A dive into 'unknown' waters : a critical analysis of the EC merger control mechanism and policy and its application in the Baltic Countries

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A DIVE INTO 'UNKNOWN' WATERS: A CRITICAL ANALYSIS OF THE EC MERGER CONTROL MECHANISM AND POLICY AND ITS APPLICATION IN THE BALTIC COUNTRIES

JURGITA MALINAUSKAITE

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Abbreviations

BIICL	British Institute of International and Comparative Law
CEEC	Central and Eastern European Countries
CET	Chief Economist Team
CFI	Court of First Instance
DG-Comp	Directorate General for Competition
EC	European Community
ECJ	European Court of Justice
ECLR	European Competition Law Review
ECMR	European Community Merger Regulation
ECSC	European Coal and Steel Community
EEC	European Economic Community
EU	European Union
EUROTOM	European Atomic Energy Community
FDI	Foreign Direct Investment
FDJ	Federal Department of Justice
GDP	Gross Domestic Product
IBA	International Bar Association
ICCLR	International Company and Commercial Law Review
ICN	International Competition Network
ICLQ	International Comparative Law Quarterly
IFLR	International Financial Law Review
IPR	Intellectual Property Rights
LTL	Litas (Lithuanian currency)
MES	Minimum Efficient Scale
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Cooperation
R & D	Research and Development
SIEC	Significant Impediment Effective Competition
SLC	Substantial Lessening of Competition / Substantially lessen competition
SMEs	Small and Medium sized Companies
SSNIP	Small but Significant Non-transitory Increase in Price
UNSTAD	United Nations Conference on Trade and Development
WTO	World Trade Organisation

Abstract

This study undertakes a comparative analysis of the approaches towards merger control regime taken at the EC and the national levels, namely the Baltic countries. The emergence and further development of competition law and policy (particularly merger control rules) in the unexplored Baltic countries represent a novelty of the work, as there are no comprehensive legal writings in this area. The comparative research revealed that the EC incorporates both a negative and a positive approach vis-à-vis merger control rules; after shifting towards a more economic based approach, the EC regulatory authorities have explicitly recognised possible pro-competitive effects of mergers on competition. Whereas, the situation differs in the Baltic countries: despite committing themselves to applying the EC competition policy, these countries employ a negative approach towards merger transactions by placing focus on finding 'dominance' rather than stressing emphasis on a merger's effects on competition. This negative approach may mean that the Baltic countries are reluctant to admit pro-competitive effects of merger transactions on competition, which can be seen as a sign that the merger control regimes in the Baltic countries are orientated towards dominance or market power rather than efficiency enhancing.

The law used in the research is stated on the basis of materials available to the researcher on 31 May 2006.

Chapter 1. HISTORICAL BACKGROUND OF THE MERGER CONTROL REGIME IN THE EC AND THE BALTIC STATES JURISDICTIONS

1. Introduction

Challenging economical and political changes in the world have led towards globalisation by accelerating the internationalisation of industry and reshaping industrial structure at a global level. One area that has been impacted upon by globalisation is merger and acquisition transactions[1], which has expanded in recent times. The increase in mergers has not gone unnoticed and is in fact a constant source of concern for competition authorities. The Baltic countries are not immune from this global increase in mergers: after re-gaining their independence in 1991, these transactions have occurred in Estonia, Latvia and Lithuania.

Considering the controversial aspects of merger transactions on competition, the inexperienced Competition Authorities of the Baltic countries have faced an uneasy task to deal with merger cases. On one hand, mergers may give undertakings the power to prevent effective competition, for instance, by creating market power with the ability to raise prices without loosing consumers. On the other hand, mergers are not always harmful to competition. Under certain circumstances, merger transactions may be the sole means to achieve efficiencies. Such mergers may contribute to the process of optimal reallocation of resources and improve the competitive performance of affected markets and as a result intensify competition. Contemplating that mergers can have anti-competitive and/or pro-competitive effects, two basic errors may occur within the work of the competition authorities. On one hand, the competition authorities might approve a merger transaction with anti-competitive effects on competition. On the other hand, the authorities may prohibit a merger with potential exploitation of efficiencies and as a result of it prevent consumers from getting the benefits, which achieved efficiencies would offer.

This research undertakes a critical analysis of the approaches towards merger control mechanisms taken by the European Community (thereafter the

[1]Term 'merger' will be used interchangeably with concentration, acquisition, take-over etc. in this research.

EC) and by the Competition Authorities of the Baltic countries, which is placed in seven chapters. The thesis employs a comparative analysis with an interdisciplinary approach. The scope of the research is limited to the merger control regimes in the EC and in the Baltic countries with the emphasis being placed on the substantive issues. The analysis is based on all markets in general, as without benchmark on any particular sector.

Chapter 1 involves the historical analysis of the introduction of the merger control mechanisms within the EC and the Baltic states, as in Estonia, Latvia and Lithuania. The question in this chapter will be raised as to what extent the Baltic countries share a similar historical development experience with the EC as far as merger control is concerned. The researcher argues that these countries have had less auspicious environments for the introduction and enforcing of the merger regime. The implementation of the merger control mechanism in the Baltic countries is not a single act *per se*. It constitutes a new revolution for these countries, as their whole legal, economic and political environment has been changed. The Baltic states have walked from a Socialist legal system to a Civil law legal system, from a centrally-planned to a market economy; and from being occupied to independent and democratic countries. The merger regime was introduced into the legal systems of the Baltic countries as a part of the *acquis communautaire* while the Baltic states have still been going through economic, legal and political reforms.

Chapter 2 discusses and explains the theoretical framework together with the methodology used in the thesis. The thesis employs a comparative law method. Traditional legal analysis has been undertaken in the research, however, this approach is not an adequate framework to analyse and explain the development of competition law and policy within the EC and the Baltic states' jurisdictions. Thus, an interdisciplinary approach has also been adopted. Explicit recourse to economic theory is essential to understand the rationale behind the law, as its basic precepts and the goals of competition policy. The chapter will further explore the methods used in the study, the problems occurred and the solutions proposed. Also, it will provide and explain a mixed model of research in conjunction with a conducted empirical research and legal analysis completed by the researcher. It also contains the main conceptual distribution of this thesis.

A merger control is a predictive exercise for two main players in opposite front-lines: companies with their impetuses to merge and regulatory authorities with an intention to block anti-competitive mergers for the sake of fair competition. Chapter 3 is based on commercial analysis, as the impetuses for firms to merge will be checked. In addition, the benchmark is within the context of the Baltic states: (i) what are the impetuses for firms in the Baltic jurisdictions to merge; and (ii) do these motives have specific implications within the Baltic countries in comparison with theory. The examination of mergers' motives is a useful tool for predicting the future behaviour of firms involved in a merger. The endeavour of this chapter is to expose a broader picture of merger transactions' effects with economic and socio-political aspects especially in the context of the Baltic states.

Chapter 4 contains the economic analysis on two countervailing motives depicted from chapter 3 and their effects on competition. These are a merger motive to achieve efficiencies, which has pro-competitive effects on competition, and a motive to obtain a market power leading to anti-competitive effects on competition. This chapter will also check to what extent the presumed anti-competitive effects accepted by the EC merger regime apply to small market economies and to what extent they can be traded-off by the efficiencies; the analysis will be made under the auspices of economic paradigms, researches and theories. A background for this is the theory of Prof. Gal, which states that small market economies[2] require different competition rules; this is because in small markets there are a limited number of market players and market can serve only to a limited number of players as a result only a limited number of firms can act effectively in the market.

Chapter 5 is devoted to the competition policy within the context of the merger regime. The attempt is to identify the goal or goals of the EC's competition policy and the competition policy of the Baltic states. The Baltic countries' experience has been to follow dictation from above: as regards the EC competition policy (especially the merger regime), the Baltic countries have attempted to apply and explore those rules without questioning whether and to

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[2]Note: There is a presumption in this research that Estonia, Latvia and Lithuania refer to small market economies. It will be further explained in chapters 2 and 4.

what extent those rules might contradict underlying interests in the Baltic countries.

Chapter 6 differs from chapter 3 and 4, which have an emphasis on commercial/economic analysis, by focusing on merger control regime from purely legal perspective. The questions in the last chapter will be raised to what extent the motives analysed in chapter 4 affect and influence the regulatory authorities of the Baltic states and to what extent the approach vis-à-vis merger control rules taken by the Baltic countries is different from its counter-part - the EC. The thesis will check the perception of the Baltic states of the EC Merger Regulation in delivering its goals.

The final chapter 7 will generalise the conclusions obtained from the each chapter and will draw the issues for future research.

The EC incorporates both a negative and a positive approach vis-à-vis merger control rules; after shifting towards a more economic based approach, the EC regulatory authorities explicitly have recognised possible pro-competitive effects of mergers on competition. Whereas, the situation differs in the Baltic countries: despite committing themselves to apply the EC competition policy, these countries employ a negative approach towards merger transactions by placing emphasis on finding 'dominance'. This negative approach may mean that the Baltic countries are reluctant to admit pro-competitive effects of merger transactions on competition. The lack of efficiency considerations can be logically interpreted as a sign that the merger control regimes in the Baltic countries are orientated towards dominance or market power rather than efficiency enhancing. As a result of this logic it might be predisposed that the regulators of the Competition Authorities mistreat the possibilities of the pro-competitive effects that merger transactions can provide and therefore look suspiciously at the effects of the mergers on competition.

The aim of the research is to be able to explain the necessity of introducing a more economic based approach towards merger control rules in Estonia, Latvia and Lithuania. The final decision of prohibiting mergers is advised to be taken after balancing the anti-competitive and pro-competitive effects of the merger. The focus on finding 'dominance' is proven to be mistaken especially in small market economies context.

1.1. Background

The globalisation process together with technological advancements, improvements in e-commerce, liberalisation of capital movement, investment and privatisation programs and other factors cause a surge of cross-border as well as domestic merger transactions. After the collapse of the Soviet Empire and a decision of the Baltic countries to open up their borders for international trade, these transactions have occurred in Estonia, Latvia and Lithuania. However, the globalisation process in particular through merger transactions cannot flow without limits. Merger control rules are designed to prevent any mergers with anti-competitive effects on competition. Chapter 1 involves the historical analysis of the introduction of the merger control mechanism within the EC and the Baltic states, as in Estonia, Latvia and Lithuania. The question in this chapter will be raised as to what extent the Baltic countries share a similar historical development experience with the EC as far as merger control is concerned. The researcher argues that these countries have had less auspicious environments for introducing and enforcing the merger regime. The implementation of the merger control mechanism in the Baltic countries is not a single act *per se*. It constitutes a new revolution for these countries, as their whole legal, economic and political environment has been changed. The Baltic states have walked from a Socialist legal system to a Civil law legal system, from a centrally-planned to a market economy; and from being occupied to independent and democratic countries. The merger regime was introduced into the legal systems of the Baltic countries as a part of the *acquis communautaire* while the Baltic states have still been going through economic, legal and political reforms.

1.1.1. Globalisation process

Challenging economic and political changes in the world have led towards globalisation. Technological advancements, improvements in communication, information, and e-commerce, falling transportation costs and many other factors have put steps towards globalisation. Domestic government policies with the opening up of borders for foreign traders and signing up to the international and/or regional organisations, elimination of trade barriers and customs distortions, liberalisation of capital movement and investment, and privatisation programs have contributed a lot by creating opportunities for foreign companies to expand business. The collapse of the Soviet Empire and the end of the Cold War is also accepted as adding further weight to globalisation. This is because no significant group of countries stands outside globalisation and capital now holds exclusive sway in all parts of the world governed by a global power.

Globalisation with global financial systems and many other driving forces have spurred a surge in cross-border businesses. According to Riegar and Leibfied (2003), for companies globalisation means two main things. First, it means a considerable expansion in opportunities to obtain competitive advantages beyond the border of the home market. For instance, the collapse of the Soviet Empire opened the opportunities for the Baltic firms to expand internationally. However, in practice this works if companies are capable and willing to exploit those opportunities. The Baltic countries have had difficulties especially at the earlier years after the re-gaining of independence to gain access to foreign markets due to unknown trade marks of the Baltic countries. Second, the situation has reverse effects: companies, which were before protected from foreign competition, must now reckon with increased foreign competition in their home markets[3]. Being part of the Soviet Empire, the Baltic countries were protected from foreign competition as the state exercised a monopoly over foreign economic relations. Since the Soviet Union has disappeared as a political entity and the Baltic countries re-gained their independence, Estonia, Latvia and Lithuania have taken steps forwards by opening their markets towards global trade and as a result facing competition from foreign firms. Starting with bilateral agreement with the countries situated nearby, the Baltic countries expanded co-operation towards the international organisations such as the World Trade Organisation (thereafter WTO), the Organisation for Economic Co-operation and Development (thereafter OECD)[4] and finally they made the commitments to the EU.

Foreign competition can occur through foreign direct investment (thereafter FDI) in the forms of the establishment of foreign-owned suppliers (i.e. greenfield) or cross-border mergers. The statistics show the increase in the FDI in

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[3] For further reading, see Rieger, E., Leibfried, Limits to Globalization Welfare State and the World Economy, Polity, 2003, pp.187.
[4] The author gives here some examples without having intention to name all the international organisations that the Baltic countries belong to.

the Baltic countries. The inward FDI to Estonia has tripled in 1998-2003 and has reached 6.5 billion USD in 2003. Meanwhile, in Latvia the increase in FDI was noticed during the 1990-2000 period with a dramatic slump in 2001, and in 2003 the sum of 3.3 billion USD had been accumulated. The FDI inflows grew appreciably in Lithuania and reached a value of 4.8 billion USD in 2003 (UNSTAD, 2003). Most of the FDI in the Baltic states belongs to the multinational companies, which have utilized the advantage to expand their activities into the Eastern and Central European market by using the high-skilled and low-wage Baltic employees[5].

There has been a tendency in foreign direct investment through mergers and acquisitions rather than greenfield investment (Kang and Johansson, 2000). Considering that the benchmark of this study is on merger transactions, the analysis involved is based on these transactions. Cross-border mergers may offer a quick and efficient entry mode in to foreign markets. As time is especially important in business, a merger appears to be a superior strategy to greenfield investment[6], since it allows immediate seizure of new market opportunity (Blanc and Corteel, 1999). Cross-border mergers may be motivated by the desire to consolidate capacities in order to serve global markets. The concentration of resources on core competencies in order to achieve benefits from global scale economies and the full utilisation of intangible assets (technology, human resources, brand names etc.) through geographical diversification are some of the strategies of multinational firms. Also, cross-border mergers may play a role in revitalising ailing companies and/or creating jobs through the restructuring process. In general, cross-border mergers may enhance economies of scale and scope through technology and knowledge transfer, industrial restructuring and/or job creation, may diversify risks geographically and may attribute other favourable patterns.

However, merger transactions may have some unfavourable aspects, as very often one merger has lead to a chain reaction of additional consolidation. For

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[5] See, for instance, J. Hyvarinen, FDI and Spillovers in the Baltic countries, The Finnish Economy and Society 304, pp.86-88.

[6] The Researcher does not say here that it is always the best strategy as other factors should also be taken into account. There is the possibility that mergers might fail, because of cultural clashes, inadequate planning, 'wrongly' defined strategy etc. This research excludes issues on success or failure of merger transactions. For further reading, see Tichy, G., What do we know about success and failure of mergers, EUNIpb, 2001.

instance, *BP / Amoco*[7] merger in 1998 was followed by *Exxon / Mobil*[8], *BP / Arco*[9] and *TotalFina / Elf*[10] mergers[11]. As a result of a series of mergers, the whole industry on a world-wide basis might be too concentrative, as in the hands of a few players. The accumulated financial power of a few players may, moreover, raise the entry hurdle for potential competitors and may make the intrusion by these firms into other markets following with the anti-competitive practice, such as dumping (Horn, 2001:18). Furthermore, the emergence of a few global firms can mean that there might be little scope left for smaller players, which will be forced to leave the market (Schaub, 2000).

Globalisation process may not only cause a surge of cross-border mergers but also may give stimulus for domestic mergers. National firms merge in order to be able to face increased international competition. The economists explain this phenomenon with the theory of oligopoly equilibrium. As if there is an oligopolistic equilibrium, by meaning stable market shares of the largest companies within the national economy, then increased imports or entry by big foreign companies would lead to dis-equilibrium. This in turn will cause national firms to merge and challenge the increased competition (Hughes and Singh, 1980:9).

1.1.1.1. Limits on globalisation process

However, globalisation process, namely in the form of merger transactions, does not flow without limits. There are restrictions placed on mergers. In fact, cross-border mergers and to some extent domestic mergers mean for large firms putting efforts to deal with two trends that push in different directions. One direction is technological innovations, which force firms to think globally and respond to the pressures of obtaining scale in a rapidly consolidating global economy. Another, governments have placed limits on globalisation by

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[7] COMP/M. 1293.
[8] COMP/M. 1383.
[9] COMP/M. 1532.
[10] COMP/M. 1628.
[11] For further reading of the concerns of the chain of these mergers, see, for instance, Mega Mergers of Oil Giants Hurt Consumers, Competition, Public citizen, 03/09/1999, available at web-site:
http://www.citizen.org/cmep/energy_enviro_nuclear/electricity/Oil_and_Gas/Gasoline/articles.cfm?ID=6318

enforcing competition law in their legal systems to ensure industrial competitiveness. This is because with the emergence of a global trade the international competition has increased. Together with the opening border for foreign competitors the national governments in the world have raised the concerns of protecting their market from unfair competition. After unlocking the gate to international trade, the Baltic countries have also faced the impact of globalisation process, including one of its forms - a new phenomenon of merger transactions. It is not enough to open up the border for global trade and start moving from a command-and-control economy towards the market economy, as in the Baltic countries case scenario. Economist Stigletz (2002) argues that countries face disaster when they try to create market economies without having sound competition laws and institutions in place. The governments need to enforce competition locally in order to have their place in the global system. Hence, the Baltic countries had to introduce the competition laws in order to protect competition in their jurisdictions. With the emergence of merger transactions in the Baltic countries, the enforcement of merger control rules in these countries has a significant importance. Thus, the research attempts to analyse this highly important phenomenon for the Baltic states.

Competition law together with competition enforcement institutions were introduced to many jurisdictions in the world. However, the governments from different jurisdiction have realised that national competition law could not give a final solution as a trade has been increasing globally and competition law is national. Thus, the importance of bilateral and multilateral co-operations among the national competition authorities and influence of trans-national regulatory institutions have augmented. This reflected in the growth of the international organisations as such the WTO, International Competition Network (thereafter ICN), the OECD and on a regional scale – the EU.

Bearing in mind that the globalisation process might be considered as a foundation for the emergence of global businesses (including merger transactions as a part of it) and international competition, a further analysis of this process is required. Globalisation is defined as a political, economic and social phenomenon of the new millennium with more opened economies and societies (Moore, 2003:15). According to Twining 'globalisation' refers to the processes, which tend to create and consolidate a unified world economy, a single ecological system and a complex network of communications that covers the whole globe even without penetrating every part of it (Twining, 2000:4). Furthermore, Twining, who has further developed the Santo's theory, stated that the global does not necessarily exclude the local, as they would rather interact to each other. As Boaventura de Sousa Santos (1995) mentioned in the theory there is distinguishing features between 'globalized localism' and 'localized globalism'. The first one consists of process by which a local phenomenon is successfully globalised, for instance, the worldwide operation of transnational corporations, the spread of the competition law and policy etc. It is commonly recognised that American antitrust law and the EC competition law have an influence worldwide. Meanwhile, 'localized globalism' occurs as '*the impact of transnational practices and imperatives on local conditions, that are thereby destructured and restructured in order to respond to transnational imperatives*', the example includes free trade enclaves etc. (Santos, 1995:263). In addition, Santo distinguishes 'core countries' and 'peripheral countries', where the former specialises in 'globalized localisms' and the latter is imposed the choice of 'localized globalisms'[12]. The example of the core countries might be the US with the influence of antitrust law. The researcher further argues that to some extent the international organisations or even the regional unions, as the EU could be presumably referred to the core countries. Due to the specification of the formation of the EU, which includes merging the basic principles and aspect of law from the core countries[13], the EU may fall into the classification of a 'core country' in this context. For instance, the influence of the competition law and policy of the EU is imposed not only on the Member States, but also is spread to the rest of Europe or even the world[14]. At this point it can be stated that the competition law and policy of the EU and the US Antitrust law form the basis for the international competition law and have influence within a single country

[12] For further reading see Boaventura de Santos, Towards a New Common Sense: Law, Science and Politics in Paradigmatic Transition, 1995.
[13] For instance, France, Germany and the UK have had the most influence in forming the EU legal order.
[14] For instance, some countries in Europe but outside the EU and some Latin American countries use the EU model of competition law and policy.

world-wide[15]. The Baltic countries, meanwhile, might be an example of the peripheral countries referring to the obligation to impose the principles of the EU into their legal systems. The theory will be further explored towards one direction - the interaction between the core system - the EU and the Baltic states as peripheral countries within the context of competition law and policy, in particular merger control mechanism.

1.2. EU policy, basic principles and competition law

1.2.1. Overview

Unlike the international organisations, the EU is, in fact, unique. Its Member States by signing the Treaty have set up common European Community's institutions to which they delegate some of their sovereignty so that decisions on specific matters of joint interest can be made democratically at European level. The European Union may be considered *'[..] as the legal and political concept which gives expression to this underlying unity'* (Hartley, 2003:9). It cannot easily be compared with other political entities, as it contains some elements of a traditional international organisation, however with some 'supranational powers', or some elements of a federation with regards to the judicial and legal system of the Community[16]. The European Union is considered as the most powerful first of all economic grouping; despite differences in culture, languages and emphasis on nationalism, it is a socially and economically integrated unit with a position to negotiate and operate as a whole in its external economic relations (Heidensohn, 1995:1).

Economic and political integration between the member states of the European Union means that these countries have to take joint decisions on many matters. Thus, they have developed common policies in a very wide range of fields - from agriculture to culture, from consumer affairs to competition, from

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[15] The commentators recognise that the EU and the US represent today the two most influential spheres of antitrust law and policy worldwide. See, for instance, Egge, Bay, Calzado, 2004, IBA 8th Annual Competition Conference.

[16] For further reading, see Hartley, The Foundations of European Community Law, 5th edition, Oxford University Press, 2003, pp. 9-10. Also see Hartley, Federalism, Courts and Legal Systems: The Emerging Constitution of the European Community, 1986, 34 Am. Jo. Comp. L. 229.

environment and energy to transport and trade[17]. The influence of the EU is significant. As Holton states, the EU '*[..] offers an even stronger example of transnational regulatory economic arrangements moving beyond intergovernmentalism than the global organizations*' (Holton, 1998:79). After the latest enlargement by the signing and ratifying of the Treaty of Nice, comprising 25 members and 454 million consumers, introducing the EU Constitution, having its own legislative and decision making bodies as the Council, Commission, Parliament and Court, the EU is the largest trading bloc in the world in political and legal terms.

1.2.2. The roots of the European integration and the origins of the EU

'Europe', daughter of the King Tyre was abducted by Zeus and taken to Crete to become queen and found dynasty. The kingdom of Tyre was seen as the ancestor of European civilisation and the womb of different religions and cultures.' (Sir Nicoll and Salmon, 2001:3).

