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Efficiencies in Merger Analysis

In recent years the world has seen a wave of mergers that is unprecedented as regards both the number and the size of the enterprises involved. The firms concerned have frequently complained that the government agencies in charge of merger control do not sufficiently take account of the welfare-enhancing efficiencies created in the process. This article analyses the differences in merger control practice and the underlying theories in Germany, the European Union and the USA.

The present, unprecedentedly high, level of merger activity can be traced back to the liberalisation of the markets. Declining trade barriers, progress in transport and information technology and the establishment of uniform norms, standards and procedures has integrated markets worldwide. The geographical expansion creates the potential for an increase in productivity. Firms can realize economies of scale and economies of scope by expanding their production to foreign markets. Mergers, particularly cross-border mergers, then represent the fastest way of acquiring access to new markets and, later on, of achieving cost savings. However, market integration also increases the number of competitors. As a result, the position of companies, both in domestic markets and in their traditional markets abroad, becomes vulnerable. Joining forces with a rival can help reduce competitive pressures. Besides cost savings, mergers may also be motivated by the desire for more market power.

Mergers which (almost) exclusively create efficiencies are welfare-enhancing, while mergers which (almost) exclusively increase market power have a negative impact on social welfare. If these cost and market power effects occur simultaneously, they will conflict. It is then the task of merger control to compare the advantages of higher concentration with the disadvantages of greater market power. The trade-off between efficiencies and competition has been well known since Oliver Williamson stressed its meaning for merger analysis in the late 1960s.[1] In the course of the current merger wave, firms complain that efficiencies are not sufficiently taken into account. For instance, German suppliers call for a less restrictive form of competition policy in order to be able to respond to foreign producers or to keep pace with consumer demands for new products.[2] The trade-off between merger-related cost savings and increased market power becomes topical again.

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The purpose of this paper is to assess the significance of the conflict in German, European and US American competition policy. The paper is divided into three parts: a sketching of merger effects, whereby cost and market power impacts are examined separately; a welfare analysis of horizontal mergers and an explanation as to how efficiency gains can be balanced against competitive losses;[3] and the results of studying the efficiency defence in German, European and US American merger cases in the past.

The Efficiency Motive

In horizontal mergers, and especially in today's massive consolidations, the desire to achieve cost savings plays an important role. Merging is a way for a firm to obtain competitive advantages by realizing economies of scale and economies of scope. Economies of scale derive from the sheer size of a firm's operations. They occur when average cost falls as output increases. However, they exist only up to a certain size of plant, the optimal plant size,[4] at which all possible economies of scale are fully exploited. Thus, economies of scale can only be realised by a merger between two firms when at least one of the merging firms is below the minimum efficient size. In addition, other cost advantages may accrue from expanding the scope of a firm's operations. Economies of scope exist when the average costs of joint

[1] O. E. Williamson: Economies as an Antitrust Defense: The Welfare Tradeoffs, in: American Economic Review, 1968, pp. 18-42; revised in: A. P. Jacquemin, H. W. De Jong: Welfare Aspects of Industrial Markets, 1977, pp. 237-271.

[2] Perspektiven für die Wettbewerbsfähigkeit Europas: Bericht über das XXIX. FIW-Symposium, in: Wirtschaft und Wettbewerb, 1996, pp. 300-304.

[3] The focus of this article lies on horizontal mergers because they represent the most frequent form of appearance in practice.

[4] The optimal plant size, also called the minimum efficient scale, is derived from the long-run average cost curve which is determined by the technology of the industry and by the prices of the factors of production. Changes in either technological knowledge or factor prices will shift the cost curve and, thus, the optimal plant size. Cf. R. G. Lipsey, P. N. Courant: Microeconomics, 11th Edition, 1995, pp. 177 ff.

production are lower than the average costs that would be achieved by production in separate firms.[5] These economies result from joint use of inputs or production facilities.

