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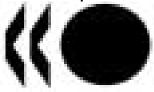

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DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

Working Party No. 3 on Co-operation and Enforcement

ROUNDTABLE ON THE USE OF ECONOMIC EVIDENCE IN MERGER CONTROL

-- Federal Republic of Germany --

The attached document is submitted by the delegation of the Federal Republic of Germany to Working Party No. 3 of the Competition Committee FOR DISCUSSION under Item V of the agenda at its forthcoming meeting on 10 June 2004.

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1. Organization and involvement of economists in the decision making process: How are economists integrated in the decision making process (e.g., part of a case team, separate unit)? Is their participation in every merger case mandatory?

1. The Bundeskartellamt is an independent authority organized in a number of (currently eleven) sector-specific Decision Divisions. Similar to the practice of German courts, each case is investigated by a case handler and decided by a college of three members of the Decision Division (including the chairperson of the Decision Devision as well as the case handler). Thus a "case team" will usually consist of those three members. The Decision Divisions have in the past maintained roughly a 50%:50% distribution between economists and lawyers on the case handling, i.e. the decision making level. In 2003, the Bundeskartellamt employed about 150 employees with higher University training, which divided roughly into 80 lawyers, 60 economists and 10 with a different degree. Typically the "case team" includes two economists and one lawyer, or vice versa. In exceptional cases, the "case team" consists only of economists or only lawyers. Thus economists are integrated as part of the case team and do not comprise a separate unit. While they participate in the vast majority of cases, their participation is not mandatory.

2. Have steps been undertaken to improve an agency's economic expertise in merger control?

2. The Bundeskartellamt has been striving to improve its economic expertise during the past years mainly through targeted recruiting of highly qualified economists. These economists have at least a higher University degree – often also a Ph.D. degree - and are usually specialized in industrial or competition economics. The Bundeskartellamt continues these recruitment efforts.

3. In February 2002 the project group „OEKON" of the Bundeskartellamt was founded. It is an informal association of economists within the Bundeskartellamt which regards itself as an „economic think-tank". It is the aim of OEKON to heighten economic expertise in competition analysis and to transport it into the Bundeskartellamt. The members analyse and discuss specific topics of relevance to the Bundeskartellamt's practical work from a more academic perspective. The research and discussion results are provided in-house.

3. Are outside economists used, and if so, in what circumstances?

4. The Bundeskartellamt maintains continuous relationships with economists from Universities. Each year the Bundeskartellamt discusses with a group of professors (the so-called Working Group on Competition Law) specific topics of competition policy which often relate to merger control.

5. So far, outside economists have not been used in specific merger cases. The Decision Devisions may ask outside economists to prepare expert reports for specific merger cases. However, this is usually not done, mainly because there is no need.

4. What type of economic evidence is typically used in merger cases?

6. Economic evidence typically used in merger cases is manifold. Economic evidence is especially important in the assessment of market definition, market shares, financial strength, entry barriers, access to suppliers and customers and counterbalancing market power. As the substantive test does not include a direct evaluation of consumer welfare, there is normally no need for econometric analyses (e.g. price-quantity-effects of a proposed merger).

7. In product market delineation the Bundeskartellamt usually assesses the substitutability of products or services from a customer's perspective as well as the flexibility of producers to switch

production. For both market sides, the relative extent of switching costs is of great importance. In geographic market delineation the analysis of transport costs plays a prominent role.

8. Market shares are usually calculated in value terms (i.e. turnover) and in some cases in quantitative terms (i.e. pieces). They are then typically analysed in terms of absolute and relative numbers as well as overall distribution and development over time. The so-called “market phase” provides additional information for evaluating market shares and their developments. In markets which are just beginning to develop, a large market share may be less indicative of a dominant position than in mature markets.

9. Financial strength is calculated by various criteria, especially turnover, cash flow, liquid funds, profits and access to capital markets. It is analysed under the aspect of discouraging and deterrent effects on competitors, i.e. whether the financial strength of merging parties may prevent market entry, innovative progress or follow-up action by competitors.

