INTRODUCTION

1. Article 2 of Council Regulation (EEC) No 4064/89 of 21 December 1989 on the control of concentrations between undertakings (1) (hereinafter: 'the Merger Regulation') specifies that the Commission shall appraise concentrations within the scope of the Merger Regulation with a view to establishing whether or not they are compatible with the common market.

2. The purpose of this notice is to provide guidance as to how the Commission makes the appraisal of concentrations where the undertakings concerned are active sellers on the same relevant market or potential competitors on that market. In the following these concentrations will be denoted 'horizontal mergers' (2). The guidance set out in this notice will focus on how the removal of an actual or potential competitor may affect competition in the relevant market (3).

3. The guidance set out in this notice draws and elaborates on the Commission's evolving experience with the appraisal of horizontal mergers under the Merger Regulation since its entry into force on 21 September 1990 as well as the case-law of the Court of Justice and the Court of First Instance of the European Communities. The principles contained here will be applied and further developed and refined by the Commission in individual cases.

4. The Commission's interpretation of the appraisal of 'horizontal mergers' is without prejudice to the interpretation, which may be given by the Court of Justice or the Court of First Instance of the European Communities.

OVERVIEW

5. Pursuant to Article 2 of the Merger Regulation, a concentration shall be declared incompatible with the common market if, and only if, it 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.

6. The Commission's appraisal of mergers notified under the Merger Regulation essentially contains two main parts which mutually interact:

   (i) definition of the relevant product and geographic markets;

   (ii) competitive assessment of the merger.

The main purpose of the market definition is to identify in a systematic way the competitive constraints that the merging firms face. The objective of defining a market in both its product and geographic dimension is to identify those actual competitors of the undertakings involved that are capable of constraining their behaviour and of preventing them from behaving independently of an effective competitive pressure. Guidance on this issue can be found in the Commission's Notice on the definition of the relevant market for the purposes of Community competition law (4). Many of the considerations leading to the delineation of the relevant markets may also be of importance for the competitive assessment of the merger.

7. The present notice is structured around the following elements:

   (a) the likelihood that the merger would have anti-competitive effects in the relevant markets, in the absence of countervailing factors;

   (b) the likelihood that buyer power would act as a countervailing force to an increase in economic power as a result of the merger;

   (c) the likelihood that entry by new firms would maintain effective competition in the relevant markets;

   (d) the likelihood that efficiencies will result from the merger;

   (e) the conditions for a failing firm defence.

8. In view of these elements, the Commission will determine whether or not the merger would create or strengthen 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. However, not all these elements are relevant to all horizontal mergers. In particular, efficiencies and the failing firm defence are typically only analysed if the notifying parties establish that the necessary conditions are met for those claims to be of relevance (see Sections VI and VII of this notice). Furthermore, analysing all elements in the same detail may not be necessary. For instance, finding that entry would be very easy, timely and effective may be sufficient to conclude that no possible competition problems can arise without detailed analysis of other factors.
II. POSSIBLE ANTI-COMPETITIVE EFFECTS OF HORIZONTAL MERGERS

9. Effective competition brings benefits to consumers, such as low prices, higher quality products, a wide selection of goods and services and technological innovation. Through its control of concentrations, the Commission prevents concentrations that deprive consumers of these benefits but allow concentrations that contribute to fostering these benefits through continued effective competition.

10. In assessing the competitive effects of a merger, the Commission compares the competitive conditions that would follow the merger with the conditions that would prevail absent the merger. In most cases the existing competitive conditions constitute the most relevant comparison for evaluating the effects of a merger. However, the Commission will, for instance, take into account likely entry or exit of firms when considering what constitutes the relevant comparison.

11. There are three main ways in which horizontal mergers may significantly impede effective competition as a result of the creation or the strengthening of a dominant position:

(a) A merger may create or strengthen a paramount market position. A firm in such a position will often be able to increase prices without being constrained by actions of its customers and its actual or potential competitors.

(b) A merger may diminish the degree of competition in an oligopolistic market by eliminating important competitive constraints on one or more sellers, who consequently would be able to increase their prices.

(c) A merger may change the nature of competition in an oligopolistic market so sellers, who previously were not coordinating their behaviour, now are able to coordinate and therefore raise prices. A merger may also make coordinating easier for sellers who were coordinating prior to the merger.

12. The Commission will assess whether the changes brought about by the merger would result in any of these effects. In oligopolistic markets, a merger can significantly impede effective competition in two ways (b) and (c). They may both be relevant when assessing a particular transaction. In both scenarios increased prices will lower consumer welfare.

Market characteristics and concentration

13. In considering the possible anti-competitive effects of the merger, a number of basic facts about the markets need to be considered. These include elements such as market shares, concentration levels and the importance of innovation.

14. Market shares often provide a useful first indication of the competitive importance of both the merging parties and their competitors. However, current market shares may be less important if there are indications that the competitive conditions may change in the near future, for instance in the light of likely exit, entry or expansion. This could be the case if the merging firms are likely to lose demand from customers who pursue a multiple sourcing strategy. In bidding markets, market shares may not be informative of the likely competitive impact of a merger. In these cases it is preferable to obtain direct information about the role of market players in the bidding processes, for example by means of win/loss analyses. The more precise the customer preference information is, the less weight should be placed on market shares as indicators of the possible competitive effects of a given merger.