Historically, the idea to integrate Europe from the mythology has been developed through many different periods of history. For instance, the Roman legacy of culture, language and values gave the concept of Europe a wider foundation (Nicoll and Salmon, 2001:3). Napoleon with the French Revolution also began the informal integration of the European and world economies by instigating a major increase in the flow of people, goods and services between the states (Nicoll and Salmon[18], 2001:4).

Despite some thoughts towards European integration, the actual progress started after the Second World War behind the idea for the European co-operation within a particular area of activity in order to recover after the wars[19]. The first institution to emerge in Europe was the Organisation for European Economic Cooperation (thereafter OEEC) in 1948, primarily as allocation of Marshall Aid following with the second major institution the Council of Europe, which lacked any supranational powers (Goyder, 1998:16-18). It was a moment for a new

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[17] For further discussion, see web-site http://europa.eu.int

[18] For further discussion on the root of the European integration, see Nicoll and Salmon, Understanding the European Union, Longman, 2001, I Ch.

[19] For further reading see R.Mayne, The recovery of Europe, 1970, Ch.8-10. Also, see D.Swann, 1984, Ch.1.

radical idea, which was provided by Jean Monnet, French administrator and civil servant, who came up with the idea to create a common market for iron, steel and coal in Europe without any market restrictions, such as customs, duties, tariffs, quotas and administered by an independent High Authority endowed with supranational power over all participating countries (Goyder, 2003:18-19). As a result of these ideas together with support of R.Schuman, French Foreign Minister at the time, the Treaty of Paris was signed in 1951 by creating the European Coal and Steel Community.

Hence, the foundation of the European Communities has started from signing the European Coal and Steel Community (thereafter ECSC) followed by the Treaty of Rome in 1957, which founded the European Atomic Energy Community (thereafter Eurotom) and the European Economic Community (thereafter EEC). The aim of establishing a common market and progressively approximating policies of Member States to promote a harmonious development of economic activities and closer relations between the Member States was enshrined in the Treaty of Rome[20]. Thus, the first organisation of European integration was created and there the competition law was included as an important part of it. With the founding Treaty of Rome four fundamental freedoms with the purpose to remove artificial restraints on trade and promote competition were established. The first freedom provides that goods moving from Member States are not to be subject to customs duties or other restraints; the second freedom involves free movements of workers within the Community. The third contains a provision of free movement of capital and the fourth, free movement of services in the Community. The Treaty of Rome envisaged a process of the economic integration based on competition. However, the Treaty did not serve only an economic objective as political objective was also involved. The idea was to create a common market that '*[..] the countries of Europe would be tied together economically in a way that would preclude or at least reduce the possibility of conflicts and wars*' (Gerber, 1998:343). According to Gerber, the competition law was politically acceptable because it was a necessary tool for the economic integration[21]. The political aspect of the European integration was also

[20] Art. 2 (8) of the Treaty of Rome.
[21] For further reading see Gerber, Law and Competition in twentieth century Europe, 1998, ch.IX

supported by other scholars. For instance, according to Roney and Budd (1998:3) the Communities were established '*[..] to put an end to the futile squandering of lives in wars*' in Europe. Threat of the Soviet Empire as one of the motives towards integration was mentioned by Nicoll and Salmon (2001). It can be considered that this motive also played a role for the Baltic countries to join the EU.

The Treaty of the European Union (thereafter the EU) in 1992 brought about some conceptual changes; the European Economic Community (EEC) treaty was re-named into the European Community Treaty (thereafter EC). Apart from the first pillar, which embraces what is known as the European Communities together with the four freedoms, competition rules and some other issues, two new pillars were created by the Treaty of the European Union. They are 'common foreign and security policy' and 'justice and home affairs'. It took some time for the Member States to remove all the barriers to trade virtually between them and to turn their 'common market' into a genuine single market in which goods, services, people and capital could move around freely. As a result, the Single Market was formally completed at the end of 1992[22]. The most important feature of this Single Act was the single market commitment. The Single Act inserted into the Treaty a few new sections, for instance, economic and social cohesion. Also, a new section on the environment was introduced by the Single Act. The concern was that different standards between the Member States in matters such as pollution would distort cross-border trade. Also, there was an assumption that the single market programme would lead to acceleration in growth of the Community economy. As a result two main side economic effects may occur. On one hand, the increased competitive pressures may tend to lead firms to focus on the cost savings but not on the adoption of less environmentally safe technologies and practices. On the other hand, on the contrary, the increased competition may lead to rapid technological change that could increase the opportunity for firms to adopt more environmentally friendly process (Swann, 1996:53-55).

Furthermore, the Treaty of Amsterdam introduced a new title[23] on 'closer co-operation', which was developed and re-named in the Treaty of Nice (Hartley,

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[22] For further reading, see the web-site: http://europa.eu.int/abc/history/index_en.htm

[23] See Title VII [VIa].

2003:9). The main task of the Treaty of Nice, which was signed on 26 February 2001, was to reform institutions of the Community and to prepare them for a major enlargement following the introduction of ten new Member States[24].

1.2.3. Enlargement towards eastward

'*The Community always goes forward; never backward...*' (Lord Cockfield, 1994)

The 1st of May 2004 had opened the next page of the history of the European Union's expansion. Ten new countries had joined the EU. The Baltic countries are among new Member States. Already the Treaty of Rome set up the room for a future expansion of the EU. However, the EU is not a club, which can be joined without first undertaking fundamental changes in law and economy (Mayhew, 1998:179). The Treaty allows the accession into the EU only for suitable European countries. At the European Council in Copenhagen in June 1993 was decided to introduce the requirements (widely known as Copenhagen criteria) for the accession into the EU. A country is assumed to be applicable for the membership by satisfying the economic, political and administrative conditions. Political conditions include the ability to take on the present and future obligations of membership, including adherence to the aims of economic, political and monetary union, and guarantee democracy, the rule of law, human rights and protection of minorities. Introduction of a functioning market economy, which would be capable to cope with competitive pressure and market forces are the economic conditions. The institutions to deal with these issues refer to administrative conditions. Furthermore, the European Council in Madrid in 1995 introduced the pre-accession strategy. This means the creating conditions *'[..] for the gradual, harmonious integration of the applicant countries through the development of the market economy, the adjustment of administrative structures and the creation of a stable economic and monetary environment'* (Van Miert, June 1998). After the collapse of the Soviet Union and throwing off the socialist shackles after 50 years of occupation, the Central and Eastern European countries (thereafter the CEEC) showed their eagerness to re-join the Europe from which these countries had been estranged by the 'iron curtains' (Danta and Hall, 2000:3).

[24] Here the author refers to the enlargement of 1 May 2004.

After re-gaining their independence, the Baltic countries also exposed the desire like other Eastern and Central European countries to join the EU. However, the accession of the Baltic countries arguably represents one of the most historic dimensions of the enlargement process first of all in terms of European geopolitics and continental integration (Pettai, 2003:1). As a result of the enlargement, the EU embraces almost the entire Baltic Sea into one economic and political bloc, consolidates a part of the continent, which has long been the outside of Europe, and entrusts these countries to be the gate-keepers of the newly enlarged EU[25]. Since the Eastern enlargement has had an impact on both the EU and the new Member States[26], the observation of these aspects is necessary.

1.2.3.1. The impact of the enlargement on the EU

First of all, the eastern enlargement has been a significant accession from a political point of view leading to an increase in the power and prestige of the EU in international arenas (Mathew, 1998:186). After adding ten new Member States, the EU is the largest trading bloc with an important voice in the world in political and legal terms. However, the last enlargement has had two side effects as it has caused some challenges as well as opened some opportunities for the EU. The Eastern enlargement or in general the CEEC enlargement has constituted the challenge for the EU on an institutional level. The basis for the Treaty of Nice was the institutional amendments. In particular the actual impact of the Baltic states on the EU has been mitigated by their small size. For instance, the Baltic countries together in the European Parliament have 26 representatives out of 732. A different situation is in the European Commission where each country has one representative. However, the commissioners are committed to act in the interests of the Union as a whole and not taking instructions from national governments[27]. Despite the small size, the Baltic countries have brought three different languages to the political and administrative machinery of the EU and thereby placed an additional burden on the EU.

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[25] For further reading, see V.Pettai, Historic and historical aspects of Baltic accession to the European Union, as published in V.Pettai and J.Zielonka, The road to the European Union, Vol.2., Estonia, Latvia and Lithuania, Manchester University press, 2003, pp.1-13.

[26] The author here refers to new 10 Member States, which joined the EU on 1st May 2004.

[27] For further reading, see http://europa.eu.int/institutions/comm/index_en.htm and also http://europa.eu.int/comm/commission_barroso/index_en.htm

Some authors as Mayhew (1998) acknowledge the economic benefits of the accession of new Member States, which may occur from three different sources. First of all, the 106 million consumers and the thousands of companies within the CEEC are an important market for existing Community producers. Secondly, according to Mayhew the Eastern and Central European countries are a potentially important production location for the Community companies wishing to expand their businesses to lower–cost location[28]. For instance, it is notably the case for Germany, where German companies have expanded the business into the CEEC and shifted production sites, which the cost structure was particularly dependent on labour costs (Mayhew, 1998:191). For many companies which operate in CEEC countries, in particular for the Nordic and the German firms operating in the Baltic states, have opened the opportunities to cut costs and it as a result has helped to compete more effectively with other firms. Thirdly, the new Member States have brought more competition to the market of the European Community, leading to a break-up of market rigidities and in the longer term a stronger European economy (Mayhew, 1998:188-193).

As regards political aspects, particularly the accession of the Baltic states with their '*shadow of Russia*', is one of the most intriguing issues for scholars of European integration (Pettai, 2003:5). The Baltic countries are the first three former Soviet republics to join the European integration and the first with unsettled questions with Russia and the first to bring sizeable Russian minorities, especially in case of Estonia and Latvia because of the 'rusification' process, on the territory of the EU[29]. Also, the internal and external links between the three Baltic countries and Russia brings '*[..] a new political dimension to the EU agenda*' (Tilikainen, 2003:14). Furthermore, the new role of the Baltic states as the gate-keeper is another challenging issue for the EU. The EU has had to entrust the Baltic authorities, in particular the Latvian and the Lithuanian border authorities to control illegal migrants to use these states as passageways to other European countries (Mannonnen, 1997).

[28] The CEEC can offer low cost labour costs in comparison with the western European countries.
[29] For further reading, see Tiilikainen, The political implications of the EU's enlargement to the Baltic states, 2003.

As regards competition issues, for the European Commission adding new members, has meant to burden the internal operations of the Community's competition law system because of their little experience of competition and much less of competition law (Gerber, 1998:395). Also, there is a possibility that more merger transactions will fall under the European Commission's jurisdiction as a result of the enlargement with ten new countries. This is because the 'one-stop-shop' in which companies engaged in large-scale mergers need to obtain the EC merger clearance, became bigger after the last enlargement. For instance, *Kesko Food Ltd / ICA Baltic AB* was the first case[30], which was referred to the jurisdiction of the Commission to avoid multinational filings due to the fact that the proposed transaction between Nordic companies had presumed anti-competitive effects on competition in several countries, including all three Baltic states.

1.2.3.2. The impact of the EU on the Baltic countries

The Eastern and Central European countries, including the Baltic states, with weak security and economic situation needed a strong anchor, what the EU could offer, for the market economy and democracy (Mayhew, 1998:194). For the Baltic countries the membership in the EU and NATO is the final step in their political recognition as independent states after the collapse of the Soviet Empire and re-gaining their independence in 1991. For the people in all Baltic countries the inclusion in the most extensive and cohesive political formation '*[..] offers a much greater prospect for stable development and lasting independence than at any time in their modern history*' (Pettai, 2003:1).

However, the requirements for the membership of the EU have been as a new revolution for the Central and Eastern European countries. Life behind the 'iron curtains' had left these countries far at the back from the western European countries with modern economies. Communist industry was technologically backward and monumentally inefficient; agriculture was stagnated because of collectivisation and state control (Milgrom and Roberts, 1992:13). The conditions to the accession into the EU for the Baltic countries meant transforming whole

[30]The Commission's decision No. COMP/M 3464. It will be discussed in the further sections.

economies and legal systems, dealing with outmoded technology, overcoming embedded political systems, even changing deep-rooted socialist mentality (Danta and Hall, 2000:3-5, Lydeka, 2001). The Baltic countries have faced great problems in re-designing their systems. They had to set up capital markets and create banking, financial and monetary systems; they needed to re-draft their laws to allow for new forms of economic organisations, new sorts of transactions and obviously new patterns of ownership (by including a private ownership) (Milgrom and Roberts, 1992:15-16). They had to educate people, especially business people, to the new rules of the game and gain acceptance for these rules, as to re-educate managers who can take their own strategic decisions (rather than follow orders from Moscow) and operate in a market system and compete in a world market (Lydeka, 2001, Milgrom and Roberts, 1992). They also had to decide on competition and regulatory policies in order to find a way how to deal with a problem that simply privatising the giant, inefficient state firms (inheritance from the Soviet Empire) will yield a system of inefficient private monopolies[31]. Hence, the Eastern European countries, including the Baltic states, had to travel a long path through the transition from authoritarian politics and planned economies to more democratic and liberal regimes.

The closer interest to the European Communities has not only affected the basic economic (as change from planned to market economy) and administrative framework but also the basic legal background in Estonia, Latvia and Lithuania. The transition has not been required only political decision and economic expertise but also comprehension of the legal conditions of a market economy, in particular of the European Communities (Mueller-Graff, 1993). The applicant states must not only accept the Community system but also have the capacity to implement it. This in turn means that the applicants must have a competitive market economy, and an adequate legal and administrative framework in both the public and private sector (Stavridis, Mossialos, and Morgan, 1997:162). In general, the policy of the EU has meant that all candidate countries have been required to adapt their laws and institutions by implementing the *acquis* in very significant ways before the accession, and therefore they were left in such a position where they do not have any influence on the making of the European

[31] For further reading, see Milgrom and Roberts, 1992, pp.15-16.

laws and policies. Thus, the Baltic countries had to meet the Copenhagen criteria (June 1993)[32], before they could join the Community, which involve: (i) the stability of institutions guaranteeing a functioning democracy and the rule of law as the basis for society, respect for and protection of minorities; (ii) the existence of a functioning market economy which is developing in such a way that it can sustain the competitive pressure from and in the Single Market and the Economic and Monetary Union; (iii) and a 100% correct implementation of the *acquis communautaire*, unless otherwise agreed with the EU, together with a public administration that efficiently, correctly, and without corruption applies and enforces the *acquis* conformed legislation.

A result of being a part of the Soviet Union and having the state-run economies, the Baltic countries were required to re-design the entire economic system. It is because the competition policy within the EU involves the monitoring and intervention into the markets of Member States to ensure that there is an adequate level of competition. Therefore, the purpose behind this competition policy is to ensure that there is an efficient allocation of resources and there is a belief that the market economy is a more effective way of allocating resources than the centrally-planned or state-run[33] economies (Barnes I. and Barnes P., 1995:212). Mario Monti, the European Commissioner for Competition Policy, in his speech delivered in June 2001, mentioned that without a strict competition policy preventing any market-distorting behaviour of undertakings the market economy is unlikely to keep the promises and, furthermore, without a strict competition policy the formerly state-run economies will not be able to survive the competitive pressures and market forces of the internal market (Monti, 2001).

The other requirement for the membership into the EU was the governmental capacities to manage the European affairs. This was an important criterion, as the institutions capabilities to administer the EU matters affect not only the Baltic countries' ability to benefit from the EU membership but also the EU's governance capacity as to have the uniform application and enforcement of the *acquis* (Nakrosis, 2003:104). Adjusting the Baltic countries' administration to

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[32] Available at web-site: http://europa.eu.int

[33] Centrally-planned economies and state-run economies are used interchangeably in this research as different sources refer to either of these terms.

deal with the EU affairs, required huge reform efforts, including cleaning up after the inherited system from the communist tradition, the establishment of new regulatory institutions and the development of new regulatory skills[34]. New institutions were established in all Baltic countries as in Estonia – Competition Board, the Competition Council in Latvia and the Competition Council in Lithuania to deal with competition affairs.

1.2.4. Legal sources of the EU

It is important to understand the different types of the EU legislation in order to comprehend the policy of the Union. For developing its policy, the European Community law has a number of formal legal orders: the primary sources contain all the founding Treaties with the following amendments, and secondary sources include regulations, directives and decisions. Also the interpretation of both primary and secondary sources by the European Court of Justice (ECJ) and by the Court of First Instance (CFI) must be added. Recommendations, opinions, guidelines as opposed to the more formal measures such as regulations, directives, and decisions are labelled as 'soft' laws as they do not have binding force. Meanwhile, regulations, directives and decisions refer to 'hard' laws due to their binding nature. According to article 249 (ex. 189) regulations are '*[..] binding in its entirety and directly applicable in all Member States*'. Directives differ from regulations in two important aspects: (i) they do not have to be addressed to all the Member States; and (ii) even if they are binding, the choice of form and method of implementation is open to the Member States. Decisions as stipulated by article 249 (ex. 189) are binding in their entirety but only on those to whom they are addressed. And, finally, recommendations, opinions, guidelines and other 'soft' law without binding force, have importance in explanation of EC law and in putting steps towards transparency. For instance, the Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings[35] issued by the

[34] For a further reading, see Nakrosis, who's analysis is mainly based on Lithuania, but to some extent can be applicable to Estonia and Latvia as well.
[35] 2004/C 31/03.

Commission has an important impact on the way in which the Commission chooses to exercise its control vis-à-vis merger transactions.

Considering that this thesis involves study about the EC Merger Regulation, the researcher assumes that some explanation of regulation is required. First of all, only regulations have a direct applicability. The precise meaning of the term 'directly applicable' has caused some concerns and debate for the scholars[36] at the early stage due to the absence of *travaux preparatoires* of the Treaty. The question has been raised whether the Treaty's drafters meant that by this term the individuals have rights, which they can enforce through the national courts in their own name (Craig and Burca, 1998:106-107). Indeed, the ECJ interpreted the 'direct applicability' in this manner and has gone even further. In the *Variola / Amministrazione delle Finanze* case[37], the ECJ mentioned that a regulation from its entry into force and its application in favour of those subject to it are independent from any measure of reception into national legal systems. This case also explained that regulations become automatically part of national legislation and do not require any further implementation. This means that the EC Merger Regulation is binding and directly applicable in the Baltic states since joining the EU on 1 May 2004.

The EC law has direct effect at both horizontal and vertical levels. Horizontal direct effect refers where an individual seeks to invoke a provision of the EC law against another private party, whereas, vertical – an individual against a Member State. In *VanGend en Loos* case[38] the ECJ held that rights and duties according to the Treaty refer not only to governments but also to people and the object of the ECJ *'[..] is to secure uniform interpretation of the Treaty by national courts and tribunals*' and '*[..] the states have acknowledged that Community law has an authority which can be invoked by their nationals before those courts and tribunals*'. Thus, the European Community legal system is such a system in which the EC law is a source of law in the Member States legal systems and even prevails over conflicting national laws. Any doubts as to the primacy of the EC

[36] See, for instance, Steiner J., Direct applicability in EEC law – a chameleon concept, 1982, 98 LQR 229; Dashwood A., The principle of direct effect in European Community Law, 1978, 16 JCMS 229.
[37] *Variola / Amministrazione delle Finanze*, No. 34/73, (1973), ECR 981.
[38] *Van Gend en Loos/Nederlandse Administratie der Belastingen*, No. 26/62 (1963), ECR 1.

law over national law was emphasised in *Costa / ENEL* case[39], where the European Court of Justice stated that by signing the Treaty '*[..] the Member States have limited their sovereign rights, albeit within the limited fields, and have thus created a body of law which binds both their nationals and themselves*'.

The discussion above shows that the development of the legal system of the European Community has occurred not only by the Treaty itself (not by expressed agreement by the Member States) but also through the interpretation and principles formed by the ECJ or CFI. Through the case law these courts have built up a bold theory of the nature of the EC law '*[..] attributing to it the characteristics and force which it considered necessary to underpin a set of profoundly altering and potentially far-reaching common goals within a group of politically and geographically distinct nations and historically sovereign States*' (Craig and Burca, 1998:163). Thus, the questions arise here, what are the general principles and in what way are these general principles a source of law within the context of the EC[40]. For answering the first part of the question, Sir G. Fitzmaurice stated that a principle of law underlies a rule and explains the reasons for its existence (Fitzmaurice, 1957 as quoted in Tridimas, 1999:1). According to Tridimas, principles provide a minimum substantive content and guide the judicial inquiry on that basis (Tridimas, 1999:2). The principles of the European Community fall into a *principes communs* category, which is apparent to supranational legal systems and consists of principles common to the constituent parts of this legal system[41], and explains the reasons for the EC law existence. As regards the second part of the question, the ECJ has developed a doctrine, which provides that the Community law may be derived from the general principles of law[42], mainly for the reason to '*cloak the nakedness of judicial law-making*' (Hartley, 2003:133). The idea behind it is that a legal foundation for the judgement will be provided, if a ruling is delivered from a common assent[43]. The

[39] *Costa/ENEL* No.6/64 (1964) ECR 585.
[40] The EC rather than EU, due to the fact that the ECJ lacks jurisdiction over the second and the third pillars. For further reading see Craig and Burca, 1998, pp. 164.
[41] This category is widely known among continental authors, such as Papadopoulou, Principes Generaux du Droit et Droit Communautaire, Bruylant, 1996, Schermers, Waelbroeck, Judicial protection in the European Communities, Usher A., General principles of EC Law, Longman, 1998, Tridimas, The general principles of EC law, 1999 etc.
[42] For instance, general principles of law are also one of the sources recognised by international law (Art. 38 (1) (c), Statute of the International Court of Justice.
[43] For further discussion, see Hartley, 2003, pp. 133-135.

origin of these general principles is the Community Treaties and the legal systems of the Member States (Hartley, 2003:133).

As regards the particular principles, the case law has developed, for instance, proportionality, legal certainty and protection of legitimate expectations to general principles of law transcending specific provisions (Tridimas, 1999:5). The Treaty of European Union added article 5 (3) (ex. 3 b (3)) to incorporate the principle of proportionality governing the exercise of the competence of the Community. Due to the fact that proportionality is also incorporated by implication in the principle of subsidiarity, the researcher considers that firstly the analysis on subsidiarity should be provided.

According to article 5 of the Treaty, the Community will take action *'[..] only if and in so far as the objectives of the proposed action cannot be sufficient achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community'*. Thus, there are two basic conditions for the Community jurisdiction: (1) the intended action, which cannot be sufficiently achieved by the Member States, either at central or regional level and local level; and (2) it can be better achieved within the Community jurisdiction [44]. Due to the ambiguity of this principle, the Protocol on the Application of the Principles of Subsidiarity and Proportionality was added to the Treaty of Amsterdam. However, there have been still some uncertainties left, which were expressed by the various commentators. It is not clear which areas should be regarded as exclusive jurisdiction of the Community (considering that the principle of subsidiarity only applies in the areas, which are the exclusive jurisdiction of the Community)[45]. Toth (1992: 1080-1086) argues that all the areas of power grated to the Community under the EEC Treaty as originally concluded is exclusive. Steiner (1994), meanwhile, states that the only areas in which the Community has exclusive competence within the meaning of article 5 are those in which it has already legislated[46]. Therefore, Hartley (2003) concludes that the Commission has identified the areas satisfying this criteria, which include the removal of barriers to the free movement of goods, persons, services, and capital; the common commercial policy; the general rules on competition etc. (Com.