The cost savings of mergers fall into two broad categories: production efficiencies and dynamic efficiencies. Production efficiencies include all the savings associated with integrating activities within the new firm and all cost reductions attributable to the transfer of superior production techniques and know-how from one of the merging parties to the other. Savings flow from specialisation, indivisible factors of production, learning by doing, elimination of duplication, reduced downtime, smaller inventory requirements, the avoidance of capital expenditures that would otherwise be required, and the rationalisation of administrative and management functions.[6] Cost savings may also be brought about with respect to distribution, advertising and the raising of capital. Dynamic efficiencies include gains achieved by the optimal introduction of new products, the development of more efficient productive processes and the improvement of product quality and service. Normally, it is extremely difficult for both parties and agencies to forecast such merger-related savings, because they can only be measured ex post, i.e. when manufacturing processes are aligned or other rearrangements are settled.

Mergers also cause cost disadvantages. As size increases, business organisation becomes more complex. Internal organisational costs[7] arise when firms with differences in culture, management and ownership structures merge. Normally, companies fail to minimize costs when the merging parties differ substantially in their corporate cultures and management styles, or weak competition enables the firms to neglect cost discipline. Therefore, special care has to be exercised in the integration process. Otherwise, a lack of communication and information or intransparent decision-making impedes the realisation of cost savings. Thus, an uncoordinated merger process brings about higher costs. Empirical studies reveal that companies are inclined to underestimate the costs of post-merger integration, especially those of cultural integration.[8] Additional costs arise when the merging firms lessen their efforts to achieve competition advantages after the merger is consummated. Under less competitive pressure, managers and employees tend to aim at achieving personal objectives (prestige, an easier life etc.) rather than at minimising costs.

The Market Power Motive

The search for market power is an obvious incentive for horizontal mergers. By eliminating side-by-side competition between two firms, a merger increases the market power of the combined firms. Market power or market dominance is given when a firm or a group of firms is able to raise prices above the competitive level (marginal cost) for a sustained period of time.[9] The extent to which firms can exercise market power depends inversely on the firms' elasticity of demand, i.e. the less elastic its demand curve, the more market power a firm has. Several factors determine a firms' elasticity of demand.[10] First, as the firm's own demand will be at least as elastic as market demand, the elasticity of market demand limits the potential for market power. The second determinant of a firm's demand curve is the number of firms in the market. If there are many companies, it is unlikely that any company will be able to affect price significantly. Third is the interaction among firms. If firms compete aggressively in a market, each firm will be afraid to raise its price for fear of being undercut by another firm, and thus it will have little market power.

The market power effects of horizontal mergers are generally analysed in quantity-setting markets (the Cournot model).[11] The increase in demand caused by a merger makes the demand curve of the merging parties more inelastic than the demand curves of the independent firms. With the fall in the firm's elasticity of demand, profit-maximizing firms will reduce their outputs to below the previous level in order to set higher prices and increase profits. As firms outside the merger also benefit from higher prices, they have an incentive to expand their own output in an attempt

[5] J. C. Panzar: Technological Determinants of Firm and Industry Structure, in: Handbook of Industrial Economics, 1989, Vol. 1, pp. 3-59.

[6] F. M. Scherer: Industrial Market Structure and Economic Performance, 3rd Edition, 1990, pp. 97 ff.

[7] Leibenstein named the costs of organisation X-inefficiencies. Cf. H. Leibenstein: Allocative Efficiency versus X-Efficiency, in: American Economic Review, 1966, pp. 392-415.

[8] M. R. Träm: Integration nach Unternehmenskauf, Study of A. T. Kearney, Feb. 1999.

[9] M. A. Utton: Market Dominance and Antitrust Policy, 1995, p. 10.

[10] W. M. Landes, R. A. Posner: Market Power in Antitrust Cases, in: Harvard Law Review, 1981, pp. 937-983.

[11] S. W. Salent, S. Switzer, R. J. Reynolds: Losses from Horizontal Merger: The Effects of a Change in Industry Structure on Cournot-Nash Equilibrium, in: The Quarterly Journal of Economics, 1983, pp. 185-199; J. Farrell, C. Shaprio: Horizontal Mergers: An Equilibrium Analysis, in: American Economic Review, 1990, pp. 107-126.

to take further advantage of the increased prices.[12] The output expansion of the non-merging firms restrains, however, the post-merger price increase and thus the market power effect. As long as total output is less than that prior to the merger, some increase in price can occur. In the extreme case, non-merging companies profit more from the merger than the participating parties. But under such circumstances, a merger does not usually take place. Thus, merging companies have to take the possible reactions of the non-merging firms into account, otherwise their merger may fail to achieve market power.