15. Changes in historic market shares often provide useful information about the competitive process and the likely future importance of the various competitors, for instance, by indicating which firms have been gaining or losing market shares.

16. The overall concentration in a market also gives useful information about the competitive situation in a market. The Commission will apply the Herfindahl-Hirschman Index (HHI) as a first indication of the competitive pressure in the market post-merger. The HHI is calculated by summing the squares of the individual market shares of all the firms in the market. The HHI gives proportionately greater weight to the market shares of the larger firms, in line with their relative importance in the competitive process. The Commission is unlikely to investigate cases where the aggregate HHI after the merger remains below 2000.

17. An important part of the competitive analysis is to establish the main parameters of competition in a particular market. Two broad types of competition are normally distinguished. First, competition primarily in output or capacity occurs in practice in situations where firms choose output or capacity and then, given the level of demand, adjust prices to sell this output. For example, in some commodity industries, price levels are determined by the overall level of output on the market. Second, competition primarily in prices occurs when firms set prices and adjust their production level according to demand.
18. However, in some markets innovation is the main competitive force. In these cases, the Commission examines how the merger will affect the competitive pressure to innovate in the market.

A firm with a paramount market position

19. Some proposed mergers would, if allowed to proceed, leave a firm in a paramount market position. This would occur if, as a result of the transaction, the merged firm (13) would not be constrained in any significant way by actions of actual competitors in the relevant market. A paramount market position is found by reference to a number of different criteria.

20. According to well-established case law, very large market shares — in excess of 50 % — may be in themselves, save in exceptional circumstances, evidence of the existence of a dominant market position (14), in particular when the other competitors on the market hold much smaller shares. Indeed the smaller firms may not act as a constraining influence if, for example, they do not have the incentive or the ability to increase their production or they do not have a sufficient overall presence in the market. A firm, the market shares of which will remain below 50 % after the merger, may also be considered as holding a paramount market position in view of other factors such as the strength and number of competitors (15).

21. Various factors may also be taken into account in order to determine the extent of the merged entity’s economic power:

— economies of scale and scope: whenever large-scale production or distribution gives the paramount firm a strategic advantage over smaller competitors (16),

— privileged access to supply: the paramount firm may be vertically integrated or may have established sufficient control of the supply of upstream products (17) that expansion by the small rival firms may be difficult or costly,

— a highly developed distribution and sales network: the paramount firm may have its own dense outlet network (18), established distribution logistics (19) or wide geographic coverage (20) that would be difficult for rivals to replicate,

— access to important facilities or to leading technologies may give the merging firms a strategic advantage over their competitors (21),

— privileged access to specific inputs such as physical or financial capital. In the large majority of cases financial strength is unlikely to be an issue. However, in some cases it may be one of the factors that contribute to a merger giving rise to competition concerns (22), in particular in those cases where (i) finance is relevant to the competitive process in the industry under review; (ii) there are significant asymmetries between competitors in terms of their internal financing capabilities; and (iii) particular features of the industry make it difficult for firms to attract external funds,

— other strategic advantages, such as the ownership of the most important brands (23), a well-established reputation, or an extensive knowledge of the specific preferences of customers.

22. Some of the factors listed above are likely to benefit the customers of the paramount firm (see Section VI). However, they may also make it difficult for competitors, either individually or in the aggregate, to effectively constrain the paramount firm to a sufficient degree. For instance, they may make expansion of smaller firms or entry of new competitors difficult. The Commission will thus examine whether the merging firms will face sufficient residual competition to make it unprofitable to increase prices or decrease output.

23. A merger may either create a paramount firm or it may strengthen it by further eliminating some of the remaining competitive constraints. To ascertain the specific competitive effects of a merger, it will, inter alia, be appropriate to consider the competitive constraints that the merging firms exert on each other pre-merger and to examine whether the elimination of these constraints will lead the merged firm to significantly raise prices. Thus, the elimination of inter-brand rivalry (24), or more generally, the fact that rivalry between the parties has been the main source of competition on the market (25), may be an important factor of the analysis. The fact that one of the merging parties, although small, had an important competitive function may also be relevant, in particular when the market is already concentrated (26). This analysis would be similar to that described in more detail in the following section on non-collusive oligopolies.

24. In deciding whether a merger creates or strengthens the dominant position such that effective competition is likely to be significantly impeded, the Commission will also take into account whether the analysis of entry barriers, buyer power or efficiencies (see Sections IV to VI) points to a negative conclusion.

Non-collusive oligopolies

25. Many oligopolistic markets exhibit a healthy degree of competition. Nonetheless, under certain circumstances, some mergers may diminish the degree of competition by removing important competitive constraints on one or more sellers, who consequently find it profitable to
increase prices or reduce output post merger. The most direct effect will be the elimination of the competitive constraints that the merging firms exerted on each other. Before the merger, the merging parties may have exercised a competitive constraint on each other. If one of the merging firms had raised its price or reduced output, then it would have lost customers to the other merging firm, making it unprofitable. The merger would thus eliminate this particular constraint (27). In addition, non-merging firms can also benefit from the reduction of competitive pressure that results from the merger since the merging firms' price increase or output reduction may switch some demand to the rival firms, which, in turn, may find it optimal to increase prices. The elimination of these competitive constraints could lead to a significant price increase or output reduction in the relevant market.

