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NEED FOR ECONOMETRIC ANALYSES: “LESSONS LEARNED” FROM THE EC COURTS

The European Courts qualified economic analyses performed by the European Commission in merger proceedings already several times as “flawed”. However, the ruling of the Court of First Instance in the Impala judgement is remarkable in this respect. The Court annulled the approval of a transaction between Sony and BMG which was given by the European Commission two years ago.¹ The disputed issue was whether the merger would lead to the creation of a collective dominant position on the market for recorded music. The Court criticised in its judgement the insufficient line of argument and claimed that the European Commission needs to apply detailed econometric analyses to support their conclusions.²

This judgement is of particular interest because the Court itself developed the required economic standard of proof to assess a collective dominant position. Other judgements discussed the collective dominance concept in theory. In the Impala judgement, the Court clarified which economic tools are mandatory to assess the effects. This means that in fact the European Courts themselves specify the actual implementation of the “more economics based approach” thereby providing legal certainty as required by many lawyers. This guidance will lead to better founded and more precise competition decisions in the future. But what are the consequences of this judgement for the companies seeking approval?

From a competition economist’s point of view like EE&MC, the requirement of the Court namely

„a delicate prognosis as regards the probable development of the market and of the conditions of competition on the basis of a pro-

¹ CFI, Judgement of 13.07.2006, Case T-464/04, Impala/Commission.

² CFI, Judgement of 13.07.2006, Case T-464/04, Impala/Commission, para. 250.

spective analysis, which entails complex economic assessments ... supported by a concrete analysis of the situation existing at the time of adoption of the decision” –

can only be implemented by a complex econometric merger simulation model. The development of such a merger simulation model cannot be performed within 4 weeks. Experiences show that it is more likely that the development of such a merger simulation model needs about 3-4 months. This means that companies seeking for approval in Phase I need to start working on such econometric models well in advance before the notification. The other option is that the transaction goes directly to Phase II.

The European Commission needs detailed market data as well as a substantiated forecast of the likely effects of the transaction in order to monitor the standard as specified by the Court in the Impala judgement. If this information is not available in Phase I, it is very likely that the European Commission opens – also in cases where an approval is likely - an in-depth inquiry/ Phase II. Commission officials already announced that they will pass on the pressure of the Courts to the notifying parties namely that the companies seeking approval need to provide all the relevant market information and modelling. Whether the companies will provide these complex economic analyses in Phase I or Phase II is in fact a matter of tactics only. That the European Commission will resist on the provision of this information is very likely to avoid further rejections of the Courts.

Phase II proceedings are intense, can last a few months and are quite costly. The transaction is blocked until approval. Employees, customers and capital markets are insecure. Therefore companies prefer in principle a quick approval. In this respect lawyers can assist companies in a proactive way namely to use the time for the pre-negotiation talks already for the econometric implementation of the Courts' standard of proof. This means that it is not a must that the number of Phase II proceedings will increase in the future. However, the discussions with the European Commission in Phase I might be – based on the findings of the econometric models – more intense, concrete but shorter.

The following CCR discusses this trend by illustrating the economic standard of proof as developed by the European Courts in two recent judgements. In addition, the application of econometric analyses in one of the decisions of the European Commission is examined in order to illustrate the growing acceptance of econometric studies. The CCR closes with a discussion about the arising opportunities for merging firms.

ECONOMIC STANDARD OF PROOF IN THE GE/HONEYWELL JUDGEMENT

The Court of First Instance approved the contentious prohibition decision of the merger between General Electric (GE) and Honeywell. However, several arguments of the decision were rejected by the Court. In the contested decision, the European Commission applied some economic models/concepts in theory and explained certain conclusions on the basis of these models. The Court found that the European Commission did not succeed in applying the economic theory correctly to market realities. The Court claimed that the likely effects on the market were not properly evaluated.