If horizontal mergers fail to attain market dominance, firms may solve the problem by cooperating with other firms. By acting collectively, the free-rider effects for firms outside the merger are 'internalized'. Collusion is therefore the next best option to raise prices above competitive levels. But the success of collusion will depend on the underlying market conditions, such as the costs of administrating and monitoring the agreement, the number of firms in the market and the effectiveness of the means of detection and punishment for cheating.[13] As horizontal mergers reduce the number of independent firms, they may lead to an industry structure more conductive to collusive behaviour. As a consequence, the transaction costs for collusive agreements are lower and cheating can be more easily detected and punished than if no merger had taken place. Similarly, collusive behaviour is likely to be simpler when a merger increases the level of sunk costs in a market.

In general, mergers that are motivated by efficiencies cause cost and market power effects at the same time. On the cost side, mergers may result in real savings of resources but normally at the expense of increased organisational costs, while on the demand side the increase in prices stands in opposition to the ability to exercise market power in a market effectively. In merger analysis, then, the net effect of costs and market power has to be taken into account.

Welfare Analysis

Horizontal mergers have different impacts on social welfare. From the point of view of welfare economics mergers should only be allowed if they enhance competition and increase social welfare, and firm combinations that restrain competition should be prohibited. To assess the welfare impacts of mergers, the cost and market power effects are analysed with regard to their efficiency.[14] As is well known, the exercise of market power by raising prices above marginal costs leads to allocative inefficiency, and real cost savings (production and dynamic economies) through mergers improve technical, and accordingly dynamic, efficiency. Thus, there is a trade-off between the welfare losses due to allocative inefficiency (market power) and the welfare gains accruing to increased static and dynamic efficiency. The task of competition policy is then to determine the net welfare effect by balancing the pro-competitive effects against the anti-competitive effects of a merger.

Although now all schools of thought agree on the relevance of efficiency for the analysis of antitrust transactions, differences remain as to how efficiencies are to be defined and what weight they should be given. Based on their interpretation of the term social welfare, two approaches to antitrust policy can be distinguished: the social (total) welfare and the consumer welfare standard.[15] Under the total welfare standard, a merger would not be challenged if it had the effect of increasing the sum of producers' and consumers' surplus. Welfare is defined as surplus in the hands of the shareholders of the merged entity as well as surplus in the hands of suppliers and customers. In contrast, the consumer welfare approach weights the surplus lost by consumers more heavily than it weights the gain in surplus by producers. Under this concept, therefore, the transfers of surplus between consumers and producers are not neutral. Thus, a merger can be allowed only when it is beneficial to customers, i.e. in terms of lower prices or better quality. The choice between the two welfare standards has important implications for merger enforcement policy.

The total welfare standard approach to assessing efficiencies in merger analysis is developed by Oliver Williamson.[16] In a simple partial equilibrium welfare economics model, he provides a clear analysis of the potential trade-offs between increases in market power and efficiencies following a merger. The model shows how the efficiency gains of a merger should be weighed against the welfare losses. If the cost savings are larger than the deadweight loss, then the owners

[12] This reaction presumes that firms outside the merger have free production capacities.

[13] See in more detail E. Kantzenbach, J. Kruse: Kollektive Marktbeherrschung, 1989; E. Kantzenbach, R. Krüger, E. Kottmann: Kollektive Marktbeherrschung: Neue Industrieökonomik und Erfahrungen aus der Europäischen Fusionskontrolle, 1996.

[14] See in more detail E. Sohmen: Allokationstheorie und Wirtschaftspolitik, 1976.

[15] D. G. McFetridge: The Efficiency Defense in Merger Cases, in: B. C. Malcolm, N. A. Kleit: Competition Policy Enforcement: The Economics of the Antitrust Process, 1996, pp. 89-115.

[16] O. E. Williamson, op.cit.

gain more than the consumers lose, and social welfare rises. In that case, a merger should be allowed even though market power is created. Williamson argued that a relatively small cost reduction generally outweighs a relatively large increase in market power.[17] But although the analysis is based on simplifying assumptions, such as the extreme change from perfect competition to complete monopoly, the theoretical framework can be extended to more likely cases in practice, such as merging firms with pre-existing market power.[18] As a result of such qualifications, in general the cost savings necessary to offset further merger-induced price increases must be significantly greater than in the simple case.