Markets where firms compete primarily in output/capacity

30. In markets where output or capacity levels are the most important strategic decisions made by the oligopolists, the important concern for firms is how their output or capacity decision influences the prices in the market. When goods are relatively homogeneous, the merging firms may have an incentive to reduce output or capacity below the combined pre-merger levels, thereby raising the market prices. Before the merger, an increase in the price induced by the contraction of output by one of the merging parties would only benefit this particular party through higher margins on its sales. After the merger the higher margins would also be enjoyed on the sales made by the other merging party. However, the extent of the post-merger price increase will depend on the ability and incentive of the rival firms to expand output.

31. When rival firms have enough capacity, buyers will easily find alternative sources of supply as long as it remains profitable for rival firms to expand output. In this case, the post-merger price increase may be limited, and the Commission may see no reason for concern. However, it may be the case that competitors are unable or unwilling to expand output sufficiently to offset the output reduction from the merging parties. Such output expansion is, in particular, unlikely when competitors face binding capacity constraints or if existing excess capacity is significantly more costly to operate than capacity currently in use (31).
Markets where firms compete primarily on prices

34. In certain markets, setting prices is the most important strategic decision made by the oligopolists. For example product differentiation may allow firms some price flexibility. Negative effects on competition may arise where, following the merger, the new entity finds it profitable to raise prices as a result of the loss of competition between the merging firms. Before the merger, the merging firms may have exercised a competitive constraint on each other in the sense that if one of the firms raised its prices, it would lose customers to the other firm. The merger would remove this particular constraint.

35. The incentive to increase prices is strongly related to the proportion of lost sales that each merging firm would be expected to recapture in increased sales of the other merging party's product. The Commission will, first, focus on the degree of substitution between the merging firms' products. The higher the degree of substitution between the merging firms' products, the stronger would be the incentive for the merging firms to raise prices and the higher the likely post-merger price increase.

36. The Commission will, second, evaluate the degree of product differentiation between the merging firms and their competitors' products. The merging firms' incentive to raise prices is more constrained when rival firms produce close substitutes than when they offer distant substitutes. The Commission will be less concerned where there exists a high degree of substitution between the merging firms' products and the products supplied by rival producers. For example, a merger between two producers that offer products which consumers view as particularly close substitutes could generate a significant price increase. If rival firms, however, offer products that are close substitutes to those of the merging parties, then the post-merger price increase may be limited.

37. In some markets it may be relatively easy and not too costly for the active firms to reposition their products or extend their product portfolio. The Commission will examine whether the possibility of repositioning or product line extension by the merging parties or competitors may influence the incentive of the merged entity to raise prices. Product repositioning or product line extension is less likely when it entails large sunk cost.

38. In order to determine the impact of the merger, the Commission will analyse the ability and the incentive of the merging firms to increase price as described above. The Commission will analyse also entry barriers, buyer power or efficiencies (see Sections IV to VI).

Bidding markets

39. In situations when sellers compete to make a specific offer to each particular buyer, the competitive effect analysis of a merger may be different from that presented above. In particular, in the case of bidding markets, the main competitive outcome is ensured by the presence of several competitive bids. The Commission will analyse whether there would be bidding contests where the merging firms would likely be each other's most credible contenders. This could be the case when the merging parties are the two bidders with the lowest costs and where no other bidders have sufficiently low costs to exercise a competitive constraint on the winning bidder.

Increased risk of coordination

40. A merger may change the nature of competition in an oligopolistic market so sellers, who previously were not coordinating their behaviour, are now able to coordinate and thus raise their prices, without having to enter into an agreement or resort to a concerted practice within the meaning of Article 81 EC(34). The alteration of the market structure may be such that they would consider it possible, economically rational, and hence preferable, to adopt on a lasting basis a course of action on the market aimed at selling at above competitive prices.

41. A merger may also make coordinating easier for sellers who were coordinating already before the merger, either by making the coordination more robust or by further departing from the competitive outcome. It is unlikely that the Commission would approve a merger if coordination were already taking place prior to the transaction unless it determines that the merger is likely to disrupt such coordination.

42. Coordination may take various forms. In some markets the most likely coordination may be on keeping or raising prices above the competitive level. In other markets coordination may aim at limiting the production or the amount of new capacity brought to the market. Firms may also coordinate on dividing the market, for instance by geographic area (33) or by other customer characteristics or by taking turns in winning contracts in bidding markets.

43. Coordination is more likely to emerge in markets where it is fairly simple to establish the terms of coordination. This includes both the type of coordination and the implicit rules governing the coordination. Parties should thus be able to arrive at a common perception as to which actions would be considered aggressive (‘cheating’), thus justifying countering responses (‘punishments’) by the other members of the oligopoly.
44. Three basic conditions must be fulfilled for coordination to be sustainable. First, the coordinating firms must be able to monitor to a sufficient degree whether the terms of coordination are being adhered to, that is, to detect whether any firm in the group is deviating from the terms of coordination. Second, there must be credible deterrent mechanisms that can be activated in case deviation is detected. Such deterrent mechanisms should be sufficiently severe that they convince the coordinating firms that it is in their best interest to adhere to the terms of coordination. Third, the actions of outsiders, such as current and future competitors, as well as customers, should not be able to jeopardise the results expected from the coordination.