Among other issues, the European Commission was worried that the merged firm could bundle jet engines with avionics and non-avionics products and offer those packages for very attractive prices leading to foreclosure of competitors. This rationale is based on the so-called “Cournot-effect-theory”, which means that the profit-maximizing price for two complementary products is lower if these are offered by one instead of two firms.³

In the GE/Honeywell case, this reasoning was partly flawed since the jet engines were produced jointly by GE and SNECMA. SNECMA had no stake in the manufacturing of the avionics and non-avionics products. Price reductions that lead to higher sales for avionics and non-avionics would not benefit SNECMA. Therefore, GE would need to compensate SNECMA for the price reductions or rather bear the full costs of the discounts. Such an action would reduce the profitability of this strategy for GE considerably.⁴ Therefore, the real likelihood of such a strategy is debatable.

Another major issue in this case is that the European Commission did not examine demand side reactions to such product offers. The Court argued that the European Commission assumed a competitive threat through bundled offers without examining if the reaction of the demand side would lead in fact to such a foreclosure effect. This error was aggravated by the fact that the European Commission stated several times during the investigation that an empirical survey would be necessary to substantiate such a theory. Such an empirical survey of the demand side reactions was

³ The reason for this is that a price reduction for one good increases the demand for both goods since they are complementary. However, increase in demand for the second good is not taken into account, if the goods are produced by separate firms.

⁴ CFI, Judgement of 14.12.2005, Case T-210/01, GE/Commission, para. 459-460.

never carried in this case and the Court therefore criticized this inaccuracy:

„In the absence of a detailed economic analysis applying the Cournot effect theory to the particular circumstances of the present case, it cannot be concluded from the Commission’s brief mention of that theory in the contested decision that the merged entity would have been likely to engage in mixed bundling after merger.“⁵

Thus, according to the Court a mere discussion of economic models does not suffice. The Court clarified, that the application of these models to reality must go along with appropriate empirical studies. Convincing conclusions can only be drawn, if the applicability of theories to a specific case is given:

„The Commission could produce convincing evidence (...) by relying on the Cournot effect only if it demonstrated its applicability to this specific case.“⁶

An appropriate tool for the analysis of demand side reactions is conjoint analysis. This empirical methodology allows the valuation of certain product characteristics as well as price. With such a study, it would have been possible to compute the demand function and to calculate if the bundling of products would have been profitable for GE/Honeywell.⁷ Effect based analyses require that economic theories are applied to real market circumstances. Thus, to take a well-founded decision on the Cournot effect empirical evidence is needed. Since such an analysis was not carried out by the European Commission, the Court found that the European Commission did not provide sufficient evidence to prove that the merged entity would have bundled its products.

⁵ CFI, Judgement of 14.12. 2005, Case T-210/01, GE/Kommission, para. 462.

⁶ CFI, Judgement of 14.12. 2005, Case T-210/01, GE/Commission, para. 462.

⁷ On the basis of such a demand function, that is computed using a conjoint analysis, it is also possible to perform the hypothetical monopolist test which is an important empirical tool for market definition.

ECONOMIC STANDARD OF PROOF IN THE IMPALA JUDGEMENT

The European Commission could not comply with the burden of proof as required by the European Courts in this case either. The interesting issue is that the Court annulled for the first time a merger approval and ruled in favour of Impala, an independent music label that had brought this case to the Court. The issue at hand was the question if the merger between Sony and BMG would lead to the creation of a collective dominant position on the market for recorded music.⁸

In principle, the European Commission applied in this case established European case-law.⁹ The Court of First Instance stated – consistent with game theoretic findings – that collusion is only possible if it is based on sufficient transparency, a deterrent mechanism, and low potential competition. However, the Court clarified that the European Commission failed again in applying economic theory correctly to a real world case. According to the Court, it is not sufficient to describe the appropriate economic theory and assume that the prerequisites in a certain case are fulfilled. What is necessary is to investigate thoroughly if the preconditions are fully met. According to the Court, it is the task of the European Commission to apply theories to market realities and perform complex economic assessments.¹⁰

To implement the standard of proof as required by the Court, detailed market investigations and the application of econometric studies are mandatory. To forecast future behaviour of the merged entities, a merger simulation model is required. From an economist perspective, the elaborations of the Court in this case are very helpful. By the way, the knowledge on merger simulation models the Court illustrated in this judgement is quite impressive. In their judgement, the judges clearly described every analytical step which needs to be performed in a merger simulation model. In addition, the requirements on modelling were clearly specified in the judgement.