Under the consumer welfare approach, the trade-off analysis is different. In accordance with the consumer orientation of this concept, the monopoly overcharge (redistributed surplus between consumers and producers) as well as consumer deadweight loss are viewed as harmful. The standard is therefore indifferent to the welfare attained by the shareholders of the merging firms. Cost savings accruing from a merger only have relevance if they are sufficient to offset the incentive to increase prices due to increased market power.[19] This condition implies that a merger only satisfies the consumer welfare standard if the market price does not rise.[20] As fixed cost savings will not affect prices in the short run, this trade-off analysis gives efficiencies occurring from marginal cost reductions more weight. Thus, it is more difficult to offset the likely anti-competitive effects of a merger under the consumer welfare than under the total welfare approach. But both welfare standards yield the same enforcement decisions when merger efficiencies reduce marginal costs.

Efficiency Defence in German Merger Control

The purpose of German competition policy is to guarantee competitive markets and to ban all agreements between parties that restrain competition. Besides preserving competition, the German cartel law also takes non-competition goals into account, whereby efficiency aims are only considered in extraordinary cases. In those cases, merger analysis is based on the social welfare approach. For examining merger-related efficiencies, German merger control uses a two-tiered procedure. In the first stage, the Federal Cartel Office analyses the effects of mergers on competition. In the second stage, the Federal Minister of Economics investigates whether, despite the negative effects on competition, a merger can still be approved for reason of the advantages to the economy as a whole or of a predominating public interest.[21] In order to grant an exemption, the minister has to publicly overrule the Cartel Office. Consequently, the requirements for ministerial approval are very high.

In practice, the Monopoly Commission and the Federal Minister of Economics have considered a broad range of efficiencies, including real resource savings and advantages due to public interest. The ministerial decisions reveal that economies due to rationalisation are most likely to be accepted if they are of a considerable size, merger-specific, and subject to reliable proof.[22] The review of merger cases shows that rationalisation savings alone are rarely adequate for a defence of the merger based on efficiency arguments. But in connection with other economic advantages, such savings will be more substantial. For instance, efficiencies can be recognized when a merger strengthens the parties' ability to compete permanently in foreign markets.[23] Furthermore, efficiencies are acknowledged when a merger contributes to securing useful technological know-how or ensuring jobs.[24] The review of ministerial decisions also demonstrates that mergers have positive impacts on the general public when they facilitate reorganisation in distressed industries or lead to reductions in state aid.[25]

According to the trade-off analysis, efficiency arguments must be balanced against competition considerations. Therefore, the Monopoly Commission determines the weight of increased market power. While the quantitative market structure effects are measured on the basis of the market volume as determined by the Cartel Office, the qualitative effects of the restraints are examined by means of market criteria such as market share, financial strength etc.

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[17] For numerical estimates for the trade-off analysis under Cournot quantity competition see G. L. Roberts, S. C. Salop: Efficiency Benefits in Dynamic Merger Analysis, in: World Competition, Law and Economics Review, 1995, pp. 5-17.

[18] K. Cowling: Mergers and Economic Performance, 1980.

[19] A. A. Fisher, F. I. Johnson, R. H. Lande: Price Effects of Horizontal Mergers, in: E. M. Fox, J. T. Halverson: Collaborations among Competitors, 1991, pp. 361-402.

[20] For this reason the approach is sometimes called price standard.

[21] See Section 42 (1) of the Law Against Restraints of Competition.

[22] See the merger cases Kaiser/VAW, Sondergutachten der Monopolkommission No. 3, 1975 and Daimler-Banz/MBB, Sondergutachten der Monopolkommission No. 18.

[23] See the merger case IBH/Wibau, Sondergutachten der Monopolkommission No. 10, 1982.

[24] See the merger cases Thyssen/Hiller, Sondergutachten der Monopolkommission No. 6 and PCS/K+S, Sondergutachten der Monopolkommission No. 25, 1997.

[25] See the merger cases IBH/Wibau, op. cit. and Daimler-Benz/MBB, op.cit.

Both the Monopoly Commission and the Federal Minister of Economics use a sliding-scale approach, i.e. particularly large anti-competitive effects must be outweighed by extraordinarily great efficiencies and vice versa. As ministerial decisions have repeatedly shown, the result of the analysis cannot be valued in numbers. The weighing therefore represents a direct comparison of the relative advantages and disadvantages of the proposed merger. This method corresponds to the fundamental idea of Williamson's model.