10. Just as market shares give an indication of the relationship between merging firms and their current competitors, the barriers to entry provide information on the significance of potential competition in limiting the scope of action of powerful firms. The relative weight of entry barriers is determined by the (sunk) costs of market entry in relation to expected profits and the risk of failure. It includes the analysis of statutory, structural and strategic barriers to entry.

11. Access to suppliers or customers is analysed by examining activities and links to upstream and downstream markets (e.g. vertical integration) as well as the significance of full range or “complete system” offers (e.g. portfolio effects) in the markets concerned.

12. The scope of action of powerful firms may be limited through counterbalancing market power. Thus the Bundeskartellamt also analyses whether powerful buyers award their contracts according to market-strategic considerations, so as not to become dependant on (dominant) suppliers. Buyer conduct is likely to be based on market strategic considerations when the purchasing market for the purchasing form is especially important, e.g. because the cost of the primary product has a major effect on the sales price of the finished product.

5. What is the experience in obtaining data required to carry out economic analysis, from the parties or from third parties?

13. The Bundeskartellamt does usually not face any problems in obtaining data to carry out economic analysis as described above. The data is provided by merging parties, competitors, customers and suppliers pursuant to formal or informal information requests by the Bundeskartellamt.

14. Merging parties and competitors are usually able to provide good estimates of production switching costs as wells as market entry costs through their cost accounting data and other sources. These cost data are used in market delineation and in the analysis of entry barriers. Similarly, customers and suppliers provide detailed information about product substitutability and switching costs. In most cases, all four groups provide much more information than they are legally required to. Their responses often include several other economic aspects beyond the scope of the information requests. The case teams are frequently invited by them to less formal management discussions and on-site visits.

6. How have courts assessed the agencies’ use of economic evidence when parties appealed merger review decisions by an agency?

15. In appeal procedures, all economic evidence used by the Bundeskartellamt is evaluated again by the courts. Typically, the economic facts as such are not much disputed. It is rather the relative weight of

different market factors or their legal interpretation which are controversial. The decisions of the Bundeskartellamt are confirmed in the majority of appeal procedures.

16. The general view of the Bundeskartellamt regarding economic evidence is detailed in the annexed speech of Dr. Ulf Böge on 26 May 2004 in Brussels

ANNEX

Dr. Ulf Böge

President of the Bundeskartellamt

Speech on the theme

"The Role of Economics in German Competition Policy"

at the conference

"The Role of Economics in European Competition Policy"

on 26 May 2004,

in Brussels

Ladies and Gentlemen,

I.

Everybody's talking about the so-called "more economic approach" in competition control. One might think that the light of economics is finally to shine through in competition policy after decades of competition law practice spent in the dark.

However, if you look at the origins of this call for a "more economic approach" you could also think that what is desired is not "better" enforcement of competition but a laxer application of competition law.

In the following thirty minutes I will examine both ideas or opinions.

II.

Let me begin with the question: is the "more economic approach" really something new?

I would like to answer this question from a German perspective.

It was **economic** considerations that led to the establishment of a legally binding competition system in Germany almost 50 years ago.

And, again, it was economic needs that shaped its gradual development. The discussion of theoretical economic approaches and the constant monitoring of the courses taken have played, and continue to play, an important role in this process.

The practice of incorporating experience with the application of law as well as economic findings into periodical amendments to competition law – that is, providing the legal basis with economic expertise - may distinguish ours form other competition law regimes.

In any case, the Act against Restraints of Competition (ARC) was decisively shaped by the ideas of the economic school of ordoliberalism from the very beginning.

It was characterised by a coherent and logical idea of how to create a comprehensive system of protection of competition.

However, in the legislative process of the 1950s only a reduced draft which provided for a ban on cartels and abuse control was able to secure a majority.

Merger control was introduced with the second amendment to the ARC in 1973.

Several individual aspects relevant for reviewing a case were used to clearly define merger control. The aspect of "financial power", for example, is likely to have originated in the resources theory.

By introducing the criterion of "barriers to market entry", research results of the Austrian economist Fritz Machlup (1902-1983) as well as of discussions by Joe S. Bain and the Harvard School and applied later in the theory of contestable markets were taken into account.