[44] For further reading, see Article 5 of the Protocol on the Application of the Principles of Subsidiarity and Proportionality.
[45] For further comments, see Hartley, 2003, pp.114-118.
[46] As published in O'Keeffe and Twomey, Legal Issues of the Maastricht Treaty, 1994.

Doc.Sec (92)). The Commission has also made clear that this large area would expand with integration[47]. As regards merger control, the Commission has set the criteria [48] and according to them the merger cases are divided between the European Commission and the Member States jurisdictions. First of all, threshold has become the means by which the principle of subsidiarity is applied. Secondly, other certain conditions, as stated in articles 9 and 22 of the EC Merger Regulation allow the transfer of cases from national to European level and vice versa. Thus, both qualitative and quantitative elements define the principle of subsidiarity within the merger regime context (Cini and McGowan, 1998:219).

As it was mentioned above the principle of proportionality [49] first 'discovered' by the ECJ was later incorporated into the Treaty. Thus, the condition to article 5 was added, which states that *'[..] any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty'*[50]. The principle applies to the Community institutions in the sense that they cannot go beyond what is necessary in order to bring about the EC law. Hence, the proportionality principle is well established as a general principle and can be used to challenge *Community action* itself as well as the legality of *Member State action* which falls within the sphere of application of the Community law (Craig and Burca, 1998:350). The reason why this principle was added was to ensure that the Community respects the Member States' interests not only where it exercises concurrent competence but also where it has its exclusive jurisdiction, which falls outside the scope of article 5 (3) (ex.3 b (2)) (Lenaerts and Van Ypersele, 1994 as quoted in Tridimas, 1999:119). The example of the proportionality principle within the context of the merger regime to some extent can be found in article 9 of the ECMR (the EC Merger Regulation). According to this article with conformity of the certain conditions a Member State may lodge a request for referral of merger case to its jurisdiction despite the fact that the case falls under the exclusive jurisdiction of the Commission.

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[47] See, The Principle of Subsidiarity, Com. Doc. SEC (92) 1990. Also see, Hartley's comments 2003, pp.115.

[48] See ECMR. These criteria will be discussed in the following section of this thesis.

[49] The principle of proportionality was delivered from the 'core' country – Germany, which governs the relationship of the Federal authorities and the Lander.

[50] Article 5 (3) of the Treaty.

Other principles are legal certainty and legitimate expectations, and transparency. The most apparent application of legal certainty is in the context of rules with an actual retroactive effect. Retroactivity may occur in one of two ways: (i) where the date of entry into force precedes the date of publication; or (ii) where the regulation applies to circumstances, which have been concluded before the entry into force of the measure (Craig and Burca, 1998:357). As regards legal certainty and transparency in competition rules, firms must be able to know and understand the law in order to work within a legally defined framework of rules (Cini and McGowan, 1998:218). Cini and McGowan further argue that an unpredictable policy may prevent firms from being law-abiding, as what is one day legal may become illegal the next; and it is in the institutions of the EU's (as regards the competition rules, the Commission's) interest to develop a clear and transparent policy. The examples of the development of transparent policy of the EU are the Notices[51], Guidelines[52] and other explanatory documents.

Apart from the principles as discussed above, the Community has other general principles, which include human rights principles as the duty to give reasons, the right to due process, *non bis in idem* and the *audi alteram partem,* introduced by the common law tradition, with the meaning of recognition by the court a company's right to a fair hearing in the decision making process before an administrative body[53].

Since the EU's institutions play an important role in developing the European Union's rule of law, it is important to analyse them.

1.2.5. The Political institutions within the EU

According to the founding treaties, the European Union has five main institutions: the Commission, the Council, the European Parliament, the Court of Justice and the Court of Auditors. The Council is the organ, which represents the

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[51] For instance, Commission Notice on Case Referral in respect of concentrations, Official Journal C 56, 05.03.2005, pp. 2-23; Commission Notice on restrictions directly related and necessary to concentrations, Official Journal C 56, 05.03.2005, pp. 24-3.

[52] Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, Official Journal C 31, 05.02.2004, pp. 5-18.

[53] For a further analysis, see Vranken M., Fundamentals of European civil law and impact of the European Community, Federation press, 1997.

political will of the Member States and has final legislative authority[54]. It gave to the Commission the power to play a major role in shaping the competition law system. Considering the fact that the European Parliament and the Council of Ministers have only a peripheral role, and at the institutional heart of the supranational enforcement of competition policy is two main bodies the Commission and the Court of Justice, a further analysis will be based on them. Both these institutions are responsible for the legal supervision of the competition rules, including the merger control, and they also have had a pivotal role to play in the day-to-day administration and in shaping the substantive and procedural characteristics of the Competition regime of the EC (Cini and McGowan, 1998:38-59).

The European Commission is the politically independent institution that represents the interests of the EU as a whole. It proposes legislation, policies and programmes of action and it is responsible for implementing the decisions of the Parliament and the Council[55]. Furthermore, the European Commission is the institution responsible for the implementation of the EC competition law and policy at the EU level. The European Commission can apprise competition concern by a complaint of an undertaking (-s) or Member State (-s) or by itself and act on its own initiate ('ex officio') to investigate the cases fallen to its jurisdiction (El-Agraa, 2004:202).

The main role of the Court of Justice is to ensure that the EU legislation, which is technically known as 'Community law', is interpreted and applied in the same way in each Member State, as it is always identical for all parties and in all circumstances. The Court has the power to settle legal disputes not only between Member States, but also between the EU institutions, businesses and individuals[56]. For instance, in a several key judgements the Court of Justice enhanced the status of the Community law, as referring to the *Van Gend en Loos* case[57] which established the doctrine of direct effects and the supremacy of Community law over national law (Hartley, 2003:52). Moreover, the Court has played a major role

[54] The Council has the final legislative authority within the Community. Meanwhile, the Commission has the initiative power. For a further reading on these institutions, see http://europa.eu.int
[55] For further information about role and functions of the Commission, see web-site http://europa.eu.int
[56] For further information about the Court of Justice, see web-site http://europa.eu.int
[57] *Ibid*, fn. 37.

in developing the competition law. For instance, the Court of Justice frequently enunciated broad principles and values without just limiting itself on the facts of individual cases. It has looked to the future and has guided the Commission in developing the competition law and policy (Gerber, 1998:352). For supporting the integration as the main goal, the Court made teleology as its interpretive strategy. The court interpreted the provisions of the competition law in a way what was necessary to achieve the integrationist goals of the Treaty (Gerber, 1998:353). The *Continental Can* case[58] illustrates such teleological justification, where the Court disregarded both textual and historical analyses, which opposed the application of article 82 (86 at that time) to mergers, and held the applicability of this article to merger cases. The Court further stated that such interpretation was necessary for the Commission to accomplish its pro-integration goals[59]. Thus, during the foundational period the primary role of the Commission together with the Court of Justice was 'making competition law'. However, the situation has changed ever since. The Court's decisions became less 'aggressive' in the sense that the Court limited itself to the statements required for the decision of the concrete legal controversy as in opposite to the past future-oriented judgements with generalised significance (Everling, 1986 as quoted in Gerber, 1998:372)[60].

1.2.6. The origin of the Competition law in Europe and in the EU

1.2.6.1. Overview

The idea to develop a general law to protect competition in Europe started in 1890s in Austria as *'[..] a product of Vienna's extraordinarily creative intellectual life'* (Gerber, 1998:6). The task of the competition law proposals was to protect the competitive process from political and ideological onslaughts and they relied on bureaucratic application of a 'public interest' standard. Despite the political events in Austria, which blocked the further development of the competition law ideas, the inspiration to form the competition law was debated in Germany. Germany enacted the first competition law as such in 1923 in response

[58] *Continental Can/Commission*, case 6/72, (1973) CMLR 199.
[59] For further reading, see Gerber, 1998, pp.360-361.
[60] Some of the recent judgements by the Court will be examined in chapter 6.

to the post-war inflation crisis. Although the competition law was eliminated during the 1930s pressures, it was an important factor of economic and legal life in Germany and the ideas of competition law spread during the late 1920s throughout Europe. Many European governments after the war turned to competition law as a means of encouraging economic revival and embedded it in economic regulatory frameworks (Gerber, 1998:8). For instance, business activities conflicting with good trade practices and customs were also prohibited in Estonia in 1931 by the provisions of law, which dealt with unfair competition. However, the application of the law ended together with the disappearance of the state of Estonia (Proos, 2002).

Gradually competition law in Europe has become a 'pillar' of the 'social market economy' and *'[..] has played a key role in some of post-war Europe's most impressive economic and political successes'* (Gerber, 1998:8 [61]). The additional stimulus for the competition law has had the creation of the European Economic Community in 1957 together with the task of eliminating obstacles to trade across the national borders and creating the conditions for the effective European market.

Thus, a European competition 'tradition' has started with a vague idea of a competition law, which has gradually acquired enough support to be enacted into legislation and has spanned throughout Europe, and has grown in economic and political importance. This competition tradition has broadcasted the ideas and perceptions over time across borders and has played a central role in the integration of Europe and economic and social progress[62]. Meanwhile, the Baltic countries, as being a part of the Soviet Union, were excluded unlike the Western European countries from developing a competition tradition. The competition policy and law was an 'undiscovered island' for the Baltic states until the re-gaining of their independence at the very end of the 20^{th} century.

[61] D. Gerber, American Professor in Law, is widely known for his original contribution outlining the German ordoliberal thinking in the development of EU competition policy and uncovering the key historical transformation and movement of the EU competition law. For further analysis, see, for instance, Gerber D., Law and Competition in Twentieth century Europe, Clarendon press, 1998.

[62] For further reading, see D.J.Geber, 1998, pp. 6-10.

The creation of the European Economic Community has begun the process of integration in which competition law has played a pivotal role[63]. However, the Competition law of the Community has not only itself become a major factor in economic decision-making power through Europe, but also the Member State and the Candidate States have modelled their competition laws to the competition law of the Community (Gerber, 1998:334). For instance, the Competition laws in the Baltic countries were introduced as a part of the *aquis communautaire* and have been highly influenced by the Community's law.

1.2.7. The merger control in the Community

1.2.7.1. The origin of the merger control mechanism within the EU

The first trans-European provisions on merger control was introduced by article 66 of the ECSC[64], which was influential by the US experience as there was no virtually European experience at that time (Gerber, 1998:341). The High Authority was given a permission to restrict mergers, where the parties of the transaction would have power *'[..] to influence prices, to control or restrain production or marketing, or to impair the maintenance of effective competition in a substantial part of the market for such products; or to evade the rules of competition [of the treaty], particularly by establishing an artificially privileged position involving a material advantage in access to suppliers or markets'* (Article 66). The reasons behind articles 65 and 66 of the ECSC reflected the adherence of the drafters to competition as an economic way of life with the major concerns being that cartels (and concentrations) might become the real political power of the Community and possibly may constitute a challenge to the Community's sovereignty (Vernon, 1953 as quoted in Gerber, 1998:337). However, these first merger control rules within the EU, was applicable only in the steel and coal industries.

[63] The EC Treaty embedded a set of wider policy goals orientated towards the objective of European economic integration. For instance, article 3 (1) (g) of the Treaty states that a system has to ensure *'[..] that competition in the internal market is not distorted'*. The competition rules were included in the EC Treaty as a means to achieve economic integration. For further discussion, see chapter 5.

[64] This Treated expired in 2002 OJ C152/5.

The competition law and policy without any exclusion to any particular industry was introduced in the European Community by the founding Treaty of Rome in 1957. Traditionally, the Competition policy within the European Community is based on the control of the behaviour of undertakings. For instance, articles 81 and 82 of the Treaty give the power to the Commission to enforce sanctions on undertakings as regards restricted agreements or abuse of a dominant position. However, this Treaty is silent and does not contain any specific provisions for merger control. Cini and McGowan (1998) give two reasons why merger control rules were excluded. The first one is the differences between the EEC and the ECSC treaties, where the former is a *'[..] traite-cadre that established a framework of action but which compels further legislation to apply the principles'* and the latter is a *'trate-loi which specifies the regulatory content'* (Bulmer, 1994:423-424, as quoted in Cini and McGowan, 1998:116-117). It was easier to agree on the rules of the specific industries than establish a more general regulation. The second reason was the generally held view and the economic and political situation in Europe in the 1950s. While signing the Treaty of Rome, the main concern was made on how to deal with an abuse of dominant firms or restrictions of competition through agreements and a merger control was left behind as it had little economic impact at that time. Merger transactions were not considered as a threat to competition, and therefore, economies of scale were held to benefit industrial competitiveness (Cini and McGowan, 1998:116-117). Hence, merger transactions had been looked at from a positive view: providing they increase the industrial competitiveness.

However, the position towards merger transactions has changed. The first attempt by the Commission to introduce a regulation on the control of concentrations between undertakings[65] in the rest of industries apart from coal and steel was in 1973 following with the further proposals in 1981 and in 1986. Even the Member States did recognise the importance of merger control, but this attempt was unsuccessful as the Member States could not agree on the specific form: whether the merger control must be left to national authorities or to the Commission (Craig and Burca, 1998:1034). The gap of the absence of merger control was covered by articles 81 and 82 (85 and 86 at that time) of the Treaty.

[65] Commission proposal for a regulation of the Council of Ministers on the control of concentrations between undertakings, 1973, OJ C92/1.

Article 82 deals with an abuse of dominant position and article 81 focuses on anti-competitive agreements rather than market position. In *Continental can*[66] case a US company with a dominant position was attempting to gain a control of a Dutch company operating in the same market. The Commission was under the opinion that the Continental Can is using its dominant position to acquire the target - the Dutch company and it would constitute an abuse according to article 82 (86 at that time). The Commission's decision of prohibiting the merger was overturned by the ECJ, but it upheld its reasoning in relation to article 82, by lifting up the applicability of this article towards mergers control as in the case of the expansion of a dominant position through mergers.

Article 81 was also applied in a several merger cases. For instance, in *Philip Morris*[67] case, Philip Morris intended to purchase 50% of shares of Rothmans Holdings. After the intervention of the Commission, Philip Morris reduced the size down to 30.8% of the shares where there were only 24.9% of them with the voting rights. However, the decision appeared before the Court, as there were the complainants who were not happy with the decision. Thus, the Court in this case stated that article 81 was applicable to the acquisition of shares, where the acquisition leads to the ability of the acquirer to influence the conduct of the target undertaking, especially the acquisition of a minority shareholding in the undertaking. The Commission further followed this policy in 1988 by forcing British Airways to surrender some of its routes to its main competitors after it had taken over British Caledonian (Cini and McGowan, 1998:119). Hence, the Court of Justice chose to interpret both articles 81 and 82 within the spirit of the Treaty of Rome. It was mentioned that articles 81 and 82 had to be interpreted in the manner to achieve the task set up in article 3 (1)(g) (ex Article 2 and 3 (f)) (Goyder, 2003:337).

Despite some experience of applying articles 81 and 82 in merger cases, the nature of these two articles as neither the intention of the drafters, nor actual wording of the articles or other evidence support the argument, that articles 81 and 82 are responsible to cover merger control (Goyder, 2003:335). As it was illustrated above, there were a number of obstacles for them being used as an

[66] *Continental Can/Commission*, case 6/72, (1973) CMLR 199.
[67] *BAT/Commission*, cases 142 & 156/84 (1987), (1988) 4 CMLR 24 hereinafter cited as *Philip Morris/Commission* case.

instrument of a general merger control. For instance, article 82 was applicable to include mergers or acquisitions by companies which already had a dominant position and therefore the acquisition itself was defined as abusive; the creation of a dominant position through a merger was out of the scope of article 82. Furthermore, article 82 did not cover mergers that might result in a supply structure that facilitates concerted practices on oligopolistic markets. In general terms, articles 81 and 82 were also not applicable to shelter all merger cases.

As mentioned above the position towards merger transactions had changed. Sutherland, the member of the Commission responsible for Competition policy in 1986, remarked that the policy about the difference in competitiveness between European and American firms due to the sizes of European and American firms[68] in the 1960s had changed[69]. Furthermore, Sutherland was concerned that an increasing number of mergers, especially cross-border mergers, were likely to have substantial consequences on competition and trade between the Member States, and separate Member States were not capable of enforcing their merger control as regards to cross-border mergers. This is why the necessity of the merger regime at the Community level arose.

1.2.7.2. Emergence of the Merger Regulation within the EC

The Merger Regulation, which was adopted on 21 December 1989 and came into force on 21 September 1990, provided the Community for the first time with an adequate instrument to control cross-border mergers (Faull, Nikpay et al, 1999:205 para 4.01). Thus, the merger control within the EC was finally introduced because of several main reasons: first, due to the gap left in competition law of the European Communities as regards a merger control (for instance, recital 6 to the Regulation 4064/89 marks the insufficiency of articles 81 and 82 to tackle all mergers producing anti-competitive effects); and second, because of the augment of cross-border mergers, there was a necessity to introduce a merger regime together with the requirement of mandatory pre-

[68] The previous position was expressed that the European firms were too small in size for competing large American firms and because of that merger transactions were favoured or encouraged.
[69] The speech by P.Sutherland was addressed to international Bar Association Committee on Antitrust Law in New York, on 17 September 1986. Mergers and Joint Ventures: New trends in European Community Competition policy, Commission press release, IP/86/430, 17/09/1986.

notification of major mergers. The EC Merger Regulation has provided a means to prevent anti-competitive concentrations and with a single framework, where such transactions can be assessed (Faull, Nickpay et al, 1999:205 para 4.02). However, the aim of the EC Merger Regulation is not to prohibit all large mergers, as the former commissioner of Competition Sutherland stated:

'[..] Mergers are not inherently good or bad. Community competition policy which seeks to promote technological innovation and competitiveness while maintaining workable competition should not in a systematic way encourage or discourage mergers. What is essential is to separate the beneficial from the dangerous and this, the Commission feels, can best be done on a Community level where mergers can be viewed in the light of the entirety of Community policies. Even though in almost all Member States some control of mergers exists, albeit in varying degrees, there is need for a Community system.'[70]

The Merger Regulation of 1989 divided a merger regime between the European Commission and the Member States. The allocation of mergers cases between the European Commission and the Member States is based on the principle of subsidiarity, i.e. what dimension authority is best placed to deal with the case. However, not all merger transactions fall under either European jurisdiction or that of a particular Member State. There is a *de minimis* rule and only large merger transactions, which are usually defined by the thresholds within a single Member State, may be investigated by the competition authorities at either dimension. The jurisdiction of a Community dimension in the field of merger control has been defined by the application of turnover thresholds in the ECMR[71]. The Commission has a sole competence to deal with concentrations falling to its scope, because it has more powers of investigation, remedial and enforcement than the limited means available to the Member States. This means that the Commission has jurisdiction over large-scale mergers, which have wider effects than simply within one Member State (Goyder, 2003:341). According to a 'one – stop - shop' principle, the Commission is the best place to take a merger case and take out the additional burden (i.e. multiply filling etc.) of the transaction's participants, if the transaction may have competition concerns within three or more countries. This in turn means that mergers, which meet certain

[70] *Ibid*, fn. 67.
[71] See the Article 1, ECMR, No. 139/2004.

revenue thresholds, can be reviewed by the European Commission rather than by each Member State of the EU affected by the transaction. For instance, the proposed merger transaction of the Finnish company *Kesko Food* Ltd and the Swedish company *ICA Baltic* AB[72] was referred to the Commission due to the fact that the transaction had to be notified to the competition authorities of several countries including three Baltic states.

Moreover, there is a possibility of repatriation of merger cases from the European to national jurisdiction and vice versa. The right was given to the national authorities to deal with the merger cases, which might have impact on their national markets. In this case, upon the request of the Member State, the merger case may be referred under certain circumstances from the European to the national jurisdiction (the situation known as the 'German clause'). This clause was introduced in order to encounter Germany's concerns not to entrust the Commission with exclusive jurisdiction over all merger cases with a Community dimension[73]. However, this situation is rarely used in practice more likely due to the policy of the Council and the Commission expressed in the Nineteenth Report on Competition Policy, which provides that this referral procedure should be applied only in exceptional cases[74]. This policy reflected in the first two cases *Varta / Bosh*[75] and *Alcatel / AEG Kabel*[76] sought by the Bundeskartellamt but rejected by the Commission as not having anti-competitive effects within the German market. The first successful referral was the *Steetley / Tarmac* case[77] submitted by the UK Department of Trade and Industry in 1991. This case resolved the uncertainty of the scope of article 9 providing that more restrictive interpretation is used by the Commission. This case showed that the Commission can refer not entire case but a part of a case which may raise concerns to the national market.

Another situation with possible referral is defined in article 21 (4) where national legislation would apply in order to protect their legitimate interest. There

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[72] The Commission's decision No. COMP/M 3464.
[73] At that time Germany had a longstanding merger control regime, as being the first Member State to introduce the national Merger control rules in 1973, which had proven its efficiency, whereas the merger control mechanism within the Community jurisdiction was just being introduced. See Werner, 2004, pp.688.
[74] Nineteenth Report on Competition Policy, pp. 265.
[75] *Varta v Bosh,* M. 12, 25 February 1991.
[76] *Alcatel v AEG Kabel*, case No. M 165, 1991.
[77] *Steetley v Tarmac*, case No. M180, 1991.

is a contrasting situation known as the 'Dutch clause', where a Member State or States may refer the case under the Commission's behalf even if the case does not fall within its jurisdiction. This provision was introduced to the regulation due to the concerns of some Member States, namely Belgium, Denmark, Greece, Italy, Luxemburg and the Netherlands for not being able to provide sufficient regulatory control over concentrations outside the jurisdiction of the Commission (Bael and Bellis, 1994:428). This clause has lost its importance since all Member States do have their own systems for merger control.

Further development of the jurisdictional issues was introduced with a new Merger Regulation 139/2004, where a better allocation of jurisdiction in the light of the subsidiarity principle has been provided while still retaining the idea of a 'one–stop–shop'. The new streamlined referral system has presented the pre-notification system where the parties involved in a merger transaction have a possibility to make applications for referral at a very early stage[78].

1.2.7.3. The substantive issues of the ECMR and their development

Two basic stages may be distinguished in the development of the substantive test of the ECMR in its brief history: before the No.139/2004 regulation came into force and after it. This division portrays the major changes in the Commission's policy towards merger regime, insofar. The new substantive test was introduced with the Regulation of 139/2004, which represents the culmination of a long legislative history commencing with the adoption of merger control rules on the specific industries of coal and steal in 1950, continuing with the Commission's attempts to introduce general merger control rules throughout most of the 1970s and 1980s, the adoption of the first Merger Regulation in 1989 and finally issuing the modernised Merger Regulation in 2004.

A substantive test used by the Commission is one of the tools to assess merger's effects on competition falling to its jurisdiction. According to the former substantive test, a merger will be prohibited if it *'[..] creates or strengthens a dominant position as a result of which effective competition would be significantly impeded'*. The antecedent substantive test was known as a dominance test, which

[78] See Articles 4(4) and 4(5), 139/2004. The procedural issues are excluded from the scope of the analysis of this research.

consisted of two limbs: i) a creation or strengthening of a dominant position; and ii) significant impediment of competition. The decisive criterion was laid on the creation or strengthening of a dominant position leaving little independent significance to the significant impediment of effective competition. Many Member States and the Candidate States (including the Baltic states at that time[79]) followed the path of the Commission and introduced a dominance test in their jurisdictions. The Baltic countries were among those to instigate in their jurisdictions a dominance test as a substantive test for merger control.