45. A market where it is reasonably easy to establish the terms of coordination and where the three criteria mentioned above are fulfilled to a sufficient degree, is prone to the emergence of coordinated behaviour. This is not to say that substantial coordination will necessarily occur. However, the fewer firms in the oligopoly, the more likely it is that firms will be able to take advantage of the favourable market condition and establish or improve a situation of mutual coordination. In most cases a merger in this context would thus either strengthen existing coordination or increase the likelihood of it occurring.

46. The Commission examines whether it would be possible to establish the terms of coordination and whether the three necessary conditions are likely to be sufficiently met in the post-merger situation and the changes that the merger brings about in this respect. This will allow the Commission to assess whether a merger would lead to an increased risk of coordination occurring or to coordination being made easier or more successful.

47. The Commission takes into account both the structural features of the markets concerned and the past behaviour of the firms in these markets. Many structural features are important for more than one of the conditions.

48. The analysis of the possibility of coordination in a particular relevant market typically requires considering a large amount of information, which may not all point to the same conclusion. Evidence of past coordination in similar product or geographic markets may then be useful information indicating that the necessary conditions mentioned above are likely to be fulfilled also in the markets relevant to the merger. Similarly, firms may be vigorously competing prior to the merger in ways that make the emergence of coordination unlikely.

Establishing terms of coordination

49. Coordination is more likely to emerge if the members of the oligopoly could easily arrive at a common perception as to how the coordination mechanism works. Members should have similar views regarding what would be considered to be in accordance with the aligned behaviour and which actions would be likely to result in a punishment from the other members of the oligopoly.

50. Generally, the more simple and stable the economic environment, the easier it is for the firms to establish the terms of coordination. It is easier to coordinate on a price for a single, homogeneous product, than on hundreds of prices in a market with many differentiated products. Similarly, it is easier to coordinate on a price when demand and supply conditions are relatively stable than when they are continuously changing. In this context substantial organic growth by some firms in the market may indicate that the current situation is not sufficiently stable to make coordination likely. Coordinating by way of market division will be easier if customers have simple characteristics that allow the coordinating firms to readily allocate them. Such characteristics may be geographically based, based on type of customer or simply based on the existence of customers who typically buy from one specific coordinating firm.

51. Coordinating firms may, however, find ways to overcome problems stemming from complex economic environments. They may, for instance, establish simple pricing rules that reduce the complexity of coordinating on a large number of prices. One example of such a rule is establishing a small number of pricing points, thus reducing the coordination problem drastically. Another example is having a fixed relationship between certain base prices and a number of other prices so that all prices basically move in parallel.

52. Detailed knowledge about the other firms may also help overcome some of the problems in establishing terms of coordination. In particular transparency as to the cost structure may be important. Structural links such as cross-shareholding or participation in joint ventures may help in aligning incentives between the oligopolists. Another way to establish the common terms of coordination would be to publically exchange strategic information through the press. One such example would be if the firms were confronted with the challenge of coordination on how much extra capacity to put on the market from one year to the next. Stating publicly how much demand is expected to increase could be a way to overcome this challenge. The more complex the market situation is, the more transparency or communication is needed to establish the terms of coordination.
53. Firms will also find it easier to establish terms of coordination, the more symmetric are the firms (37). Symmetry among firms enhances the probability that firms have compatible incentives to coordinate and, in particular, that they agree on what are desirable terms of coordination. For instance, firms with similar cost structures and market shares, operating at similar capacity levels and with the same degree of vertical integration, will likely find it relatively easy to coordinate on desirable prices.

54. The Commission will pay particular attention to any change the merger may bring about with respect to how easy firms would find establishing terms of coordination. For instance, a merger may increase the symmetry of a group of firms by making the market shares, the levels of capacity usage, the degree of vertical integration or the cost structures of these firms more similar. A merger may also involve a firm, which consistently in the past has shown to prefer lower prices than its competitors. Such a firm is sometimes termed a maverick. If the merged firm were to follow pricing strategies similar to those of the other competitors, the remaining firms would find it easier to coordinate on desirable prices, and the merger would increase the likelihood of coordination.

Transparency may be diminished if actual prices also comprise unobservable discounts.

57. In particular in bidding markets the degree of transparency depends on the type of auction method that is applied. In sealed bid auctions, no bidder may obtain access to information regarding the offers submitted by other bidders. In an open outcry auction, bidding behaviour by one bidder is readily observable by the other bidders. Similarly in other markets, it is of importance for assessing the degree of transparency to investigate what type of information about each transaction is publicly available. In some markets prices are publicly available.

58. When evaluating the level of transparency in the market, the key element is to identify the information about the other oligopolists' actions that can be inferred from the information available. Coordinating firms should be able to interpret with some certainty whether unexpected behaviour is actually the result of deviation from the terms of coordination. For instance, in unstable environments it may be difficult for a firm to know whether its lost sales are due to an overall low level of demand or to a loss of market share to a competitor who is offering particularly low prices. Similarly, in a situation where overall demand or cost conditions fluctuate, it may be difficult to interpret whether a competitor is lowering its price because it expects the coordinated prices to fall or because it is behaving aggressively.

59. In some markets where the general conditions may seem to make monitoring of other firms' behaviour difficult, firms may nevertheless engage in practices, which have the effect of easing the monitoring task, even when these practices may not necessarily be entered into for such purposes. These practices, such as voluntary publication of information or announcements may increase transparency or help competitors interpret the choices made. Cross-directorships, participation in joint ventures and similar arrangements may also make monitoring easier.