With the 6th amendment to the ARC that came into force in 1999 further economic concepts were introduced which until then had not been explicitly referred to in the law.

For example, denial of access to networks and infrastructure facilities was added as a new standard example to the list of abusive practices under section 19. This took account of the Essential Facilities Doctrine.

We can safely say: without economic insight and its legal implementation the liberalisation of networks would never have happened.

This process of constant development and improvement never ends. It is the task of every competition authority to take consideration of new findings in economics and to continuously check, improve and amend current views.

In current debates on competition control a return to what should be the main focus of evaluation is taking place: the effects on the market.

However, the development process of competition law is also being shaped by more recent theoretical approaches (keyword: game theory in evaluating market dominant oligopolies) and improved quantitative methods (keyword: Merger Simulation Models).

III.

But how does the "economic approach" fare in the practical application of competition law?

Here I would like to focus on the three areas of abuse control, combating cartels and merger control.

1. Economic concepts play a decisive role in **controlling abusive practices** applied by dominant companies. In the end, these concepts have to explain why prices that are set too high or too low can violate competition.

   Take **abusive pricing**: certain market situations can result in a dominant company demanding abusively excessive prices.

   Of course, the classification "abusive" is in itself not an economic evaluation. However, applying economic principles can help to evaluate the economic incentive for excessive pricing. Examples are monopoly pricing or the targeted exclusion of competitors.

   Sound criteria are needed to establish whether the pricing policy of the dominant company is objectively justifiable or not.

   The comparable market concept and cost examination are well-known economic instruments applied in such cases.

   Economic theory is of particular relevance when classifying prices as abusive that are set too low, such as in the case of alleged cut price strategies.

   Is the pricing policy of the dominant company indeed an attempt to force other competitors out of the market or is the company merely engaging in active competition?

   According to older theoretical approaches that go back to the Chicago School cut price strategies are not rational and are therefore irrelevant for competition law.

More recent models of game theory disprove this claim. They describe conditions under which the best strategy for a dominant company can be to offer goods and services below cost in order to force other competitors out of the market.

A decisive factor for the success or failure of a cut price strategy is the market structure.

High barriers to market entry, economies of scale and network effects, such as seen in the aviation industry, raise the prospects of success.

In this industry we have witnessed several times how a dominant airline drastically cuts its prices for certain routes after a competitor has entered the market serving the same routes, and how it raises prices again after the competitor has left the market.

One example of this practice where the Bundeskartellamt had to take action was the Lufthansa/ Germania case. This revolved around the pricing of flights for the Berlin-Frankfurt route.

Lufthansa, who until then had been the sole operator on this route, had drastically cut its prices for certain fully-flexible economy class tickets after the low-cost airline Germania had entered the market, but only on the Berlin-Frankfurt route. Lufthansa's pricing policy threatened to force the newcomer out of the market and thus to crush competition before it could even develop.

The Bundeskartellamt held the view that Lufthansa's pricing policy for the Berlin-Frankfurt route constituted an abusive hindrance to Germania with the aim to force the new competitor out of the market.

Therefore, in February 2002 it prohibited Lufthansa from continuing its cut price strategy.

Without the economic "evidence" of the medium- and long-term effects of strategically low prices, competition authorities would find it difficult to explain to consumers why they act against low pricing strategies.

2. And now to the **ban on cartels**.

The ban is based on the insight that cartels can have serious negative effects for the economy as a whole.

On first sight, investigating and gathering evidence in specific cases seems to have little to do with economics. However, economic considerations play a significant role here, too.

For example, observed market behaviour can stand in contradiction to rational entrepreneurial conduct judging from a competition perspective. For example, rising prices despite a continuing overcapacity of supply.

Such market behaviour can be explained, though, by assuming an agreement between competing suppliers.

Thus, it can serve as an indication for investigations by the Bundeskartellamt.

So far, so-called "economic evidence" has not constituted a central element of initial suspicions, nor has it been used as evidence in proceedings.

However, economic evidence has recently been accepted in one case as additional information in order to obtain a search warrant from the court.

The case, which is still ongoing, concerned the first public invitation in April 2003 to tender for service contracts put out by the "Der Grüne Punkt- Duales System Deutschland AG" (DSD) ("The Green Dot").