The idea to reform the old merger regime was foreseen in the first Merger Regulation[80] and with the enlargement ahead it was considered that this would be a good opportunity for a review of the merger control mechanism (Ryan, European Commission, 2004). Moreover, the globalisation of economic activity including transnational merger transactions and the increased number of these transactions falling to the EU and US jurisdictions and consequently the divergent decisions[81] between the EU Commission and the Federal Trade Commission were other forces for revision. It was a necessity to adapt a substantive test to a global environment and to bring it considerably closer to the US test as set out in the Clayton Act, section 7, which provides that '*[..] effects of [..] acquisition may be substantially to lessen competition, or to tend to create a monopoly*'. However, the Commission on several occasions issued a statement that there is no material difference between the dominance test and the substantial lessening of a competition test ('the best' substantive test is a mere matter of semantics), providing that neither test can stand on its own but requires the interpretation through guidelines or case law, or both. It is not only the wording itself that matters but also the theories of competition harm which are used in the application of either of the tests[82]. Although the Commission and other commentators agreed that application of the substantive test was more important than its actual wording[83], the controversy over the existence of possible gap

[79] Note: when the Baltic countries introduced the merger control regime in their jurisdictions they were referred as the Candidate countries.
[80] No. 4064/89.
[81] For instance, *GE v Honeywell.*
[82] See for instance, Substantive criteria used for the assessment of mergers, OECD, DAFFE/COMP(2003)5.
[83] For further discussion, see, for instance, point 54 of the Explanatory Memorandum accompanying the Commission's proposal of December 11, 2002. Also see Monti's speech at the DG Competiiton/IBA conference, November 7, 2002.

revealed that language still matters (Fountoukakos and Ryan, 2005: 287-288). Furthermore, the overturning by the CFI of the three Commission's decisions to block mergers in *Schneider / Legrand*[84], *Airtours / First Choice*[85] and *Tetra Laval / Sidel*[86] cases due to shortcomings of proof in the Commission's assessments in 2002 put a further impetus for a review. Hence, the idea to modify the substantive test started in 2001 with the Green Paper[87], where the Commission raised the question of whether the market dominance test should remain in existence or whether the substantial lessening of competition test (thereafter SLC), which is applied in the USA and other jurisdictions (i.e. UK, Ireland etc.), should be introduced. There were various opinions expressed in this Paper, which can be grouped into three main groups.

The first group of scholars advocated that a dominance test should continue due to the legal certainty[88] and supported the notion that '*if it ain't broke don't fix it*'. The proponents of a dominance test further commented that the actual application of the test is much more important than the wording, and that the Commission applying this test has stretched it to embrace the theories of harm even if it does not involve dominance *per se*. However, as the *Airtours* case[89] proves, these stretches might be insufficient providing the high burden of proof put on the Commission.

The second group, led by the UK, favoured moving to a SLC test declaring that the SLC should be introduced mainly because the dominance test did not cover all mergers with anti-competitive effects on competition[90] and would be better for taking into consideration efficiencies resulting from merger transactions. The opponents of the SLC based their views on the economists' opinions who argue that the dominance test focuses mainly on static structural considerations, such as a firm's size, and the concentration of industry without taking into sufficient consideration dynamic and behaviour issues[91].

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[84] Case T-77/02; No COMP/M.2282.
[85] Case T-342/99; No IV/M.1524.
[86] Case T-5/02; No COMP/M.2416.
[87] Green Paper on the review of Council Regulation (EEC) No. 4064/89, 11 December 2001, COM(2001) 745.
[88] Many Member States had already enshrined a dominance test in their national legislation.
[89] Case T-342/99; No IV/M.1524.
[90] For instance, oligopoly cases.
[91] For a further reading, see Green Paper, *ibid*, fn. 85.

The third group supported a hybrid-type test combining the language of both the dominance test and the SLC test in the manner found in the French, Greek or Spanish national laws (Fountoukakos and Ryan, 2005: 286).

Finally, after fierce debates[92], the new regulation opened a new chapter in the brief history of the EC Merger Regulation since 1989. The new substantive test was introduced with the new Merger Regulation[93], what can be referred to as a 'hybrid' formulation of the test, constructed essentially from the existing language of the old test but placing the emphasis on 'significant impediment of competition' at the centre of the new test, while reserving the notion of dominance as an example of a competitive harm (Fountoukakos and Ryan, 2005: 287). Article 2 (3) of 139/2004 Regulation provides, that *'[..] a concentration which would significantly impede effective competition, in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market'*. The old dominance test has been replaced by the 'significant impediment to competition' test (thereafter the SIEC test). Despite the fact that the same two limbs were left, the main parameter for the assessment is not on dominance but whether a merger would significantly impede effective competition (thereafter SIEC limb). For Fountoukakos and Ryan (2005:288) a two limbs test, at least semantically is transformed into a unitary one, with one central standard, that mergers leading to an impediment to effective competition should be declared unlawful. According to the new substantive test, establishment of dominance is no longer a prerequisite to block a merger, but just a supportive element in assessing whether the merger leads to a significant impediment of effective competition. It focuses more clearly on the effects on competition (including dynamic aspects) rather than the market structure (otherwise static market effects), as was the case with the previous regulation and is still used by the Competition Authorities of the Baltic countries.

Riesenkampff (2004:718-727) distinguishes three distinct goals for the rationale of the new substantive test. The first goal is to close the gap in the dominance test, second - to harmonise with the US antitrust law and the final goal is to ensure legal certainty through the reference to the creation or strengthening

[92] The author here refers to the major disputes in the Council of Ministers.
[93] No. 139/2004.

of a dominant market position. As regards the first goal, the new test is broader compared with its predecessor, as it extends and covers situations where there are no dominance issues, but competition concerns nonetheless may result from the existence of a non-collusive oligopoly. This new element is regarded as the convergence with the SLC test and brings closer to the jurisdictions applying the SLC test and will obviously facilitate the alignment between the Commission's and the US Competition Authorities' (i.e. US Department of Justice and the Federal Trade Commission) policies (Werner, 2004:685; McDavid and Hatton, May 31, 2004). The application to non-collusive oligopolies of the new test will also facilitate the Commission's work, due to the fact that there will be no task to prove lasting, tacit co-ordination (Werner, 2004:685). This in return will assist to avoid mistakes like it was in the *Airtours / Commission* case[94]. However, Riesenkampff admits that despite the similarities in the assessment criteria for merger transactions in the EU and the US jurisdictions and now even the language of the substantive tests, there can still be diverging decisions of both authorities due to the fact that the effects on competition may be evaluated differently on both sides of the Atlantic. For legal certainty, the Commission left the concept of the creation or strengthening of a dominant position as an example of significant impediment of effective competition in order to preserve the Commission and Courts' past practice[95]. According to Riesenkampft (2004:727), the retaining evaluation criteria for a merger in article 2 (1) of the ECMR indicate that the same standards for the assessment of merger transactions will also be used in the future. For instance, the first element of the assessment is whether the merger creates or strengthens a dominant market position, and if this is the case, a significant impediment to effective competition can be assumed without a further examination. This approach offers an advantage for the jurisdictions which still apply a dominance test. However, the researcher argues that this approach serves as a disadvantage rather than an advantage for the Baltic states with small market economies, where in some sectors only dominant firms may be efficient and the evaluation of whether a merger may significantly impede effective competition should play a major role rather than focusing on dominance. Hence, the first

[94] Case T-342/99, 2002 E.C.R. II 2585.

[95] See recitals 25 and 26, the ECMR 139/2004.

element in the assessment of a merger case should be placed on the SIEC limb[96] rather than on dominance, which is no longer a necessary requirement and therefore can no longer be characterised as a 'legal straight-jacket' that all competitive scenarios must wear[97].

The reform of the merger control mechanism within the EC jurisdiction has also involved the re-organisation of DG-Comp[98]. This has included allocating cases along sector lines, where staff with prior knowledge and understanding of the particular sector would handle the case, the establishment of the peer review panel in order to increase the checks and balances into the system[99] and the introduction of the chief economist office (otherwise, Chief Economist Team – CET, where Lars-Hendrik Roller, the first incumbent Chief Economist) to strengthen the economic analysis.

1.2.7.4. Treatment of efficiencies within the EC

In conjunction with the new substantive test, the Horizontal Merger Guidelines were introduced, which have explicit provisions on efficiency issues. The Commission indicates that efficiencies may be considered as a counterbalance to anti-competitive effects providing these efficiencies benefit the consumers, they are merger-specific and likely to materialise, and substantial enough to outweigh any anti-competitive effects of the proposed transaction[100].

According to Lowe, the Commission's decision on taking efficiencies into account more explicitly is a result of natural development. First of all, the European Commission is still regarded as a relative new-comer to merger control mechanism and in its early days the main concern was purely on applying the

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[96] The discussion above provides a theoretical approach towards two possible interpretations of the EC new substantive test. The EC practice shows that the primary stage of merger analysis addresses the issue of possible market power. However, the testing does not stop once dominance is found. Further steps are taken by evaluating efficiencies and dynamic factors. The Commission may be tempted to place too much emphasis on the dominance limb; this would undermine the role of the significant impediment of competition once dominance is found.

[97] The researcher agrees here with the interpretation provided by Fountoukakos and Ryan (2005).

[98] Directorate General for Competition.

[99] This measure was put into effect in 2002 before the regulation of 139/2004 came into force.

[100] Accepting the conditions for the efficiencies the Commission followed the US approach, where similar conditions are set up in the US Merger Guidelines.

dominance test, without any consideration on industrial policy[101]. For instance, in the previous statements (i.e. in 1996 in the Competition Policy and efficiency claims in horizontal agreements, OECD) the Commission stated that *'[..] there is no real possibility of justifying an efficiency defence under the Merger Regulation. Efficiencies are assumed for all mergers up to the limit of dominance – the 'concentration privilege'. Any efficiency issues are considered in the overall assessment to determine whether dominance has been created or strengthened and not to justify or mitigate that dominance in order to clear a concentration which would otherwise be prohibited'*[102]. This position had reflected in some Commission's decisions, where the claims of efficiencies were considered as 'offence' rather than 'defence'[103]. The Commission was reluctant to take into account efficiencies to counter-balance the anti-competitive effects of mergers under 'development of technical economic progress' provision, article 2 (1)(b) of the old ECMR[104]. However, this approach has changed. The wording of article 2 of the new ECMR better expresses an effects-based competition test. Furthermore, recital 29 provides that *'[..] it is possible that the efficiencies brought about by the concentration counteract the effects on competition, and in particular the potential harm to consumers, that it might otherwise have and that, as a consequence, the concentration would not significantly impede effective competition'*. The commissioner Lowe (2002) stated that the Commission now has sufficient experience and knowledge to make its merger review process more sophisticated and finely-tuned to merger-specific efficiencies cases. This development of the assessment of efficiencies is in line with the endeavour of the Commission to enhance its economics based analysis in merger cases[105].

The following sections involve the analysis on the remaining part of this thesis – the Baltic countries. The analysis is about the development of the competition

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[101] As presented during the Fordham Annual Antitrust Conference, New York, 30-31 October, 2002

[102] OCDE/GD(96)65 available at web-site: http://www.oecd.org

[103] See, for instance, cases IV/M.050 *AT&T/NCR*, 1991; IV/M.130 *Delta Air Lines/Pan AM*, 1991 etc.

[104] Nonetheless, some scholars and the Competition Commissioners, as V.Verouden, expressed that there was no need to change article 2 of the ECMR for the purpose of analysing efficiencies. Verouden, Merger Analysis and the Role of Efficiencies in the EU, FTC and U.S. DOJ Merger Enforcement Workshop, Washington, DC, February 17-19, 2004.

[105] For further discussion, see speech of Lowe P. delivered on the 30th October 2002.

policy and law, including merger control regime, in the Baltic countries by complying the EC model.

1.3. Introduction to the Baltic countries legal systems

1.3.1. Overview

Historically, the Baltic countries had come a long way from socialism, as a part of the Soviet Union, to civil law legal systems after gaining back their independence. With the collapse of socialism and the beginning of a new independent era the Baltic countries faced lots of changes in an economical, political, social and cultural climate. For the transfer to a civil law legal system the Baltic countries were required to resurrect and bring up to date their own Constitutions[106] from the 1920's together with the rule of law and the basic principle of democracy, to modernise codes, statutes and the normative acts, to restructure their public institutions and court systems. They also had to introduce and implement the rules and institutions of a market economy and finally after signing the European Agreement with the EU in 1995 Estonia, Latvia and Lithuania had to honour their commitment to the EU policy and to implement the *acquis communautaire*. The European Union was not only a unique chance for the Baltic countries but also a huge challenge. First of all, under the Molotov-Ribbentrop pact, the Baltic countries were officially distributed to the Soviet Union itself and disappeared as states and societies for 50 years. As a consequence the Baltic countries gained the bad inheritance of the Soviet system. This included an unstable economy together with high inflation and the big state monopolies, a collapsed social system, an unstable political situation with changeable government[107], chaotic legislation, big bureaucracy and corruption. Then, over ten years after their independence the Baltic countries have been clearing up the inheritance of the Soviet system, using massive reforms.

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[106] The Estonian Republic Constitution was adopted by the popular elections held in June 28, 1992. The Constitution of Latvia was reintroduced in 1991. The Constitution of the Republic of Lithuania was approved by the citizens of the Republic of Lithuania in the referendum on 25 October 1992.

[107] Note: from 1990 to 2000 the Government in Lithuania has changed five times.

Before discussing the reforms for the implementation of *acquis* and the merger control mechanism as a part of it, the researcher considers that more detailed historical analysis of each country is required in order to expose the knowledge of who and what the Baltic states are, their differences and similarities.

1.3.1.1. Historical synopsis of Estonia

Centuries of struggle for identity and independence are the hallmark of Estonia, which is similar to the rest of the Baltic countries. The land, which is now within the boundaries of the Republic of Estonia was ruled by outsiders for most of its history (Unwin, 2000:133-134). The nation of Estonia was first settled in 2,000 B.C. and remained independent until the 13th century, when the Pope called for a crusade against the Baltic countries and Estonia was overrun by Danish and German knights (Williams, 2 May, 1997[108]). From 1558 onwards, Estonia became the battleground for Denmark, Sweden, Poland and Russia. Sweden came out as the winner and the Swedish kingdom took control over Estonia until the beginning of the 18th century when Estonia was given over to the Russian empire. The 19th century blew the winds of numerous national movements throughout Europe. Estonia was no exception to this. The 19th century was the period of national awakening. Estonians preserved their identity through foreign dominations and finally reached victory during the War of Liberalisation in 1918-1920 fighting the Soviet Russia. On 24 February 1918 the Estonian Republic was proclaimed[109]. The Soviet Russia signed a peace treaty with the parliamentary Republic of Estonia recognising its independence in perpetuity. However, freedom lasted until 1939 when the independence of Estonia and the other Baltic countries were curtailed by the signing of the Molotov – Ribbentrop Pact between Nazi Germany and the Stalinist regime (Williams, 2 May, 1997; Ministry of Foreign Affairs of Estonia, 27 May, 2004). Estonia was occupied by Soviet troops, then by Germany and finally by the Soviet Union for the second time in this period. Estonia's attempt to restore independence was unsuccessful with the loss of tens of thousands of Estonians citizens. A part of the Soviet plan was to abolish Estonian

[108] Available at web-site http://www.geocities.com
[109] For further reading, see the publications of the Ministry of Foreign Affairs of Estonia available at web-site http://www.vm.ee

statehood, including its national elites. As a consequence of the deliberate policy of genocide, a large Russian ethnic population still exist in Estonia [110]. Furthermore, the aim of the Soviet leaders was *'[..] to transfer the entire nation – political structure, society, economy, education, media and cultural establishments – to the Soviet system'* (Jakobson, 17 May 2004). The imposition of a command economy with centralised decision - making from Moscow, forced industrialisation and agricultural collectivisation policies. During the Soviet rule the industry and trade of Estonia was highly influenced by the Soviet Union (Unwin, 2000:134). The introduction of the reforms such as *glasnot* and *perestroika* by Gorbachev gave impetus for Estonians to re-gain their independence. In November 1989 the supreme council of the Estonian SSR announced that the 1940 resolution by which Estonia was declared a part of the USSR was null and void. Eventually, Estonia re-gained independence in August 1991 (Unwin, 2000:135).

1.3.1.2. Historical synopsis of Latvia

Latvia was originally settled by the descendants of an ancient group of people known as the Balts. The Baltic tribes came into Latvia in approximately 2,000 BC and are regarded as the ancestors of Latvians and Lithuanians (History of Latvia, 1993[111]). Despite the fact that the area was mentioned at least as early as the 1st century AD in connection with the amber trade with the Roman Empire, the territory which at present is known as Latvia occurred during the 6th century when East Baltic tribes were driven westwards by the Slavonic Kryvycy (Danta, 2000:196). Similar to the situation in Estonia, Latvia was ruined by outsiders over centuries. The Knights of the Sword, who became a part of the German Knights of the Teutonic Order in 1237, conquered all of Latvia and ruined it for three centuries. Latvia was partitioned between Poland and Sweden from the mid- 16th to early 18th century, until annexed by Russia at the end of the 18th century[112]. Taking advantage of the 1917 Bolshevik Revolution, Latvia proclaimed

[110] In 1934, there were 88.1% ethnic Estonians living in Estonia. By 1989, this number had dwindled to 61.5% (Ministry of Foreign Affairs of Estonia). The number has changed recently as the majority of Russians accepted Estonian citizenship.
[111] Available at web-site http://www.eunet.lv/VT/history.html
[112] For further reading, see History of Latvia: a brief synopsis, available at web-site http://www.latvia-usa.org/hisoflatbrie.html

independence on 18 November 1918. Eventually, after a period of fighting, the Soviet Russia and Germany recognised the independence of Latvia. By 1922 Latvia had a constitution and was on its way towards establishing an independent state (Danta, 2000:196). However, similar to the situation in Estonia, Latvian independence was abolished by the invasion of the Red Army in Latvia after signing the Non-Aggression Treaty of 23 August 1939 between the Soviet Union and Germany with its component – the secret protocol (well known as the Molotov – Ribbentrop Pact). According to this Pact, Eastern Europe was divided into German and Soviet influence: '*[..] in the event of a territorial and political rearrangement in the areas belonging to the Baltic States (Finland, Estonia, Latvia, Lithuania), the northern boundary of Lithuania shall represent the boundary of the spheres of influence of Germany and the U.S.S.R.*' (Molotov-Ribbentrop Pact (1), as quoted by Dr. Feldmanis[113]). The Russification and the Soviet – style administration resulted in mass deportations (35,000 in 1940 and about 100,000 mainly in 1949), disposal of most private property, forced industrialisation, collectivisation of agriculture and the relocation of ethnic Russians into the country, which eventually changed the proportion of natives from over three – quarters to over one – half[114] (Danta, 2000:197). Also, the Soviet strategy was to integrate the economy of Latvia into the rest of the Union by making the country dependent on the Soviet Union's resources and products, and to block the path for the State independence[115]. After 50 years of the occupation, the legislature of Latvia passed a declaration of independence and by late 1991 Latvia's independence was recognised internationally.

1.3.1.3. Historical synopsis of Lithuania

Lithuanians share the descendants of the Balts with Latvia, who moved to the western shores of the Baltic Sea in approximately 2,000 BC. For the first time Lithuania was mentioned in 1009 AD in the Quedlinburg annals and Lithuania as a state emerged in the early 13th century after the union of the main lands (Short

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[113] Available at the ministry of Foreign Affairs of Latvia web-site http://www.am.gov.lv

[114] Latvians - approximately 56%, Russians - approximately 32% (2003). The number has changed recently as the majority of Russians accepted Latvian citizenship.

[115] For further reading, see Danta, Latvia, published in Europe goes East, edited by Hall and Danta, the Stationery Office, 2000, pp.192-202.

Lithuania history[116], Lithuanian Home Page[117], 2000). Unlike the situation in Estonia and Latvia, the medieval period of history of Lithuania was marked by territorial expansion. As a response to the threat of Germanic Knights, in particular the Teutonic Knights, the Grand Duke of Lithuania Mindaugas, who became the first King of Lithuania after the adoption of Catholicism, created the Grand Duchy of Lithuania from the 1230s to 1240s (Danta, 2000:206). In contrast to Estonia and Latvia, at the end of 14th and the beginning of 15th century Lithuania became one of the most powerful states in Eastern Europe with territory from the Baltic Sea to the Black Sea. However, the growing pressure from Russia, forced Lithuania into closer union with Poland. The Union of Liublin was formed in 1569, which sealed Poland and Lithuania into a Commonwealth – *Rzecspospolita*. The agreement created a Commonwealth Republic of two nations, which shared one King and a joint legislature. Despite the union, Lithuania's state sovereignty was preserved by having its own treasury, currency, army and laws. Afterwards, Lithuania experienced the stability from wars, which in turns helped the development of agriculture, the founding of towns, the rise of culture and education and the codification of law (Danta, 2000:207). Three Lithuanian Statutes were issued in 1529, 1566 and 1588, which had an unusual legal nature, containing elements of the state law. However, in 1795 Lithuania was incorporated into Russia, which began a process of cultural assimilation and also banned the Lithuanian language be used in any prints (from 1864 to 1904). After fighting for more than one century against tsarist oppression, on 16th February 1918 Lithuania proclaimed the act of independence and restoration of statehood, and was recognised by the largest states of the world as the independent state of Lithuania. During the 1918-1939 independence Lithuania had a constitution, introduced the national currency ('Litas'), passed laws that were favourable to the national economy and financial system, organised land reforms, and developed its industry. However, similar scenarios to Estonia and Latvia were repeated in Lithuania, when the Molotov – Ribbentrop Pact opened the door for the Soviet and German occupations. The familiar process of establishing totalitarian rule and exiling Lithuanians to Siberia began (approximately 130,000 of the population was deported). Soviet planning brought to Lithuania a large – scale intensive

[116] Available at web-site http://www.litnet.lt/litinfo/history.html
[117] Available at web-site http://neris.mii.lt/homepage/liet1-1.html

industrialisation together with a tight economic integration with the Soviet Union (Danta, 2000:207-208). The country's economy was developed solely on the occupying regime, by the implementation of a giant complex of manufacturing equipment, machine tools, chemicals, processing metals and many more others, which did not reflect Lithuania's needs.

However, taking advantage of the weakening state of the Soviet system, some representatives of the intelligentsia of Lithuania founded *Sajudis*, a democratic movement, which led Lithuania into independence. Thus, this independence was declared on 11 March 1990. Despite the declaration, only after the Soviet intervention, which resulted in the killing of 15 unarmed civilians in Lithuania, and after the Moscow Putsch collapsed, Lithuania won international recognition and was admitted to the United Nations on September 17, 1991 (Lithuanian Home Page, 2000).

The history of the Baltic states proves that these countries are not newly formed countries in Europe, but their existence counts for centuries together of struggles for identity and independence. It also shows what the Baltic countries are and what historical inheritance they brought to the EU.

Furthermore, some historical facts also give the reason to believe that the idea of integration in the Baltics arose not in the 20th century[118] but many years ago. This look back into history of Lithuania raises some thoughts that the origins of European integration with regards to trade can be found within the letters of grand Duke Gediminas in the 14th century. In the 16th century the three Lithuanian Statutes, which were common to the different nations, or in 1791 the issue of the first Lithuanian–Polish Constitution applicable to both nations show some trends towards integration. Finally, in the 20th century Lithuania and the other Baltic countries had a chance to contribute their parts into the EU, which integrated not only two or four countries but twenty five with a possible enlargement in future (Landsbergis, 2002:7-15). The president of Estonia A.Ruutel in explaining the desire of Estonia to join the EU also mentioned the earlier ties with Europe by

[118] The author here refers to the primarily thoughts of the Baltic states to join the EU.

stating that the Estonian culture has been connected with European culture for centuries (Ruutel, 2004[119]).