60. The Commission will pay particular attention to whether the merger brings about changes to the ability of coordinating firms to monitor each other. For instance, changes in vertical integration may allow a better monitoring of prices. A merger may also involve a firm, which previously has not followed some industry practice, which made monitoring easier.
Deterrent mechanisms

61. Coordinating cannot take place without the existence of deterrent mechanisms that are sufficiently severe to convince all coordinating firms that it is in their best interest to adhere to the terms of coordination. It is thus the threat of future retaliation that keeps the coordination sustainable. However the threat is only credible if, in case deviation by one of the firms is detected, the deterrent mechanisms will indeed be activated. Although deterrent mechanisms often are also called 'punishment' mechanisms, this should not be understood in the strict sense that such a mechanism necessarily punishes individually a firm that has deviated. If firms expect coordination to break down for a sufficient time if anybody deviates, and thus revert to a non-coordinated outcome this constitutes in itself a deterrent mechanism. This mechanism may however not be sufficient to discipline tacit coordination, in which case other mechanisms may have to be involved.

62. A firm would only chose to deviate from the coordinated practice if the discounted rewards from deviating are larger than the discounted cost of the punishment. Compared to the alternative of maintaining the coordinated practice, a deviation would initially lead to a higher profit, but later on to a lower level of profit once the other members of the oligopoly would implement the punishment. Deviations are prevented when the net present value of the loss of future profit during punishment outweigh the net present value of the higher profit that is enjoyed during the period of deviation. The sooner the punishment is likely to be implemented, the smaller is the gain from deviation, and the larger is the loss incurred during punishment.

63. Punishments that only enter into force after some time period, or are not likely to be activated, are less likely to be sufficiently severe. For example, if a market is characterised by infrequent, lumpy orders, a firm may be tempted to deviate in order to gain a large contract. It may be difficult to establish a sufficiently severe deterrent mechanism in such a market, since the gain from deviating is large, certain and immediate, and the losses from being punished may be uncertain and only materialise after some time. The speed with which deterrent mechanisms can be implemented is related to the issue of transparency. If firms are only able to observe their competitors' actions after a substantial delay, then punishment will be similarly delayed and may influence whether it would be sufficient to deter deviation.

64. The deterrence need not necessarily take place in the same market as the deviation. If the members of the oligopoly have commercial interaction in other markets, these may offer various methods of deterrence. The deterrence can take many forms, including cancellation of joint ventures or other forms of cooperation or selling of shares in jointly owned companies.

65. Members of an oligopoly can only base coordination on a deterrent mechanism if it would be rational for each member to carry it out once a hypothetical deviation occurs. Whether a member of the oligopoly would indeed implement a deterrent mechanism depends on a balancing of short-term and long-term consequences similar to that carried out by the potential deviator. If a deviation is not punished, coordination will break down and future profit levels will likely be low. On the other hand, if the punishment is executed, coordination may be restored thus leading to higher profits in the future. It can thus be rational to implement a punishment mechanism even if it entails some short-term costs for the members of the oligopoly as long as they are outweighed by the long-term increase in profits that the restoring coordination would bring about.

66. In some cases particular punishment mechanisms may not be credible because they intrinsically prevent the reversion to the coordinated outcome. One such example would be in a stagnant market where capacity increases only can take place in big chunks (for instance by building a new factory) and where capacity has no value unless used in this particular market. In this scenario coordination aiming at keeping total capacity below the competitive level, may be unlikely because no credible deterrent mechanism is available in the case one member of the oligopoly deviates by increasing capacity to a level, where further increase in capacity would lead to a permanent oversupply.

67. In some cases the deviation may in itself bring about a durable competitive advantage that no punishment available to the other oligopolists could effectively counter. In a market with strong network effects, i.e. markets where any one consumer prefers to be supplied by the same supplier as the other consumers, the deviation may bring about an irrevocable shift in the competitive balance in the market that would leave the other competitors permanently behind.
68. The merger may bring about changes as to how severe the punishment can be in a particular market. This could, for instance, result from changes in the distribution of market shares or excess capacity. The Commission will pay particular attention to such changes in the analysis of the competitive effects of the merger.

Reactions of outsiders

69. For coordination to be successful the actions of current and future competitors, as well as customers, should not be able to jeopardise the results expected from coordination. If for example coordination aims at reducing the overall capacity in the market, this will only hurt consumers if there is nobody outside the oligopoly that would respond to this decrease by increasing their own capacity correspondingly. The analysis of these elements is similar to the way they are analysed when other types of impediments to competition from mergers are considered. The effects of entry and buyer power of customers are dealt with in the following sections. However, special consideration should be given to the possible impact of these elements on the stability of coordination. For instance, by changing its commercial practice and concentrating a large amount of its requirements on one supplier or by offering long term contracts, a large buyer may be able to tempt one of the coordinating firms to deviate in order to gain substantial new business.

Particular cases

Innovation

70. In non-collusive oligopoly markets or in markets characterised by a firm with a paramount market position, where innovation is the main competitive force, the Commission examines how the merger will affect the competitive pressure to innovate in the market. The competitive pressure in such markets may be diminished if the merger is between the only two competitors that previously provided the most important innovations. For instance, this may be the case of a merger between two pharmaceutical companies, which were the only ones with pipeline products related to a specific product market. Alternatively, if the merger increases the firms' ability to bring new innovations to the market this may increase the competitive pressure to innovate. In markets where coordination is more likely, innovation make coordination less easy to sustain. The reason is that innovations, particularly drastic ones, may allow one firm to gain a significant advantage over its rivals. Thus, this may reduce both the value of future coordination and the amount of harm that rivals would be able to inflict.