This case involved service contracts for the disposal of glass packaging and so-called light-weight packaging (plastic, tin plate and aluminium) for more than 400 contract areas throughout Germany.

The Bundeskartellamt conducted investigations on the suspicion that companies in the waste management sector had coordinated their bids for the service contracts. This suspicion arose because the conduct of companies in several areas did not correspond to what would have been expected under competitive conditions.

In around half of the contract areas only one waste management company had submitted a bid. This was even more surprising since large companies, in particular, would have been in a position to offer collection and sorting services in numerous contract areas.

Accordingly, in contract areas with only one bid prices on average were around 70 per cent above the average prices of the lowest bidder in contract areas in which more than one bid was submitted.

Another noticeable feature was that in many cases only the former contract holder had submitted a bid although a number of other companies could have submitted competitive offers.

A comparison of the actual results of the invitation to tender with what would have been likely in the case of independent economic conduct gave the impression that conduct had been coordinated.

The Bundeskartellamt based its application for a search warrant to a substantial degree on these economic considerations that were partly supported by witnesses. The competent court followed this approach.

Economic evidence is not only used to support initial suspicions. When combating cartels, economic and, in part, also quantitative methods are required to define the economic damage caused by a cartel.

Calculating the additional proceeds of a cartel member requires an exact economic analysis by which the actual situation observed in the market should be compared with a hypothetical competition result.

Hence, this is not an exact calculation but rather an estimation. By using economic methods, the Bundeskartellamt strives to determine the actual additional proceeds as exactly as possible.

3. **Merger Control** is the area in which debate about basing decisions on economic principles and about economic analysis methods is particularly intensive.

Three subject areas are of particular relevance here:

- Market definition. Here the demand-side oriented market definition and the so-called SSNIP test (Small but Significant Non-transitory Increase in Price) stand in competition with one another.

- the oligopoly theory. This is applied to determine collective market dominance;
- so-called Merger Simulation Models.
- Another area of economic analysis in connection with merger control is the evaluation of **efficiency gains.**

  Time does not allow me to examine these further today. I will just say this much: Merger control is **structural** control, which aims at maintaining the structural preconditions for competition.

  However, if market dominance is allowed to emerge, using efficiencies as an argument, this harms competitive **structures.**

  Whether the supposed efficiency gains are actually passed on to the opposite side of the market depends exclusively on the **behaviour** of the dominant company, which is no longer controlled by the eliminated competition.
  And, one more caveat: It is very questionable whether the efficiencies claimed actually emerge in the first place. As far as I know, this scepticism is shared by Prof. Röller.

3.1 And now to **market definition**:

Here the Bundeskartellamt, as well as the European Commission, goes from the assumption that the relevant product market includes all products or services which consumers consider exchangeable in terms of their features, prices and their intended purpose of use.

Differences between the authorities can arise in the definition of exchangeability in individual cases.

In its guidelines on market definition the Commission mentions the so-called SSNIP test or Hypothetical Monopoly Test.

This test uses a thought experiment as a method for evaluating the substitutability of demand. Conclusions are drawn from this on how markets should be defined. However, the Commission seems to apply this test only in a minority of its merger cases.

Still, there are those who call for the consistent application of the SSNIP Test instead of the demand-side oriented market definition.

However problems can arise in the practical application of the test which should not be too readily ignored.

- The test is not suitable for all markets as regards market structure, products, etc.

- Demands on the quantity and quality of the data to be used are very high.

- In cases where the market price is significantly higher than the competitive price, e.g. where the parties are already dominant, the Hypothetical Monopoly Test methodically runs up against its limits and does not deliver any usable results (“cellophane fallacy”).

Without doubt the SSNIP Test is a good theoretical approach which can register competition conditions. However, in view of the considerable time and energy this can involve it should also be

asked what additional advantages the application of this test has for competition authorities and companies. At any rate its wholesale application in all cases could certainly not capture reality.

3.2 The economic competition theory plays an important role in the examination of collective market dominance in the case of an **uncompetitive oligopoly.**

Game theory has helped to recognise and formulate several necessary conditions for successful collusion, e.g. the existence of a retaliatory mechanism.