However, in order to accomplish the idea of integration and come back to their European roots, the Baltic countries have had to take further steps. The integration process into the EU has been a big challenge for the Baltic states, which has taken time to deal with. Obviously, massive reforms have been involved in the preparation for the membership into the EU. Nevertheless, the magnetism of going back to their roots and being a part of the united Europe has been a major force in all of the reforms.

1.3.2. The reforms in the Baltic countries

The collapse of the Soviet empire gave the opportunity for Estonia, Latvia and Lithuania to re-gain their independence. In 1991 Estonia, Latvia and Lithuania announced their independence. There were two basic trends that the Baltic countries could turn to, one towards the East and another towards the West. The decline of the Communist system and the collapse of the Soviet bloc have not led to political tranquillity. Some impulsion which has led the Eastern European states (including the Baltic countries) to look to the EU has been the fear of political instability together with the possibility that, if the Yeltsin regime failed, Russia might lurch violently to the left and right (Swann, 1996:184). '*These have been the broad influences which have helped to propel the European Community forward*' (Swann, 1996:184). After being in occupation for 50 years in the Soviet Union, the Baltic countries turned towards the West. The European Union seemed to be the best gate-way to the Western economy. After re-gaining their independence in 1991 and gaining recognition by the European Community the same year, the Baltic countries commenced the first contacts with the European Community. The signing of Free Trade Agreements with the European Community and its Member States were the first steps of the Baltic countries to accede to the European Union[120]. Shortly after the Baltic countries signed the

[119] Available at web-site: http://www.baltictimes.com./spec_ee.php
[120] The Free Trade Agreement Estonia, Latvia and Lithuania signed in 1994 and it came into force on 1 January 1995.

Association Agreements[121] (European Agreements) and committed themselves to make their laws conform to the existing and future legislation of the European Community. Moreover, the Commission in the White Paper on the preparation of the Associated Countries of Central and Eastern Europe for integration into the internal market of the Union clearly stated that the competition policy on effective enforcement thereof must be considered as a pre-condition for the opening of the wider internal market and therefore the ultimatum of accession to the EU (Van Miert, June 1998). After meeting the pre-conditions for membership, the final step into the EU was left for the citizens of all Baltic countries to decide. Referendums were held in Estonia, Latvia and Lithuania, where their citizens voted for 'yes' to the membership into the European Union.

However, the turn towards the EU integration has been as a new revolution for the Baltic states. Since 1989, after the disintegration from the Soviet bloc, the Baltic countries have turned from the Socialist legal systems to civil law legal systems inspired by Western Europe. The Baltic countries were under the obligation to reform their legal systems and to adjust their economies to the market conditions. These countries had to exile themselves from the Socialist law and legal thinking which have had a profound influence of the ex-bloc countries. The system of law that existed in the former Soviet Union is referred to as the socialist legal system, which served '*as the communist system's prototype*' based on the Marxist – Leninism theory (De Cruz, 1998:183). The difference from the civil law legal system is that law and economy is highly integrated in the socialist legal system. For Tchikvadze, '*[..] to dissociate law and legality from the economy, to analyse the legal system independently of the existing economic relations is therefore incompatible with the basic principles of Soviet legal science.*' (Tchikvadze, 1961:206, as quoted David and Brierley, 1985:210). Furthermore, in contrast to the civil law and legal systems, the respect for law as the policy instrument of the leaders of the Soviet Union was a major social concern. As Lenin, the leader of Communism stated that there was only public law in the Soviet law (David and Brierley, 1985:212-213). Generally, the vision of the basic form for the Soviet economy as defined by Stalin was state socialism

[121] Free Trade agreement was incorporated into the European Agreement.

and central planning under the direction of the Communist Party (Milgrom and Roberts, 1992:13).

After re-gaining their independence, the legal systems of the Baltic countries have developed gradually towards civil law legal tradition: starting with the fundamental law of the State - the Constitution and further going to the reforming of the major codified areas of law such as civil, administrative and criminal law and the creating of a new area of law - competition law, including merger control mechanism. The introduction of a competition policy in the Baltic states, has been one of the major challenges, which these countries had to face in the transition to fully-fledged market economies.

With regards to economic issues, the Baltic countries, as a part of the Soviet empire, were guided by a central planning system. The scholars exploit different terms to describe the soviet system. Gregory and Stuart, for instance, stated that the soviet system had developed the 'planned socialism' as *'[..] public ownership of the factors of production. Decision – making is centralised and is co-ordinated by a central plan, which offers binding directives to the system's participants*' (Gregory and Stuart, 1994:29)[122]. The planned socialism was based on Marxist-Leninist doctrine, with the planned economics governed from Moscow. Enterprises and their managers and workers in the Soviet system were rewarded for achieving the goals set by the political leadership. Even the prices were set centrally and were often controlled for political and administrative purposes (Bradshaw, 1996:266)[123]. Moreover, the prices were not allowed to direct resources to their highest value uses, as favouring purchases from low-cost producers and supplying the goods where the shortage is. Instead, planners in Moscow decided how much goods had to be produced, where inputs were to be obtained and where outputs had to go, and finally, what prices were to be paid (Milgrom and Roberts, 1992:13-14). The market principles with prices being set up by the demand – supply curves plus other competition issues were non-existent in the Baltic states. Moreover, a common feature of centrally planned economies is the existence of large companies (even monopolies) whose size was not determined by what the market can bear. Thus, in-effective monopolies were

[122] For further reading, see Gregory, R.R., Stuart, R.C., Soviet and post-Soviet economic structure, 5th ed., Harper Collins, New York, 1994, pp. 29.
[123] As published in Daniels, P.W., Lever, W.F., The Global Economy in transition, Longman, 1996.

another inheritance from the Soviet system that the Baltic states had to deal with. However, as it was stated above, the Baltic countries rejected a Soviet state socialism as a model for political and economic development and turned towards the Western system by establishing democratic political institutions and market-type economic systems. The task was hard, as these countries had to overcome an inheritance of central planning.

During the transition period, the period from the planned economy to the market-economy, the Baltic countries were required to go through different dimensions. Bradshaw (1996) classified four main phases of transition, such as stabilization, liberalization, privatisation and internalisation. The Baltic countries have been going through all these stages during the transition period. They had to achieve macroeconomic stabilisation, which is the balance of the economy, as in terms of the level of money incomes and the supply of goods, and also in terms of the difference between government expenditures and revenues (Bradshaw, 1996:277). Then, they had to reach economic liberalisation, which generally refers to the removal of government restriction on economic activity. There was a need to free prices from state control and allow them to find their market level[124]. The third stage involved the creation of 'private sector' and privatisation processes, which are still in progress. There have been a number of merger transactions in the Baltic states, which have occurred as a result of the privatisation. The Competition Authorities in the Baltic states did not have authority to block these transactions, which merely resulted in the transfer of a public monopoly to the private sector. Nevertheless, the Competition Authorities of the Baltic states may impose fines if a monopolist firm abuses its dominance. For instance, in Lithuania after the privatisation, fines were imposed for the abuse of a dominant position on AB *Mazeikiu nafta*[125] and AB *Lietuvos Telekomas*[126]. The next stage, which is still an ongoing process in these countries, is internationalisation. Internationalisation refers to foreign trade relationships. Economic integration in centrally planned economies is fundamentally different from the integration among market economies. In market type economies or otherwise Western economies international commerce is conducted by private

[124] For a further reading, see Daniels and Lever, pp.278.
[125] 10/07/2000, available at web-site: www.konkuren.lt
[126] 21/02/2002 No.2/b and 22/12/2000 d. No.16/b.

enterprises seeking profit opportunities everywhere in the world, where they can get a better deal. A reduction in or elimination of barriers to the movement of goods, services, capital and other factors of production go across national borders areas a long way towards integration. By contrast, in centrally planned economies all these movements across national borders require an explicit action by the government involved (Marer, 1984:160-161). According to the Soviet system, this is due to the fact that the state exercises a monopoly over foreign economic relations and *'[..] this state monopoly had the advantage of enabling foreign trade to be used to serve the needs of the political leadership'* (Daniels and Lever, 1996:278). Thus, it in turn led to isolating domestic enterprises from the competitive pressures of the international economy, as was the case with the Baltic states. These countries were placed apart from competition pressure and were left in a worse position in comparison with Western companies. When the Western European companies were gaining knowledge and experience of how to survive in the market economy by competing with strong competitors, the Eastern European companies, whereas, acted under dictation from the Soviet Union without having any concerns about competition. Another disadvantage of the Baltic states in comparison with Western firms is a competitiveness of companies. According to the theory, companies, which were isolated and stayed behind from international competition, ran a risk of losing their competitiveness. If firms were making or buying products in their local ('home') markets instead of finding a better or cheaper place elsewhere, they were undercut or taken over by their rivals (Block, 1977:20). The Baltic countries were isolated from such an opportunity while being a part of the Soviet system. The membership of the EU unlocked the possibility for the firms in the Baltic states to increase their competitiveness on one hand. However, on the other hand, many local companies were taken over by foreign companies[127].

[127] The further discussion will continue in chapter 3.

1.3.3. The implementation of *acquis communitarian* in the Baltic countries

This section of the research is concerned about the relationship between the Community law and the law of the Baltic countries, as to what extent the Community law is applicable in the Baltic states' legal systems.

Theoretically, the law of each country decides to what extent international law is applicable and has the effects in the legal system of that country (Jacobs and Roberts, 1987:xxiv). With regards to international law, the Baltic countries will not implement or ratify an international treaty or organisation, which contradicts the main principles of the Baltic countries' constitutions. For instance, the Republic of Estonia does not conclude foreign agreements that are in conflict with the constitution (article 123, the Estonian Constitution[128]). Similarly, the Republic of Lithuania will participate in international organisations provided that they do not contradict the interests and independence of the State[129].

Furthermore, when countries sign a treaty they normally agree to achieve a certain result, however, the states may still have the right to determine the means on how to implement it. If the achievement of the result involves changing national law, the law will decide whether it will come directly from the treaty ('monist' situation) or whether additional law is required to implement the treaty ('dualist' situation) (Hartley, 2003:192). The Baltic countries would more likely be referred to so called 'monist' countries rather than 'dualist', where under the latter system direct effects of a treaty are impossible without a further set of legislation to give effect to the treaty in question. A good example of a 'dualist' country is the UK, where the section 2(1) of the European Communities Act 1972 gave effects to all provisions of Community law (both already adopted and those, which will be adopted in future) (Barnett, 2002:290-291). Meanwhile, the law in the Baltic countries provides that once the Treaty or other International law tool is ratified, the international law obligations are of the same nature as national law obligations. For instance, article 138 of the Lithuanian Constitution states that *'[..] international agreements which are ratified by the Seimas of the Republic of Lithuania* (the Parliament of the Republic of Lithuania) *shall be the constituent part of the legal system of the Republic of Lithuania*'.

[128] Constitution of Estonia, article 123.
[129] Constitution of the Republic of Lithuania, article 136.

However, despite the fact that the European Community law is based on the Treaty, the situation is different with the EU in comparison with other international treaties or other international obligations due to its specific nature. As the Court of Justice provided the Community law has direct effects in the national legal systems of the Member States, as by signing the Treaty the Member States have limited their sovereign rights. Thus, by signing the founding Treaty of the EU the parties agree not only to achieve a certain result but also consented on the means by which it would be brought; this in turn can be considered that all Member States undertook to adopt a 'monist' situation (Hartley, 2003:193). The supremacy of Community law over national law has caused a lot of debates in most of the Member States. However, the Community law cannot apply in the legal systems of the Member States unless the Member States express it, i.e. by signing the Treaty. For instance, in the United Kingdom in the case *Thoburn / Sunderland District Council*[130] it was stated that the European Union law depends on the United Kingdom law and not on the EU law. Or in *Brunner / European Union Treaty* decision[131] the German Federal Constitutional Court stated that European Community law applies in Germany only because the German laws ratifying the Community Treaties said so. A similar scenario was in the Baltic countries, when the question of membership was left to the people of these countries to decide. There the referendums in all Baltic countries resulted in favour of membership into the EU.

The discussion above proves that European Community law can have effects in Member States only by virtue of the national law of each Member State (Hartley, 2003:191-196). However, all rules and regulations of the Member State national law cannot contradict to their constitutions, which is the highest law of the hierarchy in their legal systems. For instance, according to article 7 of the Lithuanian Constitution[132], any law or other statute, which is in conflict with the Constitution shall be invalid; similarly, article 3 of the Estonian Constitution[133] states that *'[..] the powers of state shall be exercised solely pursuant to the*

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[130] *Thoburn v Suderland District Council*, (2002) 3 WLR 247 para 69.
[131] 12 October 1993, (1994) 1 CMLR 57 para 55.
[132] Constitution of Lithuania, article 7, available at web-site http://www.lrs.lt
[133] Constitution of Estonia, article 3, available at web-site http://www.president.ee/en/estonia/?gid=10760

Constitution and laws which are in conformity therewith'. It means that the Community law will not be valid if it contradicts the constitution of a Member State. If the constitution imposes some limits on the supremacy of the European Community law, then the constitution has to be amended, otherwise, the supremacy of the Community law will not have the desired effects. The example in the Baltic countries illustrates such a scenario. Before the joining the EU the Baltic countries were required to amend their Constitutions in order to give 'direct effects' to the Community law. For instance, the Parliament of the Republic of Lithuania issued the Constitutional Act[134] which delegated to the European Union some competencies of its State institutions in the spheres provided in the founding Treaties of the European Union in order to meet the commitments in these areas. This also recognised that the norms of *acquis communautaire* of the European Union are an integral part of the legal order of the Republic of Lithuania and in the case of a collision between the norms of the Community and Lithuania, the Community's norms prevail over the laws and other legal acts of the Republic of Lithuania.[135] Estonia also issued the Constitution Amendment Act, which states that *'[..] as of Estonia's accession to the European Union, the Constitution of the Republic of Estonia applies taking account of the rights and obligations arising from the Accession Treaty'*[136].

Although the constitutions of the Member States delegated some sovereign powers to the European Community, these powers are not open-ended, as they have to be defined in advance and the Community cannot extend its powers, as it is a case, for instance, in Germany (Hartley, 203:195). The German Federal Constitutional Court ruled if any measure issued by the Community contradicts the German principle *Kompetenz – Kompetenz*, such measure would be inapplicable in Germany[137]. Similar provision can be found in the Constitution of Latvia, which states that *'[..] substantial changes in the terms regarding the membership of Latvia in the European Union shall be decided by a national referendum if such referendum is requested by at least one-half of the members of*

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[134] Note: constitutional acts in Lithuania have the same importance as the Constitution.
[135] Constitutional Act of the Republic of Lithuania on Membership of the Republic of Lithuania in the European Union, 13 July 2004, No. IX-2343, para 2.
[136] The Constitution of the Republic of Estonia Amendment Act, passed 14 September 2003.
[137] For further comments, see *Brunner v European Union Treaty*, 12 October 1993, (1994) 1 CMLR 57. Also see Hartley, the Foundations of European Community Law, Oxford, 2003, pp.193-195 for the comments on this case.

the Saeima (Latvian Parliament)*'*. An example of '*significant change*' can be the introduction of the EU Constitution. However, the Latvian President, Ms Vaira Vike-Freiberga, expressed that there is no need to put this question forward to a referendum, as *'[..] it would not fundamentally change the content of the Accession Treaty, hence, Latvia's membership conditions'*[138]. A similar position was taken in Lithuania by the president V.Adamkus, who said that the European Constitution must be ratified by the *Seimas* (Lithuanian Parliament) and there was no need for a referendum. Lithuania became the first country in the EU to ratify the European Constitution (Political – Economical report, Lithuania, October-November, 2004)[139].

1.3.4. The Competition Law in the Baltic countries

The introduction of the competition law and policy in the Baltic countries started with signing the Europe Agreement, which provided a new framework for trade and related matters between the European Communities and the Member States on one side, and each Baltic state on a bilateral basis on the other. The European Agreements contained the main substantive competition rules, which applied if the trade between each Baltic state and the Community would be affected. These rules included the restrictive agreements, abuses of a dominant position and the provisions on state aid. However, the rules of merger control were not directly referred to in the Europe Agreements. Nevertheless the Competition Authorities of the CEEC, including the Baltic countries, were entitled to express their views according to the EC Merger Regulation, where the merger would have a significant impact on the economy of the CEEC concerned (Van Miert, 1998). This 'flexible' position of the Community towards merger control regime caused differences in the approaches taken by the Baltic countries towards the introduction of their merger control mechanisms.

The Competition law and policy was implemented in the Baltic countries as a part of the *acquis communautaire*. The adoption of the Competition Act[140] in

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[138] See Efler and Zdeb, Political probability of referendum on EU Constitution, available at web-site: http://www.european-referendum.org/countries/latvia.org

[139] However, the referendums in some Member States such as France and Holland disproved the EU Constitution. This question is still open.

[140] which was adopted on 16 June 1993 and came into force on 1 October 1993.

1993 was the first step in creating pre-requisites for protecting free competition in Estonia and marked a decisive change in the way of economic thinking. The Competition Board, which replaced a Price Board was established on October 21 1993, and was subordinated to the Ministry of Economic Affairs and Communications exercises state supervision in respect of compliance with the Competition Act in Estonia. In Latvia, the very first Competition Law came into force in 1991. The Competition Council, as the Authority to enforce competition law, came into being after the reorganisation of the anti-monopoly Committee on 18 June 1997 in accordance with the Competition Law. The first piece of legislation in the field of competition law in Lithuania was adopted on 15 September 1992 by passing the Law on Competition. The Competition Council was established to enforce competition law in Lithuania. Thus, the Competition Laws in the Baltic countries were introduced even before their application for the EU accession. In comparison to the EC competition law the Baltic states have a 'compact' version of the EC competition law and policy. In contrast to the EC, all competition issues in the Baltic countries are contained in one legal document, respectively the Competition Act in Estonia, Competition Law in Latvia and Law on Competition in Lithuania. Despite the fact that all Baltic countries share a similar approach to the introduction of competition laws, a different scenario in each Baltic state was taken with regard to the rules of merger control.

1.3.5. Institutional framework in the Baltic countries

Before the accession to the EU the Baltic countries had to show that competent competition authorities had been set up and that a credible enforcement record had been instituted. Likewise other candidate countries at that time, the Baltic countries had a high degree of flexibility in designing their competition authorities (White Paper, note 15). However, strong emphasis is placed on the requirement that competition authorities are independent and enjoy sufficient level of resources and expertise to deal with competition issues. This is because the links with government may have a detrimental impact on the business community's acceptance of decisions. Also, there is a need for independence from undue political influence to prevent corruption, which is still an issue in the Baltic countries, especially in Lithuania[141].

The first institutions dealing with competition issues in Lithuania were highly influenced by the government. The first Law on Competition in Lithuania empowered two state administrative bodies to deal with competition issues. The first body was the State Competition and Consumer Protection Office, a governmental agency, which had the status of a permanent executive institution. The second was the Competition Council, a separate entity set up by the government, which acted as a collegial decision making body applying sanctions for violations of competition (while all the preparatory and investigatory work was carried out by the Competition Office). Both institutions were governmental agencies lacking formal independence from the government. However, the institutional reforms introduced by the 1999 Law on Competition re-organised two competition organs into a single Competition Council. The current institution in Lithuania responsible for the enforcement of competition law, including merger control, is the Competition Council. Lithuania adopted an 'integrated agency model' - a single enforcement agency, which discharges investigative, enforcement and adjudicative functions (Geradin and Henry, 2005). The Competition Council is an independent public Authority of the Republic of Lithuania established by the Law on Competition of 1999. The Council's decisions are taken without any possibility of interference by the Government. The Competition Authority, namely, the Competition Council of the Republic of Latvia was founded in 1997 on the basis of the Latvian Anti-monopoly Supervision Committee. The Competition Council has been established by the Cabinet of Ministers and subordinates to the Ministry of Economics. Hence, formally, the Latvian Competition Council acts under the supervision of the Ministry of Economics. However, the Ministry of Economics does not have the power to influence the investigations and the decisions of the cases taken by the Competition Council of Latvia.

The Price Board in Estonia was re-named to the Estonian Competition Board in 1993. Two countervailing duties were imposed on the re-named body. The first duty was to supervise the compliance with the Competition Act, whereas,

[141] For further discussion, see chapter 3.

the second duty was to supervise the prices. Only after the process of liberalisation of prices came to the end, there was no need to monitor the price setting in Estonia (Proos, 2002). The current Competition Authority of Estonia is the Competition Board, which was transferred from the Ministry of Finance to the Ministry of Economic Affairs and Communications. The Estonian Competition Board is a governmental agency within the administrative jurisdiction of the Ministry of Economic Affairs and Communications. However, it could be considered that the Board acts as an independent body with regards to its role in decision-making process. In contrast to Latvia and Lithuania, the Estonian institutional model is based on a 'bifurcated judicial model'[142], where the Board's officials investigate the alleged competition law violation and the court adjudicates upon and enforces the competition law.

In addition, there are other ways in which government or ministry can exert an influence on the decision making process (Geradin and Henry, 2005). It can be done through cutting the competition authorities' budget, if the position held by the authority is contrary to the political interest. Conversely, the competition authority can be awarded an increased budget, if it adopts decisions in line with the government's interest. In order to avoid this problem it can be left to the Parliament to decide over the budget of the competition authority. The budget of the Latvian Competition Council is derisory, meanwhile, the Estonian Competition Board acts under the administration of the Ministry and, hence, the Minister decides over the budget. In Lithuania, the budget is decided by the Parliament. The appointment of the head members of the competition authority may be another example of the interference of the government. In Estonia the Minister appoints the Director General of the Estonian Competition Board. In Latvia, the Chairperson and four Council Members are confirmed in their office by the Cabinet of Ministers upon the recommendation of the Minister for Economics. Meanwhile, the Chairman and four members of the Competition Council of Lithuania are appointed by the President of the Republic of Lithuania according to the proposal of the Prime Minister. Thus, the analysis above shows that, theoretically, there is a possibility of the influence of government on the decision-making process of the Competition Authorities in the Baltic countries.

[142] As defined by Geradin and Henry, 2005.

In contrast to the EC, where the Court has played a major role in developing the competition law especially in its early days, the courts in the Baltic countries do not play a major role in developing the competition law and policy. The Court of Justice frequently enunciated broad principles and values without just limiting itself on the facts of individual cases. It has looked to the future and has guided the Commission in developing the competition law and policy. Meanwhile, the case in Estonia illustrates a different scenario. The Competition Board of Estonia in *Bread Bakers Union* case[143] issued an order to terminate the infringement, as not to meet to discuss bread prices, or to make any kind of decision to raise prices collectively, and thereby to refrain from entering into such discussions or agreements in future. The Board noted that although the members of the Union did not enter into agreement about price increases, nevertheless, they discussed prices amongst themselves and the necessity of prices increases during the Union's Board meeting in December 1995. Hence, the exchange of information about product prices, according to the Competition Board, would make it likely for them to be able to predict each other's behaviour. However, the Board's decision was quashed by the court. The Competition Board's decision was to pre-empt such behaviour in the future rather than applying specifically to the present case; however, the court rejected this view.