Potential entry

71. Concentrations where an undertaking already active on a relevant market merges with a potential competitor in this market can have similar anti-competitive effects to mergers between two undertakings already active on the same relevant market. The Commission will therefore apply similar methods of analysis to the two types of concentrations.

72. A merger with a potential competitor can generate horizontal anti-competitive effects if the potential competitor significantly constrains the behaviour of the firms active in the market. This is the case if the potential competitor possesses assets that could easily be used to enter the market without incurring significant sunk costs. This is also the case if the potential competitor is very likely to incur the necessary sunk costs to enter the market in a relatively short period of time after which the potential competitor would constrain the behaviour of the firms active in the market.

73. For a merger with a potential competitor to have significant anti-competitive effects, two basic conditions must be fulfilled. First, the potential entrant must already exert a significant constraining influence or there must be a significant likelihood that it would grow into an effective competitive force. Evidence that a potential competitor has plans to enter a market in a significant way could help the Commission to reach such a conclusion (40). Second, there should not be a sufficient number of other potential competitors, which could exert the same competitive pressure as the merging potential competitor.

Mergers creating or strengthening buyer power

74. The Commission may also analyse to what extent a merged entity will increase its economic power as buyer in upstream markets. On the one hand, a merger that creates or strengthens the economic power of a buyer may impede effective competition. In particular, the merged firm may be in a position to reduce its purchase of inputs in order to obtain lower prices. This may, in turn, lead it to lower its level of output in the final product market, and thus harm consumer welfare. On the other hand, increased buyer power may often be beneficial for consumers. If increased buyer power lowers input costs without restricting downstream competition or total output, then a proportion of these cost reductions are likely to be passed onto consumers in the form of lower prices. Competition in the downstream markets could also be adversely affected if, in particular, the merged entity could use its buyer power to impose vertical restraints on suppliers, thus foreclosing its rivals.
IV. COUNTERVAILING BUYER POWER

75. The competitive pressure on a firm is not only exercised by the competitors but can also come from its customers. The Commission will, when relevant, consider to what extent customers will be in a position to counter the increase in market power that a merger is expected to create.

76. Even firms with very high market shares may not be able to act independently of their customers if the latter possess buyer power (41). Buyer power in this context should be understood as the ability of large customers within a reasonable timeframe to resort to credible alternatives if the supplier decides to increase prices or to deteriorate the conditions of delivery (42). Examples of such buyer power would be if the buyer could immediately switch to other suppliers, credibly threaten to vertically integrate into the upstream market or to sponsor upstream entry (43), for instance by persuading a potential entrant to enter by committing to place large orders with this company. It is more likely that large and sophisticated customers will possess this kind of buyer power than will smaller firms in a fragmented industry. However, it is important to consider the incentives of buyers to utilise their buyer power in this way. For example, a downstream firm may not wish to make an investment in sponsoring new entry if the benefits of such entry in terms of lower input costs could also be reaped by its competitors.

77. The Commission may conclude that buyer power is sufficient to prevent a creation or strengthening of a dominant position as a result of which effective competition would be significantly impeded if the smaller customers without buyer power will not be faced with significantly higher prices or deteriorated conditions after the merger (44). Furthermore, it is not sufficient that buyer power exists prior to the merger, it must also exist and remain effective following the merger. This is because a merger of two suppliers may reduce buyer power if it removes a credible alternative.

V. ENTRY

78. In a dynamic competitive environment the number and identity of firms in an industry may vary over time in response to changing conditions. If the profit level in an industry is high due to lack of competitive pressure on the incumbents, one should expect entrepreneurs to seek to obtain a part of that profit by entering the industry. When entering the market is particularly easy, the mere threat of potential entry may be sufficient to prevent the merging parties from exercising market power. Indeed, in such a case, any price increase may create the incentives for new entry.

79. In assessing whether new entry can be considered as a sufficient competitive constraint on the merging parties, entry must be shown to be likely, timely and sufficient in its magnitude and scope to prevent the potential anti-competitive effects of the merger. The Commission is unlikely to find competition concerns when there is strong evidence that these conditions are met.

80. As regards the likelihood of new entry, the Commission will examine whether there is a high probability that new entry can be expected after the merger. In this respect, the Commission will have particular regard to the existence of barriers to entry to the relevant market, that is to the specific features of the market, which may give the incumbent firms a decisive advantage over potential competitors. When entry barriers are low, the merging parties will be more likely to be constrained by new entry. Conversely, when entry barriers are high, the merging firms can be expected to exert market power, and raise their prices, without being constrained by new firms entering the market.