Thus, it is again a Court specifying the concrete framework for economic analyses. In the Impala case, econometric merger modelling was judged to be suitable to illustrate probable collusion post-merger. Such simulation models complement the analytical evaluation of the facts and contribute to the compliance with the burden of proof as specified by the Courts.

⁸ European Commission, Decision of 18.7.2004, COMP/M.3333, Sony/BMG, para. 60-154.

⁹ European Commission, Decision of 18.7.2004, COMP/M.3333, Sony/BMG, para. 67-68.

¹⁰ CFI, Judgement of 13.07.2006, Case T-464/04, Impala/Commission, para. 250.

APPLICATION OF THE STANDARD OF PROOF IN A COMMISSION DECISION: THE BLACKSTONE/ACETEX CASE

Because of the Courts` rulings, the European Commission considers increasingly econometric studies in its decisions. An example for the successful discussion of econometric studies in the European Commission's practice is the Blackstone/Acetex case.¹¹ In this merger, the markets concerned were in particular the markets for acetic acid, vinyl acetate monomer (VAM), acetic anhydride, and polyvinyl alcohol (PVOH). The main issue at hand was the geographical market definition. The merging parties argued that the relevant geographic markets are worldwide and substantiated their view with several econometric studies.

- A price correlation analysis was submitted that demonstrated a high correlation of the prices worldwide what supports the thesis of a worldwide market.
- These results were completed with a co-integration and a Granger causality analysis using prices of acetic acid in different regions of the world. The study showed that there is a long term relationship between the prices in different world regions.
- Furthermore a study illustrated that unexpected plant outages caused price increases in other regions leading also to the conclusion of a globally integrated market.
- Additionally, the geographical market definition as world market was supported from the analysis of the impact of unexpected plant outages on trade flows.

The European Commission replicated and confirmed the results of the submitted studies and performed in some cases additional tests and examinations. Although the European Commission criticised certain model specifications and pointed out that the results were inconclusive, the European Commission concluded:

“On the basis of all of the above considerations, including a more thorough examination, in the light of the latest evidence, of the factors taken into account in the decision to initiate proceedings, and in spite of the inconclusiveness of some of the studies mentioned, the balance of evidence now available clearly points to the conclusion

¹¹ European Commission, Decision of 13.07.2005, COMP/M.3625, Blackstone/Acetex.

that the geographic market for acetic acid should be defined as global for the purposes of this decision.”¹²

The other three product markets were also defined as world markets. This definition led to the approval of the merger without remedies.

This case illustrates that the European Commission increasingly applies - by implementing the standard of proof as defined by the EC Courts - econometric studies. These studies can contribute considerably to a correct market definition and, hence, to the approval of a merger.

LESSONS LEARNED: OPPORTUNITY FOR COMPANIES

In the future, the European Commission will be under pressure to base all its decisions on well-founded economic analysis. This gives firms the opportunity to carry out their own econometric analyses to get the merger approved by the European Commission phase I. A merger can be executed faster and legal security increases. Considerable cost advantages are created. Even in a contested case, the European Commission can not ignore economic expert reports, but need to consider the empirical facts presented and counteract with own evidence. The case Blackstone/Acetex shows that well-founded empirical analysis has already considerable weight in the decision making. Therefore, the position of firms is strengthened by an economic expert report.

EE&MC APPROACH

EE&MC has extensive experiences with empirical expert reports in merger proceedings. Different econometric tools can be applied - always adapted to the specific situation to reach optimal results. On request, competition authorities are in principle open to discuss the applied econometric models in advance in order to increase validity of the results. EE&MC expert reports proved to be highly accepted on national level as well as with the European Commission and Courts. Therefore, economic consulting by EE&MC is an effective means to assure and speed up the approval procedure.

The time needed to produce such an expert report depends on the availability of data and the empirical instruments chosen. If e.g. a conjoint analysis is carried out and data has to be collected through interviews, the compilation of an expert report needs between 10-14 weeks. Econometric

¹² European Commission, Decision of 13.07.2005, COMP/M.3625, Blackstone/Acetex, para. 49.

analysis like for example a price correlation analysis can generally be carried out within 4-6 weeks. If complex modelling like in the Impala case is required, the time frame has to be adapted accordingly.

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