



**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

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ROUNDTABLE ON DYNAMIC EFFICIENCIES IN MERGER ANALYSIS

-- Note by Portugal --

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

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DYNAMIC EFFICIENCIES IN MERGER ANALYSIS

1. According to article 12 of the Law No. 18/2003 of 11 June, approving the legal framework for competition, the Portuguese Competition Authority must assess whether or not a concentration would create or strengthen a dominant position that results in significant barriers to effective competition in the Portuguese market or in a substantial part of it. This is the test which must be used whether one is dealing with horizontal mergers or non-horizontal mergers.
2. However, the same article (article 12.j) refers that the impact of the merger operation on technical and economic progress should be taken into consideration in merger analysis, as long as it benefits consumers and is not an obstacle to competition.
3. Efficiencies, both static and dynamic, should therefore be considered in assessing the impact of a merger, provided that they benefit consumers, and do not form an obstacle to competition. Additionally, these efficiencies should be verifiable and merger specific, i.e., not achievable by alternatives to the merger.
4. Generally, in what concerns static efficiencies, a greater weight is given to variable cost reductions, as they can have an impact in the short run. Furthermore, an important assessment to be made is to what extent cost savings are passed on to consumers. Usually, it is important to consider if enough competitive pressure remains in the market so as to ensure that efficiency gains benefit consumers.
5. As opposed to static efficiencies, a merger may encompass dynamic efficiencies when it allows for changes in innovative activity, e.g. enhancing the efficiency of R&D. As a result of the merger, duplication of R&D may be eliminated, reducing the costs of innovation, economies of scale in R&D may be attained, firms may complement themselves in their R&D activities, and the diffusion of innovation may be increased.
6. These types of efficiencies, resulting from a merger operation, may be particularly important in industries with short-lived high-technology, or requiring a considerable dimension in order to pursue R&D activities.
7. Although this sort of efficiencies may lead to considerable benefits to consumers, in terms of better quality goods, cheaper goods or greater choice, it is often difficult to predict and measure their magnitude and expected impact.
8. Consequently, a qualitative assessment of the alleged dynamic efficiencies is carried out, considering the particular conditions of the market being analysed, although quantitative information is taken into account, when available.
9. If technical progress as a consequence of the merger refers to innovation in product, these dynamic efficiencies are balanced against the harm to competition that the merger is expected to cause, although, most often, in a qualitative way.

10. If, instead, we are dealing with efficiencies related to innovation in process (lower costs of production), the notifying party should demonstrate that the cost reduction is significant, and would benefit consumers.

11. If a merger is expected to create or strengthen a dominant position, leading to a significant impediment to competition, alleged dynamic efficiencies most often are not considered sufficient to offset the harm to competition that the merger is expected to cause, although a qualitative balance may be made, which may be reflected in the set of remedies submitted by the merging parties.

1. Brief notes on the Portuguese Experience

1.1 Via Oeste (Brisa)/AEO/AEA

12. In 2006, the Portuguese Competition Authority blocked the merger between Via Oeste (Brisa) and AEO/AEA, both of the parties active in the construction, overhaul, maintenance and operation of highways, as concession companies, and operating on a parallel corridor between Lisbon and Porto.

13. The merging parties claimed the merger would allow the companies to obtain a number of synergies, which would, allegedly, have an impact on costs, innovation (R&D in toll management), best practices (e.g. road safety), quality of services provided and financial capacity of Brisa.

14. The merging parties did not provide any information on the magnitude of those alleged efficiencies, nor did they attempt to show they were merger specific. Some of the claimed efficiencies could possibly be obtained by alternatives to the merger, such as a joint-venture or contractual agreements.

15. The PCA concluded that the merger would eliminate competition in the relevant market, which would withdraw any incentive to pass a substantial part of those alleged efficiencies or synergies to the consumer. Hence, the efficiency gains were considered not to be adequate or proportionate to offset the anti-competitive effects, on prices and quality, caused by the strengthening of a dominant position.

1.2 Sonaecom/PT

16. In 2006, the Portuguese Competition Authority analysed a hostile take over by Sonaecom over Portugal Telecom (PT), both active in the telecommunications industry. The merger was cleared subject to remedies proposed by Sonaecom.

17. The proposed merger raised serious competition concerns in particular on the mobile communications market, with the creation of a dominant position which could result in increases in prices.

18. The notifying party submitted information on alleged synergies from the merger, anticipating efficiency gains which can be summarized in what follows: avoiding duplication of investments (particularly taking into account the current roll-out of a new technology – 3G), allowing for the launch of new innovative products; strengthening of the merged entity's buying power with respect to suppliers of equipment, software and media content, allowing for lower prices; reduction in operational costs (e.g. sharing of network resources – sites/antennas), and in general fixed costs.

19. During Phase II proceedings, the PCA concluded that the expected efficiency gains from the operation were verifiable, as they were quantified in detail by the notifying party, and seemed to be consistent with the synergies obtained in other merger operations in the mobile communications market. The analysis which followed evaluated whether the efficiency gains were specific to the merger and whether those gains could be passed on to consumers.