The courts of the Baltic countries have hardly had any practice with merger cases. For instance, in Lithuania due to the fact that merger cases have not been tested in court, there is slow progress of its development (Soviene, 2004[144]). The main competitor of Vesiga placed an appeal against the Competition Council decision of 1S-86 (2005), but the case was withdrawn.

[143] The decision of Competition Board on February 13, 1996. The decision of Court on March 29, 1996. For the comments, see Loor, Estijos Duonos Gamintoju konkurencija, pp. 89-92, as published in Lesser, Baltijos Valstybiu ekonomika: Pavyzdziu analize, Ansora, 1998.
[144] The information obtained during the interview at the Competition Council of Lithuania September 2004.

1.3.6. The development of the Merger Regime in the Baltic countries

1.3.6.1. Estonia

The first Competition Act of 1993 in Estonia enacted the principles of competition law and policy with respect to prohibition competition through the agreements and concerted practices, abuse of dominance, unfair competition and State Aid. However, it did not contain any merger control, similar to the EC policy where the merger control regime was not introduced until 1989, though other issues of competition law were incorporated in the Treaty of Rome. A merger regime in Estonia was introduced by passing the Competition Act in 1998. Precisely, it introduced a notification requirement for mergers if the aggregate annual turnover of the parties involved exceeded 100 million kroons or if the merging parties separately or jointly had control over more than 40% of the market[145]. However, the Competition Board of Estonia did not have an authority to prohibit mergers with possible anti-competitive effects until 2001 when the new Estonian Competition Act was issued. This new Act empowered the Competition Board to prohibit anti-competitive merger transactions. Thus, from 1998 to 2001 the Estonian Competition Board had worked as a Register body without actual power to enforce a merger control. The reason for this, as stated by Ms Margit Paddo[146], was to examine the Estonian market, gain some knowledge of it and prepare for the future work to deal with 'problematic' mergers. Also, the OECD Global Forum on Competition acknowledged that such information gained was a good practice before imposing a full control over anti-competitive mergers[147]. Apart from the power given by the Act on Competition of 2001 to the Competition Board to enforce a control over anti-competitive mergers, the Act of 2001 has also changed the thresholds for the notification: the requirement of 40% of the market control was abrogated and instead of that other conditions were introduced. According to article 21, the entities involved in a merger transaction have an obligation to notify if '*[..] during the previous financial year, the*

[145] Competition Act 1998, article 27 (1).

[146] Ms Margit Paddo, the official responsible for a merger investigation at the Competition Board in Estonia, who the researcher interviewed during my visit to the Competition Board on the 28th of September 2004.

[147] For full discussion, see OECD Global Forum on Competition, Contribution from Estonia, 04 Oct. 2001, pp.4.

aggregate worldwide turnover of the parties to the concentration exceeded 500 million kroons and the aggregate worldwide turnover of each of at least two parties to the concentration exceeded 100 million kroons and if the business of at least one of the merging undertakings or of the whole or part of the undertaking of which control is acquired are carried out in Estonia'. The new aspect of this Act was an introduction of an international element. As from the thresholds can be seen under certain conditions the foreign-to-foreign concentrations have an obligation to get approval from the Estonian Competition Board. On one hand this new element was welcomed from European or even international perspective as Estonia was ready to take a part in international market. However, on the other hand, this condition was problematic, because it did not specify when the merging undertakings were considered to be '*carried out in Estonia*'. This provision caused major problems for the Competition Board in 2002 where the majority of notified transactions were between foreign undertakings, even with modest business activities in Estonia. The Competition Board had a position that foreign undertakings take place in Estonia if they have registered a branch or a subsidiary here [148]. For instance, in *Metsalliitto Osuuskunta / Thomesto Oy* case [149] the Competition Board of Estonia dealt with the concentration between two Finnish undertakings, which had subsidiaries in Estonia. The permission to concentration was given in this case as the Competition Board came to the conclusion that the proposed concentration would not create a dominant position (Kalaus, 2002). Thus, this burden to deal with concentrations, which had little impact on the Estonian market, was unnecessary for the newly created Competition Board with little experience to enforce competition law. The sole relation to worldwide turnover was an example of 'un-rational' provision for merger control in the Estonian market. This shortage was solved by amending the Act in 2004, which provided explicit explanation of the term 'carried out in Estonia'.

From 1 October 2001 the Competition Board has an authority to prohibit concentration, provided that it may create or strengthen a dominant position as a result of which competition would be significantly restricted in the goods market[150]. In the Annual Report of 2000 it was stated that the Competition Act

148 Annual Report 2002.
149 No. 02-KO/2001.
150 22 (2), Competition Act of 2001.

establishes merger control but not prohibition of mergers. The Competition Board may prohibit the concentration or grant permission to concentrate, or by granting the permission to concentrate attach conditions and obligations directly related to the concentration for the parties to the concentration[151]. After the modernisation of the ECMR, there have not been any changes made on merger control provisions in Estonia. Nonetheless, the Competition Board is in the process of revising its merger control rules[152].

1.3.6.2. Latvia

The Competition law of 1998 in Latvia consisted of the prohibition of the agreements, which may distort competition in the Latvian market, abuse of dominant position and unfair competition. In contrast to the situation in Estonia, it also contained a merger control enforced by the Competition Council. The notification of proposed concentrations was introduced. However, the Competition Council of Latvia set up high thresholds for the notification: '*[..] the combined turnover of the participants in the merger during the previous financial year was not less than 25 million lati, and at least one of the merger participants was in a dominant position in the concrete market prior to the merger*'[153]. Two conditions had to be met in order to fall under the jurisdiction of the Competition Council of Latvia: (i) undertakings had to meet the thresholds and (ii) one of the merging parties had to have a dominant position. Hence, the only situation, where a merger can strengthen a dominant position was covered by the Competition Law of 1998. A merger, which may create a dominant position or lead to oligopoly, fell outside the jurisdiction of Latvia. This in turn can be considered that a merger control in Latvia was not so necessary as such 'problematic' concentrations could have been covered by the provision of an abuse of a dominant position, as was the case in the jurisdiction of the European Communities before the Merger Regulation came into force[154]. The further Competition Law of 2001 did not introduce any changes as regards the thresholds. The amendments to the

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[151] 27 (2) and (3), Competition Act of 2001.
[152] The amended Competition Act is due to be issued in June, 2006.
[153] Section 15 (1)(3), Competition Law.
[154] The articles 81 and 82 of the Treaty covered to some extent merger control rules before the ECMR came into being. For instance, *Continental Can* case.

thresholds was made in 2004 together with further changes to the Competition Law as results of the joining the EU and making the Law adequately in line with the 'new' Merger Regulation of the European Community. Thus, according to the current provisions on Merger Control in the Competition Law of Latvia, the Competition Council has a jurisdiction if *'[..] the combined turnover of the participants in the merger during the previous financial year was no less than 25 million Lats*[155]', or *'the joint market share of market participants involved in the merger exceeds 40% of the relevant market*[156]*'*. Therefore, the new 'foreign' element was introduced by clearly defining the market participant, as *'[..] any person (foreign person included) which performs or is preparing to perform business activities in the territory of Latvia or business activities of which may affect competition in the territory of Latvia*[157]*'*. This means that the Competition Council has a jurisdiction to review not only domestic mergers but also foreign mergers with 'spill-over' effects.

As regards the substantive test, analogous to the Competition Board of Estonia, the Competition Council of Latvia applied a dominance test. The section 16 (3) provided that a merger that creates or strengthens a dominant position, which will significantly hinder, restrict, or distort competition in any relevant market, shall be prohibited. According to the Competition Law of Latvia the market participant considers to be holding a dominant position in a concrete market *'[..] if such participant or the participants in this concrete market is at least 40 per cent and if such participant or such participants have the capacity to significantly hinder, restrict or distort competition in any concrete market for a sufficient length of time by acting with full or partial independence from competitors, clients or consumers*'[158]. To follow the modernisation within the EC jurisdiction, the substantive test for merger appraisal has been changed, as to the modified version of a dominance test, which will be further discussed in chapter 6.

[155] Section 15 (2) (1).
[156] Section 15 (2) (2).
[157] Section 1 (9).
[158] Section 1 (1).

1.3.6.3. Lithuania

The very first Law on Competition in Lithuania was introduced on 15 September in 1992. It contained prohibition of an abuse of a dominant position, restrictive agreements or coordinated activities, which may impede competition, unfair competition and it also included the control of concentrations of market structures. The compulsory notification of concentrations if they exceeded the thresholds established by the Competition Council was required. Any failure to notify the undertakings involved would result in fines. The first Law on Competition was enforced by the two institutions as aforementioned, which later were reorganised into the Competition Council of the Lithuanian Republic. However, there was a possibility to get an approval for a concentration by the written decision of the Government of the Republic of Lithuania[159] in case the permission to concentrate market structures had not been approved by the competition authorities. This involvement of the Government in Lithuania was annulled by the Law on Competition of 1999. The Competition Law of 1999 also introduced the thresholds, which are still applicable and provides that if *'[..] combined aggregate income of the undertakings concerned is more than LTL 30 million for the financial year preceding concentration and the aggregate income of each of at least two undertakings concerned is more than LTL 5 million for the financial year preceding concentration*', the firms involved in the transaction have to notify and have to gain the permission from the Competition Council of Lithuania[160]. In addition to these thresholds, the Competition Council of Lithuania may obligate the undertakings to submit notifications on concentration and therefore apply the merger control procedure even if these thresholds are not exceeded, where *'[..] it becomes probable that concentration will result in the creation or strengthening of the dominant position, or a significant restriction of competition in the relevant market*'[161]. This alternative jurisdictional expansion of the power of the Competition Council by the most recent amendments to the Competition Law was designed to address competition concerns with some markets (in particular services markets), which as the practice has showed may

[159] Article 11, Law on Competition, I-2878, 15 September 1992.
[160] Article 10, Law on Competition, No VIII-1099, 23 March 1999.
[161] Article 141, Law on Competition, No. VIII-1099, 23/03/1999 as amended by No. IX-2126, 15/04/2004.

have some anti-competitive effects even being below the thresholds defined in article 10[162]. Hence, the jurisdiction of Lithuania differs from Estonia and Latvia, and therefore from the EC, and applies both *ex-ante* and *ex-post* procedures. There is a widely accepted position to apply an *ex-ante* system because it can be difficult and costly to disentangle a merger, which has already taken place. Hence, unnecessary burden is placed on the merging parties in Lithuania. This provision has not yet been applied in the Lithuanian jurisdiction, thus, is not clear whether and how this rule will be enforced in practice.

The jurisdiction of Lithuania employs a dominance test. Article 14 (1) section 2 of the Competition Law of Lithuania provides, that the Council may permit *'[..] the implementation of concentration attaching to its decision conditions and obligations for the participating undertakings or controlling persons in order to prevent creation or strengthening of a dominant position*'. Despite the fact that after the modernisation of the ECMR, the Competition Council of Lithuania has modified the substantive test for merger appraisal, the focus is still on dominance[163].

Globalisation process has caused a surge of cross-border as well as domestic merger transactions within the jurisdiction of the EC. The Baltic countries are not an exception. After re-gaining their independence, these transactions have occurred in the Baltic countries. Thus, it was necessary to introduce a merger control regime in the Baltic countries in order to prevent the anti-competitive merger transactions. Different from the EC, where the merger control regime has been developed over time and it was introduced when the European firms had sufficient 'size' to compete with American firms, the merger control mechanism in each Baltic country was transposed as part of the *acquis*. The implementation of the merger control mechanisms in the Baltic countries has not been a single act *per se*. It was constituted as a new revolution for these countries, as their whole legal, economic and political environment has been changed. The merger regime was introduced into the legal systems of the Baltic countries, while they have still been going through economic, legal and political reforms.

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[162] See Annual Report, 2003, Lithuania.
[163] Further discussion will be provided in chapter 6.

The competition law and policy in the Baltic countries is a compact version of the competition law and policy of the EC. However, unlike in the EC competition law, the merger control rules and other aspects of competition law, such as an abuse of a dominant position, prohibited agreements and other restrictions of fair competition, are governed by a single document - Competition Law in each Baltic country. Different approaches towards introducing merger control mechanisms were taken in Estonia, Latvia and Lithuania. Latvia had set up high thresholds for merger notification. Thus, only very large merger transactions fell under the jurisdiction of the Latvian Competition Council. Until 1999 the Competition Council's blocking merger decision could have been overturned by the government in the jurisdiction of Lithuania[164]. The Competition Board of Estonia was empowered to challenge anti-competitive mergers only in 2001.

Considering that the merger control mechanisms in the Baltic states were introduced as a part of the *acquis*, there is no surprise that merger control rules have been highly influenced by the ECMR. The first competition law of each Baltic country was already to a large extent inspired by the Community competition rules, but nevertheless, the Baltic countries made further amendments as to follow the changes under the Community law. The wording of the substantive tests for merger appraisal in each Baltic state has been almost identical to the former dominance test of the ECMR. However, the situation has changed after the modernisation of the ECMR. There have been no changes insofar as to the jurisdiction of Estonia with regard to the modification of the merger control provisions. The Competition authorities of Latvia and Lithuania have modified their substantive tests for appraisal of merger transactions to correspondence to the modernisation of the ECMR, which will be further explored in chapter 6.

[164] It happened once, when the Council's decision was overturned by the government (in Sugar case). For further discussion, see chapter 6.

Chapter 2. THEORETICAL FRAMEWORK AND METHODOLOGY DISCUSSED, AND TERMINOLOGY EXPLAINED

'[L]' on peut comparer sans craindre d'être injuste' [165](Perrault, 1688 :1, as quoted in Legrand and Munday, 2003 :3).

This research undertakes a critical analysis of the approaches taken by the EC and the jurisdictions of the Baltic countries vis-à-vis merger control regime from a competition law perspective. The thesis is aimed at determining to what extent the approaches taken by the Baltic states, in particular Estonia, Latvia and Lithuania are different from its counter-part the EC.

This chapter will define the methodology used in the thesis in order to explore this virtually unexplored topic with no comprehensive scholarly writings. The thesis employs a comparative law method, which uses a comparison as a tool in order to determine objectively what approach is taken to a particular problem, as a merger control regime in this case, in the EC and the Baltic states. Despite the fact that the Baltic countries quite often have been portrayed as one unit due to their historical and some socio-economic resemblances, the researcher attempts to define the differences in the approaches taken in each Baltic country. Referring to the specific nature of the Baltic countries (they are the first former Soviet countries to join the EU with small market economies), traditional comparative law methods could not be fully employed in this study. Hence, there was a need to include relevant historical, political and economic environments within which competition policy and law has been developing in each jurisdiction. Traditional legal analysis has been undertaken in the research, however, this approach is not an adequate framework to analyse and explain the development of competition law and policy within the EC and the Baltic states' jurisdictions. Thus, an inter-disciplinary approach has also been adopted. Explicit recourse to economic theory is also essential to understand the rationale behind the law, as its basic precepts and the goals of competition policy. The following sections will explore the methods used in the thesis, the problems that occurred and the solutions proposed. This chapter will also provide and explain a mixed model of research together

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[165] 'One may compare without fear of being unjust', as translated by Legrand and Munday, 2003, pp.3.

with a conducted empirical research and legal analysis completed by the researcher.

2.1. Comparative law approach

2.1.1. Introductory remarks

This thesis undertakes a comparative analysis. Despite the fact that comparative law as a legal discipline of its own is relatively new and the term 'comparative law' became established in 1900 in Paris where the first International Congress for Comparative Law and World Exhibition was held, the origin of comparison of foreign law can be found as early as in the science of law itself, i.e. in the writings of Plato and Aristotle (384-322 B.C.)[166]. Bearing in mind that the development of comparative law as a science and the appearance of a new legal order only started in 1900, comparative law has been disputed by scholars for several decades. For instance, Kiekbaev (2003) in his article questioned what is comparative law *per se* – whether it is a scientific method, a pure science and/or an educational discipline? The scholars [167] supporting the first theory have expressed doubts of distinguishing comparative law as a distinct science purely because it lacks subject. The presumption has been that comparative law consists only of a variety of methods of investigation of jurisprudence. The comparison itself is put in the forefront of the comparative method theory and the comparative law is frequently associated with it. Other sets of scholars[168] support the notion that comparative law acts not as a method but rather as an independent scientific and educational discipline. This notion has profound at the dawn of a new millennium. Comparative law structurally and functionally is regarded as a relatively independent and scientifically detached educational discipline having its

[166] Also, the drafting of the XII Tables for Rome preceded a comparative study involving enquiries in the Greek cities as suggested by David and Brierley (1985:1-2). Many other historical precedents were also involved in a comparison studies. For instance, in Middle Ages the Canon law and Roman law were compared. Later, Montesquieu based his famous L'Espirit des Lois on comparison in order to penetrate the spirit of laws and thereby form common principles of good government. For further reading, see David and Brierley, Major Legal Systems in the World Today, Stevens, 1985, pp. 2.

[167] To this first group Kiebaev allotted the following scholars: Pollock, David, Gutteridge, Patterson, Grossfeld, Kahn-Freund, De Cruz and Szabo.

[168] To this group Kiekbaev included Ewald, Rabel, Saley, Watson, Constantinesco, Butler, Örücü, Bogdan, Saidov and others.

own subject, method and sphere of application. The last group is a compromise group of comparatists who define comparative law as a method of legal science and independent scientific discipline[169].

However, irrespective of perception of comparative law by the scholars discussed above, the thesis uses a comparative law for the comparative methods, which involve the comparison of the jurisdictions at the supra-national level - the EC and at a national level the Baltic countries, namely Estonia, Latvia and Lithuania.

2.1.2. Definition of comparative law and/or comparative method

There is no decisive definition of what comparative law and comparative method is yet (Örücü, 2002:1). It is open to discussion whether this is an independent discipline and comparatists have to re-think on their subject (Markesinis, 1990:1). A rather vague definition of comparative law is given by Zweigert and Koezt (1998:2) there *'[..] the words suggest an intellectual activity with law as its object and comparison as its process'*; the extra dimension is given to internationalism. In general terms, comparative law is the comparison of the different legal systems of the world. This study undertakes a comparison of the European legal system and the Baltic countries legal systems. The legal order of the European Community is for some scholars '*[..] a real-life laboratory for the study of the comparative method, and comparativism plays a crucial role in the "nurturing" of this (relatively) new supranational system of law*' (Jacobs, 1990:99, Hilf 1986:550, as quoted in Vranken, 1997:14). According to Twining (2000:138), the European Union's legal order like other multiple legal orders bears directly on interpreting local legal issues. Considering that the European Union consists of the member states, the law of the European Community obviously is influenced by the legal traditions of its member states[170]. Meanwhile,

[169]On the one hand, the comparative method is used as a tool for collecting information on compared systems or legal phenomena. On the other, comparative law is juxtaposed with general theory of law. For further reading, see Kiekbaev, Comparative law: Method, Science or Educational Discipline?, Vol. 7.3 September 2003, EJCL.

[170] For instance, the original framework of the European Community, i.e. the 1957 Treaty of Rome bears a strong resemblance to a civil code; further the institutions themselves, especially the European Court of Justice and the auxiliary office of the Advocate General has the imprints of French administrative law. Principle of proportionality ('*verhaltinismassigkeit*') and the concept of legitimate expectations ('*vertraversschutz*') originate from German law, and the principle of *audi*

as a part of the Soviet Union, the Baltic countries belonged to the socialist legal system. After the collapse of the Soviet Empire and the disappearance of the socialist legal system from the world's legal systems classification, these countries have turned to their civil law roots. Hence, the Baltic countries have been defined as countries in transition or belonging to 'hybrid' legal system as addressed by comparatists (see for instance, Zweigert and Koetz, 1998).

Despite being portrayed as one unit due to their historical and some socio-economic resemblances, the research attempts to define the differences in the approaches taken by each Baltic state. Wider research is placed on Lithuania, being Lithuanian and having practiced as competition lawyer at the Competition Council of Lithuania, the researcher has had a better knowledge and understanding about the Lithuanian legal system, and obviously better accessibility to the data required for the study. However, on the other hand, a more comprehensive analysis can be delivered if the approach towards merger control regime in Lithuania is analysed within the context of the Baltic countries, as Estonia and Latvia are the most comparable countries for Lithuania.

2.1.3. The importance of comparative method

Despite some discrepancies and unresolved issues as discussed above, the advantages offered by the comparative law are undisputed. The comparative law can be used as an aid to legislation and law reform, as a tool of construction, as a means to understand legal rules or as a contribution to the systematic unification and harmonisation of law (De Cruz, 1999:18, Zweigert and Koetz, 1998:15-31). The comparative law method has been adapted to suit the needs of the EU both in harmonising and approximating the commercial and competition laws of its members and in facilitating the CEECs including the Baltic countries in their modernisation programmes, often with the goal of membership of the EU (Örücü, 2002:x). For states, which are new members of the EU, like the Baltic states in this case, the harmonisation of law by supra-national means EC guidelines, directives or regulations are of ever increasing significance. There are no doubts

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alteram partem was introduced by the English legal system. All these principles have found their ways into the general principles of the EC applied by the ECJ. For further reading, see Vranken, 1997.

of the benefits that the comparative law method can deliver. Thus, the comparative method and comparison itself has been an essential tool for generating knowledge in this thesis.

It has been revealed that academia try to take a broad approach to the subject of comparative law by moving beyond the 'law as rules' (Hoecke and Warrington, 1998:495). German comparatists Zweigert and Koezt (1998:68-69) expressed that by comparing different legal systems or groups of legal systems the scholars should 'grasp their legal styles'. The term 'style' encompasses history, mode of thought, institutions, legal sources and ideology. Along similar lines, other scholars Bell (1969, 1986), Marsketinis (1994), and Legrand (1995, 1997) argued that law and the understanding of law involves more than analysis of statutory rules and judicial decisions. It has to be looked at from a broader historical, socio-economic, psychological and ideological context. Comparative law in this context can assist with finding the elements, which are influencing the law at all levels from a conceptual to ideological framework (Hoecke and Warrington, 1998:496-497). In general, comparative law can be used to evaluate the efficacy of an approach to a legal problem (in this case merger control regime) in terms of a jurisdiction's cultural, economic, political and legal background. Thus, chapter 1 presents the evolution and development of the EC legal tradition in its historical, political and economic background. The second bloc to be analysed is the Baltic countries, there the plethora of activities has been involved for the membership to the EU. The closer interest to the European Communities has not only affected the basic economic (as change from planned to market economy) and administrative framework but also the basic legal background in Estonia, Latvia and Lithuania. The transition has not only required political decision and economic expertise but also comprehension of the legal conditions of a market economy, in particular the European Communities (Mueller-Graff, 1993). Referring to the thesis, the road towards implementation of a competition regime in the Baltic countries has consisted of three crucial elements, the necessary legal framework, an appropriate administrative capacity and obviously effective enforcement, which are discussed in chapter 1.

