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**ROUNDTABLE ON DYNAMIC EFFICIENCIES IN MERGER ANALYSIS**

**-- Note by Germany --**

*This note is submitted by the German Delegation to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 6-7 June 2007.*

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## 1. Introduction

1. In this contribution to the OECD Roundtable on Dynamic Efficiencies, the practice of the *Bundeskartellamt* regarding efficiencies in the light of German merger control law will be presented.

## 2. Efficiencies and practical difficulties

### 2.1 *Dynamic and static efficiencies in economic theory and empiricism*

2. As the scoping and the background paper point out, economic theory distinguishes between static and dynamic efficiencies. The notion of static efficiencies covers one-time improvements such as economies of scale in production, economies of scope etc. Dynamic efficiencies, on the other hand, enable undertakings to improve their performance over time, whether in terms of cost, quality, service, or variety<sup>1</sup>. Such improvements may be called “innovations”. Innovations are undoubtedly vital for economic development and growth and, in theory, innovations caused by mergers may have a much more significant positive welfare effect on the economy than static efficiencies. In the absence of practical problems in assessing these efficiency gains, one might conclude that they should have even more weight in the assessment of a merger than static efficiencies.

3. An important motivation for firms to merge is to increase their efficiency, *i.e.* the merging parties expect the combined entity to operate more efficiently than they would do without the merger. Mergers may thus give rise to considerable efficiencies that enhance economic welfare in the short and/or long run. However, there is no reliable empirical evidence that mergers actually create such efficiencies on average. Most econometric studies find that mergers on average do not increase the combined shareholders’ value<sup>2</sup>, a finding which seems to contradict a presumption that mergers enhance efficiency. In addition, there are no reliable studies that quantify the relative magnitude of static versus dynamic efficiencies. Hence, there is a lack of empirical evidence for the assumption that mergers create greater dynamic efficiencies than static efficiencies.

4. However, in a more long-term perspective mergers may still be able to create efficiencies on average through a trial-and-error procedure: Even if the merging parties seem largely unsuccessful in predicting merger-specific efficiency gains, they may find out some years after the merger whether the merger was successful in creating efficiencies. If the merger did not create efficiencies, they can de-merge (the DaimlerChrysler merger and recent Chrysler spin-off may serve as such an example). Taking such spin-offs into account could thus change the empirical results mentioned above.

### 2.2 *Practical problems in forecasting efficiency gains*

5. Forecasting the likely competitive impact of a merger is a complex and difficult task. In comparison to analysing market shares, entry barriers etc., forecasting efficiency gains is much more uncertain and may end up in speculation. As the ICN Merger Guidelines Workbook (2006) put it: “The quantification of merger-specific efficiencies is often the most speculative single element of merger

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<sup>1</sup> See Background Note, DAF/COMP(2007)12, p. 2. It should be noted that the present contribution does not propose any specific definition for static / dynamic efficiencies and instead refers to the Secretariat’s Background Paper to this roundtable.

<sup>2</sup> Studies tend to find that acquisitions are on average more advantageous for the shareholders of the acquisition target than for the shareholders of the acquirer.

review.”<sup>3</sup> This is even more true for dynamic efficiencies. The key reason for these difficulties is the lack of adequate information as the basis of a merger review decision.

6. Information insufficiency starts at the level of the merging parties. In their internal analysis, the merging parties typically overestimate the merger-specific efficiency gains before and even after the merger<sup>4</sup>. The high number of value-decreasing mergers illustrates this problem. At the same time, this (largely insufficient) information of expected efficiencies is normally solely in the possession of the merging parties; in other words, there are significant informational asymmetries between the merging parties and the competition authority. Where efficiency gains have a positive impact on the competition authorities’ decision-making, there is a clear incentive for merging parties to overstate these expected gains. According to Hayek, there is “constitutional uncertainty” about merger-specific efficiency gains.