20. A considerable part of the synergies which would result from the merger were considered to correspond to fixed cost savings. The importance of economies of scale in the industry, as defended by the notifying party, reflect the importance of fixed cost in the cost structure of the operators in the market. It was considered unlikely that this type of savings (consolidation and network optimization from shared networks and reduced maintenance costs) could lead to reductions in price which could benefit consumers, in the short-run, only accruing to the company's profit.

21. Nonetheless, the notifying party defended that over 50% of the operational costs were actually variable, suggesting there would be a considerable reduction in marginal costs, as a result of the merger.

22. In order for efficiency gains to be considered, they ought to be specific to the merger. A considerable part of the synergies from the Sonaecom/PT takeover consisted in taking advantage of economies of scale. Normally, this type of synergies would not be considered, as there could be alternatives, such as internal expansion, which could lead to the same result. However, in this particular case, strong barriers to expansion were identified on the side of one of the merging parties, as a result of a very high penetration rate in the market (over 100%), and of switching barriers, which limit its ability to conquer new clients. In this context, the PCA considered the claimed efficiencies to be merger specific.

23. A thorough analysis of the data provided led to the conclusion that the greater effect of synergies was effectively expected to occur at the average fixed cost level. As such, the PCA concluded that the efficiency gains claimed by the notifying party were insufficient to reverse the merger's potential to impede competition.

24. The potential for efficiency gains resulting from the proposed merger were, nevertheless, taken into account as a complement to the merger remedies put forward by the notifying party, namely those which were not static in nature, but which could have an impact in the roll-out of a new technology (3G).

25. Given that the mobile communications industry is characterised by technological waves, where different generations of the same product or service follow each other, technological innovation plays an important role. Furthermore, the introduction of new technologies requires high network and marketing investments. Hence, the proposed merger could have a positive impact on the introduction of new technologies.

26. Simultaneously, in such a dynamic environment, with technological waves, present market shares do not reflect the true impact of a merger, and a dynamic approach, even if qualitative, should be pursued. In the Sonaecom/PT case, for example, matters such as the technological convergence between mobile and fixed communications were taken into account.

27. The remedies proposed by the notifying party, in what concerns the mobile communications market, were designed to promote entry of a new Mobile Network Operator (MNO) and of Mobile Virtual Network Operators (MVNO), by attenuating barriers to entry and expansion, and by promoting switching between the merged entity and new operators, hence increasing contestability in the market. The PCA took into due account, besides promoting entry, when discussing and analysing the set of proposed remedies, the dynamic effects of the merger, namely on innovation, through the higher incentives to invest in networks and in marketing, necessary to introducing newer technologies.

1.3 BCP/BPI

28. In 2007, the Portuguese Competition Authority cleared a merger in the banking industry, consisting on the takeover of BPI by BCP, with the imposition of remedies. The analysis of the merger allowed the PCA to conclude that the proposed merger could lead to the creation or strengthening of a dominant position, raising horizontal competition concerns.

29. According to the information made public by the notifying party, the synergies from this merger would arise essentially as a result of cost reduction at the distribution level, shared services, information technologies and central services. A substantial share of those would be at the level of fixed costs. Savings could also be expected as a result of branch closures and in terms of personnel.

30. The notifying party put forward a number of academic studies pointing to the existence of economies of scale and other synergies as a result of consolidation in the banking sector, such as the paper by the ECB “Consolidation and Diversification in the Euro area Banking Sector” (May 2005) and “M&A performance in the European Financial Industry” of the Bank of Spain.

31. In order to assess the alleged synergies and conclude whether or not they were too ambitious, the PCA analysed, based on studies provided by the notifying party, the magnitude of those cost reductions in comparison to those obtained as result of previous mergers involving the notifying party and to those experienced in mergers which took place in other countries. Additionally, and in order to assess the scope for increased efficiency, the PCA took into account the position of the two banks involved in the merger relative to a minimum efficient scale of operations in the Portuguese banking sector, as well as the information available on the efficiency differential between the two banks.

32. In terms of the studies submitted by the notifying party, the PCA studied their applicability to the case under analysis and compared their results to those obtained by other studies devoted to the same topic, concluding that they were not demonstrative of the magnitude of efficiency gains which were claimed by the notifying party as a result of the merger. In fact, the academic literature concerning economies of scale and scope in the banking industry has found many different and contradictory results, which suggested caution would be necessary in the analysis of efficiencies in this particular case.

33. Overall, the PCA found that these synergies would not be sufficient to offset the expected impact of the increase in concentration on prices and other conditions offered to the consumers of the banking products/services.

34. A set of remedies was undertaken to overcome the expected anti-competitive effects of the merger in the relevant markets where concerns were identified. In the presence of such remedies, the PCA considered that the incentives for the new merged entity to pass on eventual cost efficiencies to the consumers would be higher.