European Merger Control

EU competition policy seeks to advance the interests of consumers and protect effective competition in the common market. Contrary to German law, competition policy is also seen as a means of promoting economic integration in Europe. Although both goals must be considered in merger analysis, the competition aims have priority over integration objectives. Thus, underlying European merger control is a mixed approach that comprises elements of both the consumer and the social welfare standards. EU merger regulations consider efficiency aspects in a one-level procedure, i.e. when analysing the competitive effects of an intended merger. To decide whether a merger creates or strengthens a dominant position, the European Commission has to examine whether the proposed transaction will possibly advance the development of technical and economic progress.[26] But the efficiency criterion can be used only if it is perfectly compatible with competition and consumers' interests. According to the wording, an efficiency defence can therefore only be approved when there is no conflict between efficiency and market power.

Although the European Commission has applied the efficiency criterion in some merger cases,[27] its role still remains ambiguous in merger enforcement by the EU Commission. Though cost savings, such as economies of scale in production or synergies in R&D, are mentioned in the European merger decisions, in none of the cases have efficiencies met the required criteria. In all cases, the recognition of efficiencies failed because consumers' advantages could not be proven or competition was restrained. For instance, in the Aérospatiale-Alenia/de Havilland case, the Commission stated that the claimed efficiencies were insufficient to contribute to economic progress and that there would be no discernible benefit to consumers.[28] But as mergers increase market power per se, it is unlikely that a merger will be justified on efficiency grounds. The formal trade-off analysis, the balancing of pro-competitive effects against anti-competitive effects, is therefore impossible under the EU merger regulation. The analysis of the relevant merger decisions indicates that the Commission tends to avoid the question of efficiencies.

Its enforcement practice reveals, however, that the European Commission indirectly considers efficiency issues. Instead of examining cost savings, the Commission applies a dynamic approach when analysing future competitive effects. For instance, in the Mannesmann/Vallourec/Illva case, the European competition agency denied the creation of a dominant market position, arguing that potential competition from abroad would be sufficient to restrict the behaviour of the merging firms.[29] The relevant merger decisions demonstrate clearly that it is easier to prove the effectiveness of potential competition than to verify efficiency gains. In doing so, on the one hand, the European Commission avoids offending against its competition goals and, on the other hand, it has some leeway for taking non-competition objectives into account.

US American Merger Control

The analysis of the efficiency defence in US American merger practice differs from the German and European approaches not only in the legal system but also in the goals of antitrust policy. While Congress has passed relatively vague statutes into law, it has stated a strong preference for the protection of US American consumer interests. Thus, the enforcement agencies and the courts apply the consumer welfare approach in merger analysis. The Merger Guidelines lay down how the Department of Justice and the Federal Trade Commission should analyse efficiencies in merger cases. The 1997 Guidelines adopt the term 'cognizable' for all those efficiencies that the agencies will consider in merger analysis. Efficiencies are deemed to be 'cognizable' when they are likely to be accomplished with the proposed merger (merger-specific), do not result from market power related reductions of output, and are verifiable.[30] The agencies will not challenge a merger if the benefits from efficiencies are sufficient to prevent price increases to consumers in the relevant market.

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[26] Art. 2 par. 3 European Merger Regulation.

[27] See the merger cases Aérospatiale-Alenia/deHavilland: European Commission, 1991, MSG/Media Service: European Commission 1994, Nordic Satellite Distribution: European Commission, 1995, Gencor/Lonhro: European Commission, 1997, Saint-Gobain/Wacker-Chemie: European Commission, 1997.

[28] Aérospatiale-Alenia/deHavilland: European Commission, 1991, 65 ff.

[29] Mannesmann/Vallourec/Illva: European Commission, 1994, 130 ff.

[30] US Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, Section 4, 1997.

