special circumstances, the usual prognosis period will not be more than three years. All structural criteria mentioned above are to be taken into account in terms of their likely development in the future.

4. Lessons

a. Differentiation between competitive and non-competitive assessment

From the Bundeskartellamt's point of view the strict differentiation between the examination under competition law and political evaluation criteria is beneficial as it guarantees a high level of transparency in decision-making processes. Moreover, due to the vagueness of the public welfare concept, freedom of competition seems to be a more objective and purpose-oriented standard in merger control.

b. Preference for the market dominance test

The Bundeskartellamt does not consider it necessary to deviate from the existing substantial examination criterion (dominance test). The reasons for this are as follows:

In principle both prohibition criteria refer to the same facts. They merely approach the problem from different sides. If <u>competition</u> is defined <u>as the absence of paramount positions of power</u>, the market dominance test focuses on the paramount position of power whereas the SLC test examines the intensity of competition.

However, looking at the theoretical concepts of the two tests – which must be distinguished from the precise shape these concepts will take in different national legal systems – the difference to be noticed is that the market dominance test defines an "<u>upper limit</u>" up to which individual scope of action with regard to mergers may reach and which is largely independent from the intensity of competition previously established. However, based on its general approach the SLC test focuses on a rate of change relating to the intensity of competition. According to this definition and irrespective of their different presumption thresholds and the different ways in which they are concretised, the two criteria thus cannot lead to the same results in each possible constellation. If e.g. the SLC test stipulates that the intensity of competition may only be reduced by a “certain rate” (whatever the definition of this rate may be), the market dominance threshold will not necessarily be reached. The concept of substantial lessening of competition gives reason to assume that a reduction of the intensity of competition to a certain extent should be dealt with by an authority even if the market merely moves from a state of extremely high intensity of competition to a medium, not yet dangerous level.

In this respect the Bundeskartellamt’s view is that the market dominance test should be preferred. In merger control a mere reduction of the intensity of competition without the creation of a dominant position is not a condition that would give rise to concerns. In dynamic competitive processes imbalances and also fluctuations in the intensity of competition will constantly occur anyway. There is only reason for concern if the advantage one company gains over others by means of a merger reaches a level where the remaining competitive forces alone can no longer be expected to wear away the market power achieved. Such a condition is covered exactly by the criterion of ‘market dominance’. As a rule we will not find market dominance if a position of power is still exposed to substantial competition, even if this competition is not as intense as it used to be. In such a situation there is no reason for the state to deal with a reduction of intensity of competition.

(However, if also the SLC test is defined as a reduction of competition to a certain level (instead of by a certain rate), the principal differences between the two prohibition criteria are diminished. Depending on the concrete shape the two tests will take in the law they can even be completely in line with each other.)

The theoretical basis of the two tests does not provide any secure indications as to which approach is stricter than the other. Ultimately this depends on the concrete criteria applied by the different national legal systems in order to define the test itself and to establish the examination criteria which are to be applied in the market analysis. An analysis carried out by the Bundeskartellamt has shown that different national legal systems often define the SLC test in its concrete shape on the basis of the market power criterion.[6] This demonstrates that, in real terms, the concepts are ultimately similar. One restriction should be noted in this context, viz. that this harmonisation only relates to the wording of the respective legal texts as yet. While it is true that the definitions of paramount market power are also partly the same ("uncontrollable scope of action"), it remains unclear how this feature will ultimately be shaped in the individual decisions to be made. Also with regard to market analysis many national laws refer to criteria formulated in the same way (market shares, barriers to market entry etc.). The same argument applies in this context as well, so that the possibly different interpretations of these terms may result in different international assessments of market processes. The basic assumptions on competition regarding e.g. the extent of its potential for self-regulation and the assumed market behaviour by firms, the extent and durability of factual barriers to market entry, the power of potential competition and the assumed dynamics of progress within an economy will also account for essential differences. Moreover the purpose of protecting competition (protection of freedom and protection of the coordination mechanism vs. achievement of a certain market result) and thus the concepts of competition theory on which the protection is based will be of great importance.

[6] Cf. Bundeskartellamt (2001): Das Untersagungskriterium in der Fusionskontrolle [Prohibition Criteria in Merger Control].