A whole range of research projects on industrial economics have in various models examined the effect of single factors, such as market transparency, product heterogeneity and contact in several markets, on the market behaviour of companies.

In the merger control work of the Bundeskartellamt cases whose competitive assessment depends to a great extent on the existence of oligopolostic market dominance will increase in significance. Here I am thinking in particular of the energy sector.

Also in these cases the Bundeskartellamt plans to intensify analysis with regard to economic mechanisms.

3.3 Finally, just a few words on the discussion about the application of **merger simulation models.**

Here, price increases resulting from unilateral effects are to be predicted by using econometric methods, taking efficiencies into consideration if necessary.

Certainly: Quantifying price effects to complete the structural analysis of effects on competition can be useful.

This process is, however, not without its problems. Predicting price effects, for example, is done ceteris paribus.

Structural changes such as diminished R& D incentives or changes in access to procurement markets, which are of key significance in market reality, cannot be covered in this static analysis.

The results of a quantitative prediction of price changes have therefore only very limited relevance.

These can be used as indications for the leeway of the companies concerned for raising prices. At the same time one should not lose track of the purpose and object of merger control when using the econometric instruments of merger simulation models.

Merger control is structural control. Its purpose is to prevent risks to competition right from the start.

It would be fatal for competition if in the application of merger simulation models the demand for evidence of foreseeable serious structural deteriorations were to shift to a call for "proof" that a critical merger would almost certainly burden the consumer with higher prices. Proof, which is in the end very unlikely to stand up in court.

IV.

Ladies and Gentlemen,
This leads me to the critical part of my remarks on the “more economic approach”.

Allow me to use two cases to demonstrate how an apparently more intensive economic analysis can have negative consequences on the enforcement of competition law.

In a cartel case against companies in the ready-mixed concrete sector the Bundeskartellamt had to determine the additional proceeds.

Unlike in other EU countries the fine is not based on turnover but on the additional proceeds generated by a cartel. The fine can amount to three times the additional proceeds.

The law decrees that the additional proceeds can also be estimated.

In appeal proceedings against the decision of the Bundeskartellamt the Düsseldorf Higher Regional Court confirmed that a cartel agreement existed.

In the case of the disputed extent of the fine (additional proceeds of 10 €/t of ready-mixed concrete) the court was guided by an economic expert, who attributed the higher prices for ready-mixed concrete in the period in question to an increase in demand and denied any additional proceeds.

The result: The fine was reduced from 34 million EUR to 1 million EUR in spite of the undisputed cartel.

The intended deterrent effect against forming a cartel of course evaporates if cartels pay off.

Second case : Merger control
In merger cases the Bundeskartellamt is constantly being accused by the companies concerned of being too small-minded in its economic assessment and of basing this on national or even regional markets although the companies compete worldwide.

And so it was in the E.ON/Ruhrgas case.

The fact that competition on the international **procurement** market cannot be applied to the domestic **sales** market is, of course, not openly acknowledged.

In the discussion about a softening of merger control in the press sector large publishing houses have even demanded that market definition be laid down in the law.

It was also on economic arguments that the change of the examination criterion for merger control in the EU from the dominance to the SIEC test was founded.

But whether this will tighten up or even soften merger control only time will tell.

V.

So which conclusion can we draw?

Economics and its methods are a crucially important means of understanding, illustrating and evaluating competition problems.

However, when we look at what can be achieved by means of economic theory this should not divert our attention from what is necessary and reasonable in each individual case, and what cannot be achieved even if economic instruments are employed.

If the "more economic approach" mainly refers to the use of empirical-quantitative test procedures, it is a "more quantitative approach".

This approach can provide answers to precisely formulated individual questions. It cannot, however, replace or anticipate the overall competition assessment.

Quantitative procedures must therefore be used carefully and with a good eye for what is reasonable and necessary.

If a "more economic approach" is not to become an end in itself it must result in an improved application of the law. However, we have to be careful to ensure that it will not ultimately lead to a weakening or complication of the enforcement of the principle of competition.