81. Barriers to entry can take the form of legal, technical or strategic advantages:

— legal advantages cover situations where regulatory barriers created by legislation limit the number of market participants by, for example, restricting the number of licences,

— the incumbents may also enjoy technical advantages, such as preferential access to essential facilities, natural resources, innovation and R & D, or intellectual property rights, which make it difficult for any firm to compete successfully. For instance, in certain industries, it might be difficult to obtain essential input materials, or patents might protect products or processes. Other factors such as economies of scale and scope, distribution and sales networks, access to important technologies, may also constitute barriers to entry,

— furthermore, strategic barriers to entry may exist because of the established position of the incumbent firms on the market. In particular, it may be difficult to enter a particular industry because experience or reputation is necessary to compete effectively, both of which may be difficult to obtain as an entrant. Factors such as consumer loyalty to a particular brand, the closeness of relationships between suppliers and customers, the importance of promotion or advertising, or other reputational
advantages will be taken into account. Strategic barriers to entry also encompass situations where the incumbents already have committed to large excess capacity, or where the costs faced by customers in switching to a new supplier may also inhibit entry.

82. For entry to be likely, it must be sufficiently profitable when potential responses from the incumbents are taken into account. Entry is thus more difficult if the incumbents will be able to closely monitor which customers the entrant is trying to acquire and to protect their market shares by giving targeted pre-emptive price reductions to those customers.

83. The likely evolution of the market should be taken into account when assessing whether or not entry would be profitable. Entry is more likely to be profitable in a market that is expected to experience high growth in the future relative to a market that is expected to decline. Scale economies or network effects make entry unprofitable unless the entrant can obtain a sufficiently large market share.

84. Entry is particularly likely if suppliers in other markets already possess production facilities that could be used to enter the market in question. Such a reallocation of production facilities is more likely if the two alternatives are approximately equally profitable prior to the merger.

85. The Commission will look carefully at the history of the industry when assessing barriers to entry. It is not likely that the Commission will find barriers to entry in an industry that has experienced frequent and successful examples of entry. On the other hand if previous attempts to enter the market have been unsuccessful, perhaps due to deterring behaviour by incumbents, then entry would appear to be less likely in the future.

86. Any new entry should not only be likely but also timely and of sufficient scope and magnitude. In assessing whether entry would be timely, the Commission will look at whether any such potential new entry will be sufficiently quick and persistent to prevent the exercise of market power. The appropriate time period should depend on the characteristics and dynamics of the market, as well as on the specific capabilities of potential entrants (\textsuperscript{45}). Entry which is not of sufficient scope and magnitude is not likely to constitute a constraint on the incumbents and to deter the anti-competitive effects of the merger. For instance, entry into some market ‘niche’ may not be a credible constraint. The threat of entry must also be sufficiently intense to dissuade the merging parties from increasing prices.

VI. EFFICIENCIES

87. The Commission welcomes corporate reorganisations in the form of concentrations as being in line with the requirements of dynamic competition and capable of increasing the competitiveness of European industry, improving the conditions of growth and raising the standard of living in the Community (\textsuperscript{46}). Accordingly, the Commission takes into account in its assessment of horizontal mergers the development of technical and economic progress provided that it is to the consumers' advantage and does not form an obstacle to competition (\textsuperscript{47}).

88. The Commission considers any substantiated efficiency claim in the overall assessment of the merger. It may decide that, as a consequence of the efficiencies that the merger brings about, this merger does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded. This will be the case when the Commission is in a position to conclude on the basis of sufficient evidence that the efficiencies generated by the merger are likely to enhance the incentive of the merged entity to act pro-competitively for the benefit of consumers, by counteracting the effects on competition which the merger might otherwise have. In the interest of the consumer, it is necessary to ensure that the merged firm will have sufficient incentives not only to realise the efficiencies arising directly from the merger but also to make continuing efforts to enhance efficiency. This presupposes sufficient competitive pressure from the remaining firms and from potential entry.

89. Efficiencies are most likely to make a difference when they are substantial and the possible anti-competitive effects that might otherwise occur are small. The greater these possible negative effects on competition, the more the Commission has to be sure that the claimed efficiencies are substantial, likely to be realised, and to the direct benefit of the consumer. It is unlikely that a market position approaching that of a monopoly can be declared compatible with the common market on efficiency grounds.

90. For the Commission to reach the conclusion that as a consequence of efficiencies, a merger does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded, the efficiencies have to be of direct benefit to consumers and to be merger-specific, substantial, timely, and verifiable.
91. Efficiencies should directly benefit consumers in the relevant markets where it is otherwise likely that a dominant position will be created or strengthened as a result of which conditions of effective competition would be significantly impeded. In line with the need to ascertain whether efficiencies will benefit consumers, cost efficiencies that lead to reductions in variable or marginal costs are more likely to be relevant to the assessment of efficiencies than reductions in fixed costs, since the former are more likely to result in lower consumer prices.

92. Also efficiencies that lead to new or improved products or services may directly benefit consumers. For example, a joint venture company set up in order to develop a new product may bring about the type of efficiencies that the Commission can take into account.

93. Efficiencies are merger specific when they are a direct consequence of the merger. In this respect the Commission concentrates on realistic and attainable alternatives rather than merely theoretical ones. In particular, the Commission takes account of established industry practices as well as the respective capabilities of the merging parties. In the same vein, the Commission does not consider cost reductions, which result from anti-competitive reductions in output as efficiencies.

94. Efficiencies have to be verifiable so that the Commission can be reasonably certain that the efficiencies are likely to materialise. The longer efficiencies are projected into the future, the less weight the Commission can assign to the efficiencies being brought about (48). The Commission must also be in a position to assess whether the efficiencies are substantial enough to counteract a merger's potential harm to consumers. Where reasonably possible, efficiencies should therefore be quantified. As indicated above, in order to verify whether cost efficiencies will directly benefit consumers, reductions in variable or marginal costs are likely to be more relevant to the analysis than reductions in fixed costs. Similarly, demonstrable efficiencies leading to new or improved products, which directly benefit consumers, are more likely to be considered by the Commission than mere assertions to this effect.