7. Due to such information insufficiency, economists have differing views on whether competition authorities should consider efficiencies at all in individual case assessment<sup>5</sup>. In a world of limited agency resources that can be invested in case investigation, there is a trade-off to be made between investigating expected efficiency gains or other aspects of a proposed merger. Lack of reliable information is also the reason why those competition authorities which do take efficiency claims into account, tend to be sceptical about such claims. Typically high standards of proof must be met by the merging parties: Claimed efficiencies need to be merger-specific, passed on to consumers, verifiable and should be supported by convincing evidence and quantified wherever possible.

8. Several authors have argued that such a high standard of proof is hardly possible to meet with regard to dynamic efficiencies. These authors draw two different conclusions from this analysis: (i) that the standard of proof should be lowered or (ii) that dynamic efficiencies should not be taken into account by competition authorities<sup>6</sup>.

9. The *Bundeskartellamt* holds the view that both static and dynamic efficiencies should not be taken into account where they are speculative. With regard to dynamic efficiencies, this can be illustrated by way of an example. A possible dynamic efficiency is the combination of parallel or complementary R&D efforts<sup>7</sup>. The merging parties might argue that by pooling the two lines of research, they will produce more innovations or better innovations than each party separately. However, just the opposite might also be true: Maybe one of the merging parties is pursuing a line of research which – not yet known to the firm – will result in a dead end. And the other party is pursuing a line of research which –not yet known to the firm – will result in a successful innovation. Suppose that after the merger they will pursue only one of these two lines of research – how could one predict whether they will choose the “right” track? Taking the

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<sup>3</sup> See p. 61. The Workbook is available at:  
[http://www.internationalcompetitionnetwork.org/media/library/conference\\_5th\\_capetown\\_2006/ICNMergeRGuidelinesWorkbook.pdf](http://www.internationalcompetitionnetwork.org/media/library/conference_5th_capetown_2006/ICNMergeRGuidelinesWorkbook.pdf).

<sup>4</sup> See e.g. KPMG International The Morning After. Driving for Post Deal Success (2006), available at:  
<http://www.kpmg.ca/en/services/advisory/morningafter.html>

<sup>5</sup> For such a discussion, see Oberender (ed.) (2005), *Effizienz und Wettbewerb*, Schriften des Vereins für Socialpolitik, Berlin.

<sup>6</sup> For further references see Oberender, *ibid.*

<sup>7</sup> See Background Note, DAF/COMP(2007)12

information paradox<sup>8</sup> into account, it seems impossible for the merging parties (and even less for the competition authority) to make such a prediction.

10. However, there may still be a less assuming way of incorporating dynamic efficiencies in the merger analysis. This can be done in those instances where dynamic efficiencies can be directly tied to the competitive analysis. For example, some dynamic efficiencies may result in lowering entry barriers or in creating incentives for competitors to compete more vigorously. In such cases, dynamic efficiencies may be integrated in the analysis without making speculative arguments. A competition authority which is more humble about its own ability (and the merging parties' ability) to predict efficiency gains, can thus still incorporate those dynamic efficiencies in the analysis which improve the competitive conditions.

### **3. German merger control law and efficiencies**

#### **3.1 Substantive test of German Merger Control**

11. According to Section 36 (1) ARC<sup>9</sup>, the *Bundeskartellamt* cannot clear a concentration which is expected to create or strengthen a dominant position on a relevant market<sup>10</sup>. German merger control law focuses on structural control with the aim of ensuring effective competition. Effective competition is seen as the best guarantor for consumer welfare.

12. Whether one or more undertakings do enjoy a dominant position has to be examined in a detailed competitive analysis of the envisaged concentration. This analysis takes into account, *inter alia*, the undertakings' access to supplies or markets, their ability to shift their supply or demand to other goods or commercial services as well as legal or factual barriers to entry by other undertakings, actual or potential competition by undertakings established within or outside of Germany and the ability of the opposite market side to resort to other undertakings. On the basis of its competitive analysis, the *Bundeskartellamt* decides whether or not the creation or strengthening of a dominant position is to be expected and, consequently, the concentration must be prohibited or can only be cleared subject to conditions and/or obligations. The ARC provides for presumptions for the existence of a dominant position on a relevant market (Section 19 (3) ARC)<sup>11</sup>. However, the presumptions do not amount to a reversal of the burden of proof. In the practice of the *Bundeskartellamt*, these presumptions constitute a first indication as to which cases may deserve closer examination. Ultimately, the presumption of dominance only becomes the decisive factor if a conclusive investigation cannot establish the presence or absence of a dominant position. In practice, this is a very rare case.