Reviewing efficiencies in American merger case law shows that the courts focus predominantly on production and plant economies.[31] Other efficiencies, such as distributional, promotional, administrative or managerial ones, are often less likely to be substantial in merger evaluation. Those cost savings are generally rebutted because they can also be accomplished by alternative means such as other business arrangements or internal growth. In order to determine the least restrictive way of achieving the alleged efficiencies, the courts compare what may happen if the merger occurs to what is likely to happen if it does not take place. Analysing the merger decisions reveals, however, that the problem of proof is often the principal reason why the courts have repeatedly rejected efficiencies claims.[32] It appears that courts tend to rebut efficiencies on evidentiary grounds in cases in which they found that a proposed transaction is likely to be anti-competitive[33] and to credit efficiency claims when mergers have little competitive harm.

According to the consumer welfare standard, the efficiencies claimed can save an otherwise anti-competitive transaction only if the proposed merger leads to cost reductions that are passed on to consumers and are sufficient to offset the expected price increase.[34] Though higher consumer welfare may be achieved by lower prices, better products, or improved quality, the courts tend to favour the price test as an indicator.[35] Case law thus gives short-term efficiencies that immediately affect prices (reductions in marginal costs) greater weight than long-term cost-cutting efficiencies without any direct effects on prices. The analysis of merger cases shows, however, that the judges are reluctant to make the formal trade-off analysis and tend to resolve that issue indirectly. In some cases, it appears that the courts compare the efficiency losses of a less restrictive alternative to the proposed transaction with anti-competitive harm resulting from the merger. In doing so, the courts get an idea of the relative weight of the efficiencies but avoid a direct balancing of benefits against costs.

Conclusions

Merger-related efficiencies are taken into account in all the competition policies reviewed but in different ways. A comparison demonstrates that most diversities concerning efficiency defence are based on different legal, procedural and institutional approaches. Nevertheless, there are also similarities in considering cost savings due to mergers. In all competition laws, efficiencies are contemplated in indefinite terms in order to have leeway for the diverse forms of cost savings. But the three competition policies differ regarding the scope of accepted efficiencies. While the European Commission and the US antitrust agencies consider only real economies, the range of German ministerial approval extends to advantages in the public interest. All three policies have high requirements for accepting efficiencies as a pro-competitive factor in merger analysis. The US and the German authorities have established detailed standards.[36] In contrast, the European Commission gives the parties little guidance on how to meet the progress criteria.

With regard to the trade-off analysis, a balancing of the pro-competitive and the anti-competitive effects of a merger is only possible under the German and the US regulations. Since German competition policy is based on the social welfare standard and US antitrust policy on the consumer welfare standard, different methods are used to weigh the advantages of a merger against the disadvantages. As far as efficiencies are proven, equal weight is placed on both merger effects. In contrast, European competition policy places more weight on competition restraints than on efficiency gains. Even though the unequal treatment of efficiencies and market power effects excludes a formal trade-off analysis, the European Commission tends to resolve that issue indirectly by interpreting the other merger criteria in a very dynamic way.

The conflict between efficiencies and market power has not yet arisen very often in merger enforcement, although agencies and courts have recognized efficiencies as a factor that may tilt the balance in favour of an otherwise anti-competitive transaction. The review of the relevant merger cases demonstrates clearly that complaints by the firms that competition law is too restrictive concerning efficiency issues is without substance. Thus, in cases where the merging parties claim efficiencies but the competition agency refuses to allow the proposed merger, the alleged savings are either not verifiable or not high enough to offset the competition concerns. The legal framework of the merger policies examined is therefore sufficient to meet the challenge of the current merger wave.

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[31] See FTV v. Proctor & Gamble, 386 U.S. 568, 604 (1967).

[32] For example U.S. v. Long Island Jewish Medical Center, 938 F. Supp. 121, 148 (1997), U.S. v. Mercy Health Services, 902 F. Supp. 968, 989 (1995), FTC v. Owens-Illinois, Inc., 681 F. Supp. 27 (1988).

[33] For example FTC v. Staples, Inc., 970 F. Supp. 1066, 1089 (1997), FTC v. University Health, Inc. 938 F. 2d 1206, 1222 (1991), U.S. v. United Tote, Inc., 768 F. Supp. 1064, 1084-85 (1991), U.S. v. Rockford Memorial Corp., 717 F. Supp. 1051, 1289-91 (1989).

[34] See FTC v. University Health, Inc., 938 F.2d 1206, 1223 (1991).

[35] See FTC v. Staples, Inc., 970 F. Supp. 1066, 1090 (1997).

[36] Cost savings must be merger-specific, cognisable and verifiable.