95. Most of the relevant information, which could allow the Commission to assess whether the merger will bring about the sort of efficiencies allowing to clear a merger, is uniquely in the possession of the merging parties. It is, therefore, incumbent upon the notifying parties to provide in due time all relevant information necessary to demonstrate that the efficiencies are merger specific, substantial, timely, and verifiable. Similarly, it is for the notifying parties to provide the evidence necessary to show why the efficiencies will counteract any adverse effects on competition that might otherwise result from the merger and therefore directly benefit consumers.

96. The Commission may decide that a merger, which creates or strengthens a dominant position, is nevertheless compatible with the common market if one of the undertakings is a failing firm being acquired by another undertaking. The basic requirement is that the deterioration of the competitive structure that follows the merger cannot be said to be caused by the merger (49).

97. The Commission considers the following three criteria as relevant for the application of a 'failing firm defence'. First, the acquired undertaking would in the near future be forced out of the market because of financial difficulties if not taken over by another undertaking. Second, there is no less anti-competitive alternative purchase than the notified concentration. Third, absent a concentration the assets of the failing firm would inevitably exit the market. In such circumstances, the merger may be deemed not to cause the creation or strengthening of a dominant position as a result of which effective competition would be significantly impeded in the common market if either the disappearance of the failing firm (50) or its acquisition by any other foreseeable potential purchaser (51) would equally lead to the creation or strengthening of a dominant position.

98. It is upon the notifying parties to show that the three criteria described above are fulfilled and that the deterioration of the competitive structure that follows the merger is not caused by the merger.

99. The present public consultation is part of a wider process of review, reform and clarification of the terms and application of the Merger Regulation. Interested parties are invited to submit their views on the present draft Notice. Such comments should reach the Commission no later than 31 March 2003.

VIII. INVITATION FOR COMMENTS

By mail to:
European Commission
Directorate-General for Competition
Horizontal Guidelines
B-1049 Brussels

By electronic mail:
Comp-MTF-horizontal-guidelines@cec.eu.int
1. The term 'concentration' used in the Merger Regulation covers various types of transactions such as mergers, acquisitions, takeovers, and certain types of joint ventures. In the remainder of this notice, unless otherwise specified, the term 'merger' will be used as synonymous for concentration and therefore cover all the above types of transactions.

2. This notice does not cover the assessment of the effects of competition that a merger has in other markets including vertical and conglomerate effects. Nor does it cover the assessment of the effects of a joint venture as referred to in Article 2(4) of ECMR.

3. In this notice the expression 'increased prices' is often used as shorthand for increased prices, reduced choice and qualities of goods and services, diminished technological innovation, and other possible consequences of a lack of effective competition. The expression should also be understood to cover situations where, for instance, prices are decreased less, or are less likely to decrease, than they otherwise would have absent the merger.

4. An oligopolistic market refers to a market structure with a limited number of sizeable firms. Because the behaviour of one firm has an appreciable impact on the overall market conditions, and thus indirectly on the situation of each of the other firms, oligopolistic firms are interdependent.

5. Scale and scope economies result from the spreading of fixed costs over larger output or a broader set of products.
Although most markets involve some elements of product differentiation, there exist markets in which goods are relatively homogeneous. Goods are relatively homogenous if customers consider the products from one producer as a sufficiently good substitute for the product from any other producer.

Products may be differentiated in different ways. There may be differentiation in terms of geographic location, based on branch or stores location. For example, location matters for retail distribution, banks, travel agencies, or petrol stations. Differentiation may also be based on brand image, technical specifications, quality or level of service. The level of advertising in a market may be an indicator of the firms’ effort to differentiate their products. For other products, buyers may have to incur switching costs to use a competitor’s product.

The increase in concentration as measured by the HHI can be calculated independently of the overall market concentration by doubling the product of the market shares of the merging firms. For example, a merger of two firms with market shares of 30% and 15% respectively would increase the HHI by 900 (30 × 15 = 900). The explanation for this technique is as follows: before the merger, the market shares of the merging firms contribute to the HHI by their squares individually: \((a^2 + b)^2\). After the merger, the contribution is the square of their sum: \((a + b)^2\), which equals \((a^2 + b^2 + 2ab)\). The increase in the HHI is therefore represented by \(2ab\).

The cross-price elasticity of demand measures the extent to which the quantity of a product demanded changes in response to a change in the price of some other product, all other things remaining equal. The own-price elasticity measures the extent to which demand for a product changes in response to the change in the price of the product itself.

The diversion ratio measures the proportion of sales of a product that is lost to another product in the event of a price increase.

This may be the case if the oligopolists concentrated their sales in different areas for historic reasons.

For example, the market for game consoles is characterised by strong network effects. The individual consumer will want to buy the game console that is most popular among other users, because the number of games developed for that particular console is likely to be higher and there would be more other users to exchange games with.

Benefits from efficiencies that are projected into the future are to be discounted over time. In part this is because in most cases, the longer efficiencies are projected into the future, the less probability the Commission can assign to the efficiencies actually being brought about.