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<sup>8</sup> There is no way to know whether research will deliver specific information. If one knew, there would be no need to research.

<sup>9</sup> An English translation of the ARC is available at:  
[http://www.bundeskartellamt.de/wEnglisch/download/pdf/06\\_GWB\\_7\\_\\_Novelle\\_e.pdf](http://www.bundeskartellamt.de/wEnglisch/download/pdf/06_GWB_7__Novelle_e.pdf).

<sup>10</sup> The exception to this rule, the so-called weighing clause, will be discussed in greater detail in the context of the treatment of efficiencies in German merger control (see 3. b) below).

<sup>11</sup> These presumptions are based on market shares: Single dominance is presumed if one undertaking has a market share of at least one third in the relevant market. Collective dominance is presumed if up to three undertakings reach a combined market share of 50% or if up to five undertakings reach a combined market share of two thirds.

### 3.2 *Efficiencies are not mentioned explicitly in the law*

13. German merger control rules do not explicitly mention efficiencies. The *Bundeskartellamt* holds the view that efficiencies arising from a merger should in principle not be seen as negative factors, *i.e.* as indicators for the strengthening of a dominant position. That means that there is no “efficiency offence”. On the other hand, it is clear that no formal efficiency defence exists under German merger control law either.

14. One could argue that either the presumptions for dominance, which are based on market shares, or market dominance in itself constitute an exhaustive incorporation of efficiencies with the assumption that concentrations only give rise to efficiencies if these thresholds are not met<sup>12</sup>. The *Bundeskartellamt* does not share this view: It is not plausible to assume that all concentrations resulting in aggregate market shares beyond the specified levels should never give rise to efficiencies. Furthermore, such a reasoning has been contested by Stennek and Verboven who have argued that intermediate market shares of 40 to 50% lead to the greatest pass-on of cost savings<sup>13</sup>. Therefore, safe harbours may constitute a good first filter. It should, however, not be ruled out that concentrations beyond these thresholds could also generate considerable efficiencies.

### 3.3 *Influence of efficiencies in merger control proceedings*

15. Although the ARC does not mention efficiencies explicitly, efficiencies arising from a concentration may affect the merger control proceedings in various ways.

#### 3.3.1 *Efficiencies in the competitive analysis*

16. The *Bundeskartellamt* may examine efficiencies in the competitive analysis of a concentration. In its analysis, the *Bundeskartellamt* weighs the positive and negative competition effects of the merger on the relevant markets to make a prospective analysis of the expected effects of the merger. In an oligopolistic market, efficiencies arising from a concentration could, for example, enhance competition. By joining their resources, know-how, ability to innovate etc., the parties to the merger may be, post merger, in a position to offer better products or cheaper prices and thus gain the ability and incentive to contest their competitor’s leading market position. In such a case where efficiencies make the market players’ incentives more asymmetric, a common understanding – thus the creation or enhancement of a collective dominant position – would be unlikely.

#### 3.3.2 *Improvements of competitive conditions in other markets (“weighing clause”)*

17. The German law also stipulates that a merger cannot be prohibited if the companies involved prove that the merger will also lead to improvements in the conditions of competition which outweigh the disadvantages of dominance (section 36 (1) ARC). The parties to the merger can invoke this clause if the competitive assessment of a merger concludes that the requirements for prohibition are fulfilled. However, to avert a prohibition, undertakings have to provide evidence that the merger would improve the

<sup>12</sup> For a discussion of the general presumptions approach see e.g. Christian R Fackelmann, Dynamic Efficiency Considerations in EC Merger Control. An Intractable Subject or a Promising Chance for Innovation? University of Oxford Centre for Competition Law and Policy, Paper (C) 09/06, p. 63 *et seq.* with further references; see also Background note DAF/COMP(2007)12, p.26.