2.1.4. Legal transplant, legal transfer or legal transposition?

Theory recognises that newly formed countries, developing countries or countries which are reforming their systems have two main choices in selecting sources of laws. The choice involves adopting a law from within its own institutional mechanism, or transplanting rules from outside its political-legal zone of dominance. There is a need in the economic analysis of the law to determine a framework of predicting which of the two alternatives is the most efficiency-enhancing. More recent and sophisticated developments of comparative law revealed that the majority of countries choose the second alternative. According to Watson (1978:94) most changes in a legal system are due to legal transplants[171], as '*most changes in most systems are the result of borrowing*'. A merger control mechanism or competition law in general has been introduced to the Baltic countries because of borrowings. Being a part of the Soviet Empire with the State control regime, competition was non-existent in the Baltic countries. The collapse of the Empire and the dismantling of the iron curtain opened the door for the Baltic states to become a part of the international arena. However, there was a need to provide a stable environment for doing business, in order to attract foreign investment and therefore enhance trade openness abroad. Therefore, competitive pressure arose to harmonise their legal systems with those in countries exporting capital by incorporating foreign legal frameworks that developed–country firms perceive to enhance their productive efficiency (Buscaglia, 1999:572). To return to their European roots, membership of the EU was deemed the best opportunity for the Baltic states.

There are a number of theories analysing the phenomenon of harmonisation of laws, in particular the one conducted by the European Union. For instance, De Cruz (1999:475-496) discusses the European convergence, as with the impending of Single Market, the European systems are converging in the context of the commonality of rules, procedures, and institutions, and the growing similarities are apparent[172].

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[171] Watson was the first to introduce the term 'legal transplant'.

[172] The comparatists have formulated two main streamline theories along the 'europeanisation' lines. They are 'convergence thesis' and the 'functional equivalence' theory (Teubner, 1998:12-13). As regards the first theory Markesinis (1994:30) has expressed that industrial nations converge towards similar social and economic structures. Meanwhile, Zweigert and Koetz

The merger control mechanism appeared in the jurisdiction of the Baltic countries because of the borrowings. However, was it legal transplant, as defined by Watson or something else? Watson (1993), who is considered a pioneer of the 'legal transplant' theory argued that legal transplant is possible from one to another jurisdiction even in the case of a different level of development or 'political complexion'. However, Watson's 'legal transplant' has been criticised by other scholars. According to Legrand (1997) legal transplants are impossible[173], because laws are deeply embedded in the 'legal culture' of nations and a legal institution cannot survive a 'journey' from one legal culture to another. Teubner (1998:12) by replacing 'legal transplants' with the term 'legal irritant' argues that the metaphor of 'legal transplant' is misleading and states that *'[..] it is not transplanted into another organism, rather it works as a fundamental irritation which triggers as a whole series of new and unexpected events [..] it irritates law's "binding arrangements"'*. Nelken (2003:437) instead of 'legal transplants' recommends 'legal transfers' in order to describe the process in the ex-communist countries or the countries seeking to harmonise their laws within the EU. Örücü (2002:7) argues that the transplant theory needs some conceptual refinement. She suggests the term 'transposition', as used in music, and the role of 'tuning' becomes more vital[174]. In the context of legal transposition, each legal institution or rule is introduced in the recipient's system as it was in the system of the model, *'[..] the transposition occurring to suit the particular socio-legal culture and needs of the recipient'* (Örücü, 2002:471). The researcher considers

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(1998:34) have used the second theory by stating that *'[..] legal system of every society faces essentially the same problems and solves these problems by quite different means though very often with similar results'*. These theories will not be explored further in this thesis as they lack relevance in building the methodology for this study.

[173] However, Nelken while analysing Lengrand's thesis argued that if by 'legal transplant' is meant the attempt to use laws and legal institutions to reproduce identical meaning and effects in different cultures, then it is obviously impossible, but Watson did not mean that. As stated by Watson legal transplants just happen and they happen all the time irrespective of whether they have any broad socio-economic or other 'fit' with the suggested society or in which they are adopted. The insertion of an alien rule into another system may cause it to perform in a fresh way. It means that *'[..] the whole context of the rule or concept has to be studied to understand the extent of the transformation'*. For reading on Watson's legal transplants, see Watson, Legal Transplants, Georgia press, 1993, pp. 116. For Nelken's comments see Nelken, Comparatists and transferability, as published in Comparative Legal Studies: Traditions and Transitions, edited by Legrand and Munday, Cambridge university press, 2003, pp.442-449.

[174] Each note (as legal institution or rule) is sung (otherwise used or introduced) at the same place in the scale of the new key (of the recipient) as it did in the original key (of the model); the 'transposition' occurring to suit the particular voice-range (socio-legal culture and needs) of the singer (as the recipient country). For further reading, see Örücü, 'Law as Transposition', 2002, *51 International Comparative Law Quarterly*, 205.

that Örücü's suggested 'legal transposition' is better suited to describe the migration of laws' process in the Baltic countries, or in the CEECs as in a broader context. Referring to legal systems in transition, or transposition from the western legal traditions to the eastern and central European legal systems, Örücü places importance on socio-cultural and legal-cultural, as they are the most serious causes of mismatch[175]. With regards to the thesis, the transposition in the Baltic countries has taken place not only by transposing one legal institution with the EC Merger Regulation, but these countries have also faced changes in an economic, political, social and cultural climate. Considering that the notion of legal transplant refers to the transplanted element of a particular legal institution, assuming the other economic, social and political factors remain unchanged in both jurisdictions: from which the legal institution originated and where it was transplanted, the concept 'transposition' is better suited to define the phenomenon in the Baltic countries in this study. The term 'transposition' has also been applied in other similar studies. For instance, Geradin and Henry (2005) discussed 'transposition' of EC competition rules in the new Member States, including the Baltic countries. Along similar lines, Sengayen (2004) in her thesis also concludes that transposition has been taken place in CEECs while harmonising the product liability laws with the EU. In general, the scholars in their more recent studies favour more multi-level theories of 'transposition', 'tuning', or 'law importation' (Örücü, 2003).

2.1.5. Techniques of comparative law

2.1.5.1. Macro- or micro-comparison?

In order to construct a comparative law method, there is a need to describe comparative techniques used in the research. The comparatists compare the legal systems of different nations at a larger or smaller scale (Zweigert and Koetz, 1998:4-5). Macro-comparison involves a larger scale comparison, as from the

[175] When elements from two different communities combine, for instance, one drawing its understanding from culture and the other from law, they may mesh bringing 'cultural conversation' into a broader narrative. This is the 'fit', and 'transpositions' and 'tuning' at the time of transplant are vital for this 'fit'. For further discussion, see Örücü, Unde Venit, Quo Tendit Comparative Law?, 2003, pp. 16-17.

spirit and style of different legal systems to the methods of thoughts and procedures they use. Meanwhile, micro-comparison has to do with a specific legal institution or problem where the rules are used to solve the actual problems or particular conflicts of interests[176]. The line dividing macro-comparison and micro-comparison is flexible. Sometimes both must be analysed at the same time, for instance, the procedures, by which rules are applied, have to be studied in order to understand why a foreign system solves a particular problem in the way it does. This study undertakes a micro-comparison, as only a part of the competition law - merger control mechanism (precisely, the substantial issues of merger control rules) will be compared in this thesis. However, broader economic, socio-political and legal aspects (referring to macro-comparison) will also be examined where it is necessary to explain the rationale behind the rule.

2.1.5.2. Convergence or divergence?

There are two basic beliefs of the comparatists, as with the emphasis on similarities or differences. On the one hand, a comparison of similar or convergent systems can benefit from each other. Thus, the attempt is to enlarge the 'catch area' of systems covered by the new *ius commune* within the context of a wider Europe. On the other hand, the differences must be stressed for their value in enhancing the understanding of law in society, as it observes only differences from which the lessons can be learnt (Örücü, 2003:8). Legrand (2003), for instance, places exaggerated stress on the study of difference rather than similarity. If harmonisation is on the political agenda, it may *'[..] secure the allegiance of the various constituencies only by retreating from the imperialist drive to openness and by doing justice to the profound diversity of legal experience across jurisdictions'*. Legrand further argues that because of these and other reasons, comparative legal studies must accept the duty to acknowledge, appreciate and obviously respect alterity.

Comparison means that sometimes the similarities are observed and explained at other times the stress is on differences. For instance, Schlesinger (1995) distinguishes periods of comparisons as of 'contractive' or 'contrastive'

[176] For further discussion, Zweigert and Koetz, A introduction to Comparative law, 3rd ed., Oxford university press, 1998, pp. 4-5.

and of 'integrative', where the former focuses on differences and the latter on similarities. He emphasises that the future belongs to integrative comparative law. In contrast to Schlesinger, Bogdan (1994:18) referred that while comparing closely related systems, it is more rewarding to explain differences, where cases are entirely unrelated – the benefits are enhanced by explaining the similarities. Hence, whether or not it is better to concentrate on finding the existence of differences rather than similarities depends on the context and purpose of comparison (Nelken, 2003:442). Considering, first, that the emphasis on this thesis on micro-comparison - the Merger Control regime, which takes form as a regulation[177]; there is no room for negotiation on the principle of the acceptance of a rule or even the technique of how it is accepted. Second, the globalisation process and 'europeanisation' of legal systems has gained significant pace recently, as laws of various countries are becoming in many respects similar (Zimmermann, 1998:6-8). Third, bearing in mind the Baltic countries committed themselves to employ and apply concepts in competition law in a manner consistent with the EC approach, the more rewarding emphasis of the thesis is on the differences in approaches adopted by the Baltic countries towards merger control regime from the EC. The purpose of this thesis's comparison is to disclose to what extent the approaches towards merger control regime taken in each Baltic country is different from its counter-part the EC.

2.1.5.3. Three step plan

For a comparison study there is a need to have a plan of comparison, outlining possible methods of comparison. Although other scholars have tried to explain what a proper comparative method should consist of, only Kamba has actually suggested some 'objective' practical comparative techniques, assuming no ideology, culture or political persuasion is involved (De Cruz, 1999:233). Kamba (1974) distinguishes three main phases in the process of comparison. They are the descriptive stage, the identification stage and the explanatory stage. The descriptive phase takes place in describing the norms, concepts or institutions of the legal systems concerned. Alternatively, this stage examines the socio-

[177] Regulations are *'[..] binding in its entirety and directly applicable in all Member States'* under EC law.

economic or legal problems and the legal solutions provided by the systems in question. The identification stage therefore identifies differences and similarities of the systems compared. Meanwhile, in the explanatory stage an attempt is made to account for the resemblances and dissimilarities between systems, concepts and institutions. Referring to the thesis, the study describes the laws regulating merger control regime at the two levels: firstly at supra-national level – the EC, and secondly at national level – in the Baltic countries. An attempt of the descriptive stage of this research is to be able to define what approach has been taken towards merger control rules at the European and the national levels, namely in Estonia, Latvia and Lithuania. In order to define the approaches, the law as well as the case law have been analysed in all jurisdictions and its development over time. Two periods have been involved in the study. As regards the jurisdiction of the EU, these are: (i) from the forming of the ECMR until its reforms and (ii) after its reforms when it was issued on 1 May 2004. Alternatively, in the Baltic countries the intervals analysed are the period before joining the EU and after the juridical membership day on 1 May 2004. Contemplating that the dates of issuing the reformed ECMR and joining the EU membership day of the Baltic countries coincided, the periods analysed were the same for the jurisdictions at the supra-national level and at the national level.

During the identification stage the differences and similarities in the approaches taken in all jurisdictions have been identified. The research revealed that the approach taken by the EC towards merger control regime has shifted from the focus on structural issues towards the emphasis on the effects on competition (otherwise, towards a more economic based approach). Meanwhile, the Baltic countries are left behind by applying the former EC model. Despite the fact that the reforms in the Baltic countries have attempted to modernise their laws in accordance with the EC model (or is in a process of modernising like in the Estonian case), the researcher argues that the differences in the approaches at both levels can be exhibited. In the last stage the researcher has adopted the modified version of the model suggested by Kamba. First of all, the research has grasped its unique style referring to the specific features of the legal institution concerned. Contemplating that the merger transactions may have controversial effects, as they might enhance or decrease competition, merger control regime is a predictive exercise for the professionals of Competition Authorities. Hence, the study is based on two opposite poles: mergers with efficiency stimulus and therefore, which enhance competition and merger transactions with the 'hidden' motive to increase market power and consequently lessen competition. These two extremes will be recurring throughout the thesis. They will be checked from the economic (discussed in chapter 4, to a lesser extent in chapter 3) as well as legal (chapter 6) perspectives. Hence, the magnitude of the legal analysis of the study has been extended to embrace the inter-disciplinary approach, involving the economic models. The following sections will explain the inter-disciplinary methods applied in the study.

2.2. Inter-disciplinary approach

2.2.1. Introductory remarks

Apart from the comparative law method, the thesis also employs the inter-disciplinary approach, as between two disciplines law and economics. Both disciplines have different approaches to a problem. For instance, Mason (1937:34-49) argued that economists and lawyers use words 'monopoly' and 'competition' in distinctly different ways. Lawyers use the term 'monopoly' as 'a standard of evaluation', by designating that a situation is not in the public interest, as a monopoly means a restriction of the freedom of business to engage in legitimate economic activities. Competition, in contrast, designates for lawyers situations in the public interest. Meanwhile, to economists the distinction between monopoly and pure competition describes the differing ways in which market transactions occur and resources are allocated. Considering that firm's output decisions are made relying on the potential effect on price, a monopolist (or oligopolist) is able to influence the market price. A competitor in a competitive market cannot affect the market price and seeks to maximise profits by producing until marginal cost equals price. The difference in approaches in same notions as presented by the illustration above may raise the question how these two distinctive disciplines can benefit from each other? Hirsh (1988) argues that as legal scholars look outside the law they discovered that economics had developed paradigms that seem to provide a powerful analytic framework for the study of the law.

Despite being a relatively new subject, comparative law and economics are considered by scholars as well-established legal specialties, which can benefit from each other. According to Mattei et al (1999), both disciplines comparative law and economics combine the instruments and methodologies in order to better understand the reasons of existing legal rules and institutions and of their evolution. Moreover, by focusing on the study of the phenomena of legal divergence and convergence, it uses a dynamic approach to law. These phenomena can take place within a single legal system or among different legal systems, as is the case in this study. With regards to economic analysis of law, it provides further analytical tools that assist measuring the level and entity of analogy or divergence. Bearing in mind the nature of competition policy, where economics is the *raison d'être* of competition law, the study has involved the economic analysis in order to explain the rationale behind merger control rules. According to Frazer (1992:xi) competition policy *'[..] inhabits something of a no-man's land between the territories of economics and law'*. Prof. Whish (2003:1) has also defined that competition law is about economics and economic behaviour, and it is essential to have some knowledge of the economic concepts concerned.

The idea of applying economic concepts is to gain a better understanding of law. For instance, lawyers-economists must distil a straightforward method for applying the economic analysis of law to given legal institutions (Mackaay, 1999:93). As will be seen in this thesis (Chapter 4), it is not always an easy task and sometimes economists cannot give a straightforward answer as required by lawyers. Despite that, the importance of the economic analysis of law cannot be mitigated.

First of all, comparative law and economics allow rather original insights on the research area. Secondly, due to the specification of the competition law, in particular merger control mechanism, both disciplines play a major role in building up the methodology of this thesis. By specification is meant that competition law by its nature is comparative[178] and there are no more disputes as regards competition law links to economics. The following sections will further explain how those two disciplines have been of assistance in writing the thesis.

[178] For further reading, see Gerber, 1998.

2.2.2. Inter-disciplinary approach transformed

The importance of the economic analysis in explaining the competition law is not questioned any more by the competition lawyers. Competition law is the product of both disciplines: law and economics. The strengthening of the economic powers of the Competition DG by appointing the chief economists, the economists working on merger cases in the competition authorities, even workshops on competition law issues participated by both lawyers and economists are the examples of the undoubted ties between the two. The analysis on economic theories in this thesis is useful for two main reasons. First, a merger control mechanism contains a lot of the economic terminology, which can be explained through the economic theories. Second, for backing the hypothesis, the competition authorities should examine the rationale behind mergers in order to have 'a full picture' of mergers' effects on competition and in turn be able to set up the appropriate merger control criteria.

The research period has occurred in parallel with the modernisation of EC competition rules, which very soon led to the conclusion that the EC competition rules, including merger control mechanism, has shifted towards a more economic based approach with the emphasis on effects rather than structural issues of market. Meanwhile, the Baltic countries as argued by the researcher are left behind. Despite some modernisation of their competition laws (in the case of Latvia and Lithuania, Estonia is still in the process of modernisation[179]), the legal rules are designed to focus more on structural aspects rather than on the effects on competition. The research has further attempted to explain why the 'effect' based approach or in general the economic based approach in merger control regime is essential for the Baltic countries, by providing and explaining the economic theories, including the theory applicable for small market economies. According to Van den Bergh (2002:42), competition law, which includes merger control rules, is a very difficult field; without a proper understanding of the underlying economics no sound rules may be developed. The thesis has analysed and explored the economic theories in order to provide the rationale behind the law,

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179 The new modernised law in Estonia is due in June, 2006.

namely behind the merger control regime. Chapter 4 presents a variety of economic models in order to prove that a merger transaction is not always about the harm, as these transactions can be pro-competitive and therefore, even enhance competition. The specific implications were made to small market economies by incorporating Gal's theory, which emphasises the importance of attentiveness to national economic characteristics in designing the competition policy regime, including merger control mechanism. In particular, the theory provides that small size affects competition law from its goals to its rules of thumb and that the countries of small market economies have to tailor their competition law in accordance to their small size. However, a problem occurred during the research with regard the concept of what a 'small market economy' is and its applicability to the Baltic countries, as in a context of Gal's theory.

2.2.3. Small market economies: do the Baltic countries fall in to this category?

First of all, the researcher would like to clarify that the thesis is not based entirely on Gal's theory. Gal's theory is applied here as one of the supportive evidences referring to specific implication of the small Baltic states' markets in enforcing merger control rules. The concern with regard to the applicability of Prof. Gal's theory to the Baltic countries occurred after the OECD discussion revealed that Gal's theory does not apply to Latvia. It was stated that for professor Gal's definition of a small economy, which focuses on high concentration levels and entry barriers, these factors are more important than 'size' in a conventional sense. Forum participants referring to this interpretation further stated that according to Gal's definition *'[..] China would be a 'small' economy but the same would not be true for Latvia'*[180]. Specifically, Professor Gal in her book provides three main factors in delineating the characteristics of small market economies, which are population size, population dispersion and openness to trade (see 2003:1-2). Gal also defines that small market economies obtain two main features as high entry barriers and high concentration levels. Considering that Gal's research was made with reference to Israel and to a lesser extent to Canada, the

[180] For further discussion, see Competition Policy and Small Economies, OECD, 7 February 2003.

author of the thesis had to contact the professor in order to determine whether her theory can be applied namely to the Baltic states. It has been suggested by the professor that the researcher should look at the level of foreign trade and also at the concentration ratios of the markets in the Baltic countries. Despite applying the liberal foreign trade policy and seeking the integration into the EU market, these countries cannot still be considered as economically integrated with the EU market, as, for instance in the case of Liechtenstein, Andorra or Monaco, whose markets are so integrated with larger neighbouring states that they can be economically regarded as part of their markets. Gal also stated that it might be that the Baltic countries are still considered small in an economic sense depending on the actual concentration levels of their industries. These economies are in transition – so most of their markets are highly concentrated and others are not. Gal in her book mentioned that for an economy to be considered small, not all of its industries need to be highly concentrated, for instance, industries such as retail services are highly competitive even in small economies (Gal, 2003:2).

Besides the contacts made to the Professor, the researcher also checked how the Baltic countries, namely Estonia, Latvia and Lithuania define themselves. The variety of researches reveals that the Baltic countries experience some difficulties due to their small markets. For instance, Estonia as a small country cannot rely on its domestic market and requires liberal policy towards foreign trade to compensate the small size of its economy (Ratso, 2005). Concerns were expressed in Latvia because of relatively high market concentration, what is a characteristic feature of the Latvian market. In this case, the growth of merger concentration in the relatively small market capacity can diminish the pressure of competition on prices and on amount of goods and services thereby reaching critical level for customers in short term period (OECD, February, 2002). Also, a board member of the Competition Council of Latvia mentioned that Latvia has a small economy and therefore national undertakings require reaching a minimum efficient scale by means of consolidation in order to compete internationally. Professor Geradin and Henry (2005) in their joint article also admitted that the majority of the new Member States are considered as having small transition economies. Hence, the researcher considers that Gal's theory is applicable and therefore can be relied on as a supporting theory in this thesis. Chapter 4 of the thesis will further explore the issues of variety of the term 'small market economies', their features and applicability to the Baltic countries.

2.3. Methodological tools used by the researcher

For defining the approaches taken by the EC and by the Baltic countries towards merger control mechanism, a conducted empirical research completed by the researcher has been applied. Due to the specification of legal systems, one being supra-national and another - national, different methodological tools have been involved in gaining the information package to assist the research. The researcher has had a difficult task of depicting the development of a complex field of law with the economic ties from various sources. The data at the early stage on the competition policy of the EU and the Baltic countries as well as merger control mechanisms in these jurisdictions was obtained from books, journal articles, and newspapers, studies completed by the Enterprise-DG of the European Commission, the OECD, the IBA[181], the BIICL[182] and web-sites. The research has been made by focusing on two main directions: (i) competition policy and law (referring to merger control regime); and (ii) economic models in competition law.

Apart from the secondary sources, the research involved the examination of the primary sources i.e. the Treaty of Rome[183], the European Community Merger Regulation, together with other documents of the European Communities on the merger control as well as the case law. The researcher also used other methods to gather the required information, in particular attending conferences, making contact with academics and practitioners on competition law and being consulted by them. The Annual Merger Control Conferences in 2003 and 2004, 2005, the 5th Annual Trans-Atlantic Antitrust Dialogue on International and Comparative Law and other Competition Workshops organised by the British Institute of International and Comparative Law are the examples of the events attended, which also formed sources for the study. The comments on the particular issues by the Deputies Director-General of the European Commission

[181] International Bar Association.
[182] British Institute of International and Comparative Law.
[183] As amended.

contributed further knowledge to the research. For instance, Mr. D. Sjoeblom, Deputy Director-General, was consulted by the researcher on the approach taken by the EU to a market definition in the case of small market economies.

2.3.1. Baltic states: methodological tools used

Different sources have formed the basis for the research on the merger control mechanisms in the Baltic countries. Contemplating that competition law and policy is still considered a new phenomenon in the legal order of the Baltic countries, there are hardly any comprehensive scholarly writings. Hence, the researcher had to obtain a conducted empirical research. The research has applied two major stages in gathering the data for the research vis-à-vis the merger control rules in the Baltic countries. It has, first of all, involved examining the written laws on competition law in each jurisdiction. The annual reports on the competition policy of Estonia, Latvia and Lithuania[184], and other reports provided by the Government in Estonia, Latvia and Lithuania containing competition policy as well as the speeches delivered by the professionals of Competition Authorities were also analysed. The data obtained from the Annual Reports of Competition Authorities in each Baltic state has been largely used in composing chapter 5 on competition policy. However, the researcher has experienced difficulties in attempting to identify 'pure' competition policy from these reports as they provide a mainly one-sided approach as to the achievements in preparation for the membership into the EU[185] and in harmonising the national laws in line with the EC law.

The jurisprudence also has been analysed. The examination of merger cases has involved a variety of tasks: (i) to identify the motives for a merger in the Baltic jurisdictions; (ii) to understand the investigation process, the methods used by the Competition Authorities in the Baltic countries and in general the approach taken towards merger transactions while dealing with merger cases. In order to verify and broaden the information obtained from the first stage, a further step has involved the data gathering from the qualitative questionnaires and the critical

[184] Note: It also includes the annual reports submitted by the Baltic countries to the EU and the OECD.
[185] Before becoming the Member States on 1st May 2004.

interviews. A different strategy was obtained in each jurisdiction of the Baltic countries. This is because the researcher encountered problems trying to gain data on the Baltic countries. The difficulties occurred with the Estonian and Latvian jurisdictions, where the case law is only in Estonian and Latvian. Thus, with no-knowledge of Estonian and little knowledge of Latvian the researcher had to find ways of how to work out this problem. The researcher has used the comments on cases presented by the scholars in the articles. Also, enquiries have been made to the professionals of Competition Authorities by asking to provide comments on the particular cases. The lawyers from the leading law firm in Estonia kindly agreed to contribute their comments on *Tallinna Piimatööstuse As / Meieri Tootmise AS* case[186] involving efficiencies issues.