<sup>13</sup> Johan Stennek and Frank Verboven, Merger Control and enterprise competitiveness: empirical analysis and policy recommendations, in: Fabienne Ilzkovitz and Roderick Meiklejohn (eds.): European Merger Control. Do we need an Efficiency Defence?, p. 202 (262).

competitive conditions on a market other than the one affected by the merger, on which market dominance is created or strengthened. Undertakings also have to demonstrate that the quality of improvement on the alternative market outweighs the deterioration of competition structures on the dominated market. This means that the other market, where the pro-competitive effects occur, must be of similar or greater economic relevance as the market affected by the merger. As a rule, pro-competitive effects on a market where one of the parties to the merger holds a dominant position would carry more weight than pro-competitive effects on a market with more favourable competitive structures.

*Case example: SES Astra/Premiere Digital Playout Center*

18. One example where the anti-competitive effects on one market were outweighed by pro-competitive effects on another market was the *Bundeskartellamt's* clearance of the acquisition of all the shares in DPC Digital Playout Center GmbH (DPC) by SES Global Europe S.A. (SES Global) in December 2004. The shares in DPC were sold by the Premiere Fernsehen GmbH & Co. KG (Premiere).

19. The takeover affected the market for broadcasting satellite programmes as well as the pay TV end consumer market in Germany. Through SES Astra S.A. (SES Astra), SES Global operated the ASTRA satellite fleet in Europe and in particular provided transponder capacity to broadcasting service providers for the transmission of programmes via satellite to end consumers (DTH “direct to home”). DPC provided Premiere with intracompany technical services for pay TV (so-called digital platform: encoding, SmartCard management, set-top boxes).

20. The merger led to a strengthening of SES Astra’s dominant position in the national market for DTH transponders. The strengthening of SES Astra’s dominant position resulted from the vertical integration of the dominant satellite provider with the only service provider which was able to grant access to the Premiere set top boxes for satellite reception. Thus, two essential technical components of pay TV advance services were bundled under one provider.

21. However, the unbundling of the digital platform for pay TV from Premiere resulted in improved conditions of competition in the national pay TV market. So far, Premiere had dominated the pay TV market and sealed it off by using proprietary encoding technology and a matching set top box infrastructure. With the merger, access to the established set top box infrastructure was provided by SES Astra, a company which is independent of Premiere. Thus, a significant entry barrier to the pay TV market was eliminated. According to the *Bundeskartellamt's* findings, the positive effects on the pay TV market outweighed the negative effects on the DTH transponder markets.

#### **4. Conclusion**

22. German merger control law does not provide for a formal efficiency defence but does not treat efficiencies arising from a concentration as an offence either.

23. In its competitive assessment and within the weighing clause the *Bundeskartellamt* takes efficiencies, whether static or dynamic, into account.

24. Merger-specific efficiencies can have positive effects, in particular those resulting from the promotion of innovation due to dynamic efficiencies. On the other hand, concentrations cannot, in general, be presumed to give rise to efficiencies, since a concentration may or may not result in efficiencies.

25. Both static and dynamic efficiencies should not be taken into account where they are speculative. This risk is greater for dynamic efficiencies as these are even more uncertain than static efficiencies. While being humble about the ability to predict efficiency gains, those dynamic efficiencies which improve the competitive conditions are taken into account, e.g. where dynamic efficiencies may result in lowering entry

barriers or in creating incentives for competitors to compete more vigorously. In this sense, the *Bundeskartellamt* weighs in an integrated analysis the positive and negative competition effects of the merger on the relevant markets in order to make a prospective analysis of the expected effects of the merger. Efficiency gains and competitive disadvantages are generally not quantified on a case-by-case basis.

26. Efficiencies that improve the competitive conditions in a market other than the one affected in which market dominance is created or strengthened by the merger, are also taken into account. Clearance will be granted if the improvement on the alternative market outweighs the deterioration of competition structures on the dominated market.