The materials on the fluctuations of the economic movement with transformational phenomenon in Lithuania were gathered by interviewing the former economic professor of the researcher Prof. Habil. Dr Z.Lydeka and Dr V.Pukeliene. The data for chapter 3 on merger motives has been obtained not only from articles, cases study but also from the examination of MBA (on motives and movements of merger transactions in Lithuania) and PhD dissertations in economics.

2.3.1.1. Qualitative questionnaires

After examining the secondary sources, the researcher has conducted empirical research to obtain primary sources. At the preliminary stage the questionnaires were sent to the Competition Authorities in Estonia and Latvia. The questionnaires were intended to achieve the following tasks. The first part of the questionnaire was to gain data on the historical development of the Competition Authorities, whilst the second part was to gain information about how professionals in the Competition Authorities work with merger cases in general, what methods do they use and how they understand the nature of merger control. The purpose of the second and the other continuing parts was to ascertain the problems the Authorities have while dealing with merger cases. This in turn was supposed to assist in setting up research questions on the problematic area,

[186] Otsus 06.09.2002.a. nr 55-KO.

which requires further examination. However, the questionnaires did not produce entirely satisfactory results: the responses merely were referred to the law verbatim, whilst some were left blank, especially of the open-ended questions, the questionnaire from Estonia was not return instead the questionnaire with answers submitted to the OECD was provided. The feedback was that the questionnaires require a lot of comments. Another problem, particularly in Latvia, was that the officials from the Division of External Relations [187] commented on the questionnaires. Meanwhile, the information asked by the researcher required the experts' opinion. Nevertheless, the data gathered from the questionnaires from Estonia and Latvia has provided adequate information for the analysis for chapter 1.

The questionnaire was not sent to Lithuania. Instead, two official visits[188] have been made to the Competition Council of Lithuania in order to obtain the data required for the research.

2.3.1.2. Critical interviews

To supplement the questionnaires, critical interviews were arranged. Four officials were interviewed at the Competition Council of Latvia, five professionals at the Competition Council of Lithuania and one - at the Competition Board of Estonia. Also, interviews from the competition lawyers of the leading competition law firms in Latvia and Lithuania were obtained. A different number of interviewees in each Baltic country occurred due to various problems, such as availability of professionals and language knowledge [189] and size of the Competition Authority (Estonia being the smallest one). Face-to-face interviews were held in Estonia[190], Latvia[191] and Lithuania[192]. A problem that occurred

[187] Note: according to the policy of the Competition Council of Latvia, the Division of External Relations deals with any inquiries made from foreign countries.
[188] One visit is dated in October, 2004. More recent visit occurred in January, 2006.
[189] For instance, the head of Legal division in Estonia suggested interviewing the official M.Paddo referring that she can better speak English.
[190] Ms M. Paddo, an official who directly deals with merger cases in Estonia, was interviewed at the Competition Board of Estonia.
[191] In the Competition Council of Latvia the interviewed officials include Ms T. Jefremova, a Council member, Mr M. Stenders, a head of Division of External Relations, Ms I. Lasmane, a head of the first Analytical division (deals with merger cases in product markets) and Ms V. Ozere, a head of the second Analytical division (deals with merger cases in service markets).

during the interviews was a disclosure of confidential information. This is because the firms providing data to the Competition Authorities can restrict access to content to any outsiders. The Competition Authorities in the Baltic countries do not question whether data provided is confidential or not and as a result of this, all mergers cases contain the majority of information that cannot be disclosed. In some cases the motives behind a merger were considered as confidential information. More likely the inherited Soviet attitude of keeping information secret is to blame for a lack of the information available for public (including the researcher). This attitude and obviously the information restricted by the parties as discussed above may be the reason for the reluctance of the Baltic countries to explain their methods in merger assessment and therefore to discuss merger cases 'openly'. All this has further been exacerbated by the limited information resources on the Baltic countries in the U.K.

Nonetheless, personal contacts and experience at the Competition Council of Lithuania have helped obtain even confidential data (though it cannot be directly revealed in the thesis). In general, the data assembled from the interviews is valuable and highly assisted in writing the thesis.

The information gained from the interviews can be critically evaluated due to the fact that the researcher also interviewed the other side of the frontline - the competition lawyers, who represent companies. Further materials on the Merger Regime in the Baltic countries were gained by interviewing Ms L.Harmane, a lawyer from *Klavins & Slaidns*, a leading law firm on competition in Latvia, and Mr A.Klimas, a former member of the Competition Council of Lithuania and a consultant from *Lideika, Petrauskas, Valiunas ir partneriai*, a leading law firm on competition in Lithuania[193]. The information gained from these interviews provided some commentary on merger cases and the approaches of the Competition Authorities of the Baltic countries towards mergers.

[192] In the Competition Council of Lithuania the interviews during the first visit were held with S. Pajarskas, a head of administration and a former member of the Competition Board, A.Jakiunas, a head of Concentration Division, I.Kudzinskiene and R.Belaraziene, chief experts of Concentration Division and J.Soviene, a head of Law Division. During the second visit, the interviews were made by interviewing , A.Jakiunas, a head of Concentration Division and I.Kudzinskiene official of Concentration Division. The main task of the second visit was to up-date material on cases, as well as to clarify the misunderstanding with the *Vesiga* cases scenario.

[193] The researcher would like to express her sympathy to Klimas's family for his tragic death in a car accident in August 2005.

2.3.2. The analysis of the data obtained and problems occurred

After gathering the data, the next step involved interpreting and analysing the data obtained and finally structuring it with the thesis's framework. Here, the researcher has had to deal with an inadequacy in the data obtained. Different information has been provided by two professionals at the Competition Council of Latvia. According to Lasmane (the official who deals with merger cases in the Competition Council of Latvia), once the creation or strengthening of dominance is found, any efficiency considerations are irrelevant[194]. However, T. Jefremova, a board member of the Competition Council in Latvia, mentioned[195] that despite the absence of an efficiency defence in Latvian law, the efficiency issues, nevertheless, can be considered in 'borderline' cases, when there are concerns about the emergence of a dominant position by the merging parties, but it is not clear how the merger transaction will affect the competition and consumers. This and other problems of inadequacies dealt by the researcher and the solutions proposed will be further discussed in chapter 6.

Dealing with different legal system (as well as with different languages) in this research, terminological problems have occurred. Legal terminology can be defined as fraught with linguistic traps and potential minefields of misunderstanding which vary from one country to another. Language is one of the most important mediums of communication for lawyers, and legal concepts have precise linguistic configurations and parameters (De Cruz, 1999:214). Quite often any form of translation may cause a risk of overlooking conceptual differences between the languages. Two main problems can occur: (i) different terms in separate legal systems can mean similar legal concepts and have no significant difference apart from the term itself; or (ii) conversely, the same term can mean different things in separate legal systems. This latter terminological problem occurred during this research. The researcher had difficulties in trying to define the meaning of the term 'consumer' in competition law in each Baltic country. It is not clear whether the Baltic states have the Chicagoan notion of a consumer as 'society at large encompassing even every market player', or the EC's notion of consumer in competition law as 'any intermediate or final consumer', as a

[194] The information obtained during the interview as discussed above.
[195] During the International Workshop on Competition Policy in Seoul in 2003.

'customer' or 'user' who might be another market operator purchasing the product/service, or finally referring to consumers as the final user otherwise 'the man from the street', as acting outside his/her business or profession. The researcher concluded that the Baltic countries are still in the process of developing their competition policy and some answers cannot be provided at this stage of the research. The following sections will explain the further terminology used in the research. Contemplating that the concepts were explicitly provided by law or explained through the case law, there have no problems occurred.

2.4. Terminology used in the thesis explained

The term 'European Economic Community' (EEC) was changed to 'European Community' (EC) by signing the Maastricht Treaty in 1992. The Amsterdam Treaty 1997 provides that the EC is itself part of the European Union (EU). The EU is based on three pillars: (i) the EC, including the European Coal and Steel Community (ECSC, which expired in 2002); (ii) the common foreign and security policy; and (iii) co-operation in the fields of justice and home affairs. In the research the term the 'EU' will be used by having a broader meaning as general EU policy, as the EU does not actually make the law. The EC will be used to describe the law. Furthermore, as was mentioned above, analysis of the research is based only on the first pillar, particularly, on the Merger Regulation.

2.4.1. The concept of concentration within the EC jurisdiction

It is an essential element of any scheme of merger control mechanism to provide an exact definition of a transaction, which will fall under its jurisdiction (Goyder, 2003:346). Like its predecessor Merger Regulation 4064/89, the Regulation 139/2004 employs the term 'concentration' to describe all transactions, which in economic literature are separated into mergers, acquisitions, and take-overs etc. In particular, the EC Merger Regulation provides two basic groups in case of either of them are fulfilled a transaction would fall under the Community jurisdiction. The first group covers the transactions, where a change of control on a lasting basis occurs from *'[..] the merger of two or more* *previously independent undertakings or parts of undertakings'*[196]. The second one refers to the situation, where a change of control on a lasting basis results from *'[..] the acquisition, by one or more persons already controlling at least one undertaking, or by one or more undertakings, whether by purchase of securities or assets, by contract or by any other means, of direct or indirect control of the whole or parts of one or more other undertakings.*[197]. Within the meaning of the first group (article 3 (1) (a)) a merger may occur even in the absence of a legal merger, where the combining of the activities of previously independent undertakings results in the creation of a single economic unit *de jure* or *de facto*. This explanation was expressed in the *RTZ / GRA* case[198]. A pre-requisite for the determination of a single economic unit is the existence of a permanent single economic management. Other factors such as internal profit and loss compensation between the various undertakings within the group and their joint liability externally, or cross-shareholdings between the undertakings forming the economic unit may also be relevant[199]. Another group involves the acquisition of control either by one undertaking or by two or more undertaking acting jointly. However, the internal restructuring within a group of companies does not constitute a concentration within the meaning of the ECMR. The creation of a joint venture, which performs on a lasting basis all the functions as an autonomous firm falls under the second group[200].

The term 'person' used in the Regulation extends to public bodies (including the State[201]), private entities and individuals. As regards control, the ECMR clearly defines control as the 'possibility of exercising decisive influence' rather than the actual exercise of such influence. Moreover, the Regulation distinguishes two forms of control as sole control and joint control, which are defined in the Commission' Notice on the concept of concentration[202]. Sole control normally means an acquisition of a majority of the voting rights of a

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[196] Council Regulation (EEC) No 139/2004 on the control of concentrations between undertakings, Article 3 (1) (a).
[197] Council Regulation (EEC) No 139/2004 on the control of concentrations between undertakings, Article 3 (1) (b).
[198] Case No. IV/M660 (1995).
[199] See Commission Notice on the concept of concentration, OJ C66, 02/03/1998.
[200] Council Regulation (EEC) No 139/2004 on the control of concentrations between undertakings, Article 4.
[201] See case IV/M.157 Air France v Sabena, 05/10/1992 in relation to the Belgian State.
[202] OJ C66, 02/03/1998.

company. Also, sole control may be acquired in the case of a 'qualified minority', that can be established on a legal and/or *de facto* basis. For instance, in the case of *Arjomari / Wiggins Teape*[203] the Commission considered that a 39% shareholding was enough to constitute sole control, due to the fact that other shares were widely dispersed. A concentration within the meaning of the ECMR may also occur where there is a change in the structure of control. This includes the change from joint control to sole control. However, a transaction involving the acquisition of joint control of one part of an undertaking and sole control of another part constitutes two separate concentrations[204]. The acquisition of joint control, as in the case of sole control, can be established on a legal or *de facto* basis. The shareholders (the parent companies) must reach agreement on major decisions concerning the controlled undertaking (the joint venture) in order to constitute a joint control. Also, joint control exists where two or more persons have the possibility of exercising decisive influence over another person (undertaking). Decisive influence, therefore, in this sense means the power to block actions, which determine the strategic commercial behaviour of an undertaking[205]. It is rare in the Commission practice that a decisive influence existed by holding less than 25% of the share capital by one undertaking. However, it is not a rigid rule. For instance, in *CCIE / GTE* case[206] a share of 19% was found to trigger control, as in this case all remaining shares were held by an investment bank and its approval was not necessary for significant decisions[207]. All relevant circumstances are relevant for determining whether there is a decisive influence[208].

With regard to the international element, according to company law, international merger transactions allude to the fact that the firms participating in a transaction operate in different countries and are subject to different company laws (Horn, 2001:5). This means a definition of internationality is determined by the location of firms and the company law to which they are bound. However, in competition law the governing company law of the firms involved in the

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[203] Case IV/M25, 1990.
[204] within the meaning of the ECMR, see Commission's Notice.
[205] For a further reading, see Commission Notice on the concept of concentration, OJ C66, 02/03/1998.
[206] OJ C225/14 1992.
[207] For comments on this case, see M.Furse, 1998, pp. 326.
[208] Like was confirmed, for instance, in *Gensor Ltd / Commission*, case T – 102/96 [1999] 4CMLR 971, paras 94-167.

transaction is irrelevant. The benchmark of competition law is on the cross-border effects of a merger transaction on a market. This means that a merger has an international dimension when it exerts a cross-border market influence, due to the fact, that a merger transaction may cross borders even when the merging firms are located within a national market and governed by the same national laws[209].

2.4.2. Concept of concentration within the Baltic jurisdictions

All Baltic countries, except Latvia, like the ECMR use the term 'concentration' to define all transactions, which economists or other scholars would describe as mergers, acquisitions, or take-overs etc. The Competition Law in Lithuania has a very similar structure to the ECMR for defining the concentrations by separating them into main groups. According to article 3 (14), a concentration may occur as a result of (1) a merger '*when one or more undertakings which terminate their activity as independent undertakings are joined to the undertaking which continues its operations, or when a new undertaking is established out of two or more undertakings which terminate their activity as independent undertakings*; or (2) '*acquisition of control, when one and the same natural person or persons already controlling one or more undertakings, or one or more undertakings, acting by contract, jointly set up a new undertaking or gain control over another undertaking by acquiring an enterprise or a part thereof, all or part of the assets of the undertaking, shares or other securities, voting rights, by contract or by any other means'*. The Competition Law of Lithuania differs from the EC law[210] as it does not contain any further explicit explanations of these concepts. There is no separate provision for joint-ventures, nevertheless, they are covered by the second part of the definition. The jurisdiction of Latvia uses the term 'a merger of market participants' to describe the concentration transactions. Section 15 of the Competition Law of Latvia provides that a merger of market participants is: i) *merging if two or more independent market participants in order to become one market participant (consolidation)*; ii) *joining of one market participant to another market participant (acquisition)*; iii) *a situation where one or more natural persons who*

[209] For a further reading, see Horn, 2001, pp. 5-16.
[210] For instance, the Commission's explanatory notices, guidelines etc.

already have a decisive influence over another market participant or other market participants, or one or more market participants acquire part or all of the fixed assets of another market participant or other market participants or the rights to utilise such, or a direct or indirect decisive influence over another market participant or other market participants[211]. The Competition Act of Estonia, therefore, provides a more detailed definition of the concentrations in comparison with the other Baltic states. Section 19 of the Competition Act of Estonia describes that a concentration within the meaning of this Act arises in the following situations: i) where previously independent undertakings merge within the meaning of the Commercial Code (i.e. (a) one undertaking (the undertaking being acquired) merges with another undertaking and the undertaking being acquired is dissolved; or (b) undertakings merge so that they form a new undertaking and both merging undertakings are dissolved[212]); ii) *an undertaking acquires control of the whole or part of another undertaking*; iii) *undertakings jointly acquire control of the whole or part of a third undertaking*; iv) *a natural person already controlling at least one undertaking acquires control of the whole or part of another undertaking*; v) *several natural persons already controlling at least one undertaking jointly acquire control of the whole or part of another undertaking*[213].

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[211] Section 15, Competition Law of Latvia, 04/10/2001 as amended by 22/04/2004.
[212] As provided by Kalaus, M., Estonia in Merger Control, 2005, Global Competition Review.
[213] § 19, Competition Act of Estonia, RT[1] I 2001, 56, 332, as amended in 28/06/2004.

Chapter 3. WHY DO FIRMS MERGE?

'A merger is like a marriage in that it almost always takes at least two parties to agree. (..) Marriages and mergers both may respond to a variety of individual motives and in aggregate be subject to cyclical and secular influences.' (Steiner, 1975:1)

This chapter is based on the commercial analysis. The question will be raised as to why firms merge? It has been argued that critical analysis of the impetus to merge is one of the high necessities for setting up the criteria for merger control. This is because the motives behind a merger may serve by finding possible effects of the transaction on competition. Hence, the examination of the motives to merge is a useful tool for the competition authorities in the investigation process of mergers.

The following sections include the analysis on the reasons of the occurrence of the merger movements during different decades, followed by the impetuses to merge from the textbooks. Moreover, the practical emphasis of the theoretical motives will be checked within the context of the Baltic states, and to what extent these affect the reasons for mergers in the Baltic jurisdictions also has to be decided. Thus, the importance of this chapter lies in the question to what extent does these theoretical motives for mergers form impetuses to merge in the Baltic countries.

3.1. General overview

As far as the economists are concerned acquisitions and mergers are about growth. Usually, firms grow in two basic ways: internally (naturally) and externally. The relationship between these two depends *'[..] on which appears to be a more profitable course of action'* (Penrose, 1972:155)[214]. Natural growth can be slow; it can take many years for companies to reach any appreciable, optimal size for making profitability. For Lees (Lees, 2003:3) if firms want to grow quickly, the growth – through – a mergers or acquisitions route offers the greatest possibilities. Historically mergers have been *'[..] one of the most powerful forces offsetting the tendency of an expanding economy to produce widening*

[214] The author excludes any 'empire-building' desires in this statement.

opportunities for smaller firms' (Penrose, 1972:238). For instance, merger transactions not only inherit the potentialities for growth, but also tend to make available the possibility for the combined firms to pool unused productive services, which would not have been available for the independent firms (Penrose[215], 1972:195).

Merging or acquiring viable companies offers immediate access to their markets, technology, finance, management skills, customer relationships, trade connections and much more, that would normally take years for firms to develop through internal growth (Less, 2003:3; Sanchez and Heene, 2004:188). A merger or acquisition transaction is less risky than starting up a new business. It may also be a good solution for both parties: if an acquiring company is a successful firm with plenty of cash the investment into another company may put cash into use; meanwhile for the acquired company, especially if it is in distress, the injection of the surplus cash and the provision of better management may put the firm back on the road. Also, to acquire a company, which is in decline would be cheaper than starting a company from scratch (Stallworthy and Kharbanda, 1988:72). Firms can diversify quickly through mergers or acquisitions and overcome easier entry barriers than companies setting up the business for the first time. This is because these diversified firms have usually larger resources upon which to draw and may be able to apply skills developed in the former activities, which in turn give them a competitive advantage (Morgan et al., 1980:29). When a firm undertakes, for instance, the development of a new product or starts catering to a new market by internal means, this process gradually will proceed. Meanwhile, an acquisition transaction generally means the immediate exposure of plunging into a new product or a completely new market (Linowes, 1968:44-58). Furthermore, mergers may offer more of the efficiencies compared with internal growth (Bork, 1993). The growth through mergers is highly important for small markets where demand is limited (Gal, 2003). Despite the advantages that mergers can offer, the priority in the Baltic countries in the first years after they re-gained independence was given to natural growth over the growth through merger transactions. The

[215] The author continues the discussion by stating that the realisation of the unused resources provides a basis for the further growth of the combined entity, which might not have been possible before the transaction. For a further reading, see Penrose, Growth of the firm, Oxford, 1972, pp.194-196

main reasons behind this were insufficient financial resources[216] and lack of management knowledge, as the main strategy in the Soviet system was organic growth.

As regards the international context, foreign direct investment (thereafter FDI) may occur as a result of greenfield investments (by establishing a new company) or cross-border merger transactions. They both have socio-economic effects on the host countries (Kang and Johansson, 2000). First, both greenfield investments and cross-border mergers are about the accumulation of capital. However, cross-border mergers are more flexible as they may contribute only to intangible capital accumulation rather than merely physical capital. Secondly, both cross-border mergers and greenfield investments may have favourable influence on industrial innovative capacity by promoting the transfer of new technology, advanced management skills and as a result enhance competition by increased efficiencies. Thirdly, greenfield investments may increase competition by adding a new player in the host market; meanwhile, cross-border mergers may decrease or not alter the market structure, in the sense that no new firm will be introduced. However, cross-border mergers may still increase competition with the help of financial or management resources from parent companies or in the case where inefficient companies were acquired by foreign investors. Fourthly, both modes of FDI have a tendency to influence employment. Greenfield investments may create new jobs, while merger transactions often result in layoffs but may contribute to employment gains in the future, if the foreign owners expand their businesses[217].

A general rule suggests that it may be cheaper to expand externally when the market is growing rapidly. 'Time' to market[218] is critical and has a higher value in terms of sales lost, especially in high-tech industries, which form a large part of overall market capitalisation. This is due to the immediate availability of the necessary backup without a time lag waiting for engineering and construction and '*no risk of time and cost overruns*' (Stallworthy and Kharbanda, 1988:72). In this case merger or acquisition transactions prevail over greenfield investments as

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[216] The Baltic countries in the period 1990-1997 had experienced high inflation and bank crises.
[217] Note: for further reading, see Kang and Johansson, Cross-border Mergers and Acquisitions: Their role in Industrial Globalisation, OECD 2000.
[218] For further discussion see Newbould's comments on 'time' element in his book, Management and merger activity, Guthstead Ltd., 1970, pp. 117-119.

what would normally take a year to build can be bought in one week (Black, 2000; Newbould, 1970:117). Thus, a merger or an acquisition enable firms to quickly realise market opportunities and establish a critical mass. Also, the companies prefer merger or acquisition transactions rather than greenfield investments because acquired local firms give an in-depth knowledge of local customs and regulations, established distribution network or access to consumers (Kang and Johansson, 2000). This is why the majority of international firms decided to get access to local, the unexplored Baltic states' markets through merger transactions.

With the possibility of quick access and start up in the foreign market and other advantages as discussed above, firms would rather buy and sell assets and diversify operations and activities than invest in 'greenfield plants'. For instance, the value of cross-border mergers in relation to world FDI inflows rose from 53.7% in 1991 to 85.3% in 1997 (Kang and Johansson, 2000).

An overall surge in merger and acquisition transactions at both domestic and international levels is due to their inherent advantages over the other forms of investment such as organic growth or greenfield investments. For instance, in the pharmaceuticals sector all of the largest companies worldwide have grown through mergers, rather than through 'organic' means (UNCTAD, World Investment Report 2000).

3.2. Two basic forces for mergers

There are two basic forces that drive the increase in merger transactions. They can be distinguished by external and internal factors.

First of all, the external factors - such as the globalisation process within liberalisation, falling tariff barriers, new technological advancements, improvements in communication and information and the opening of borders to the international market can all be stimulus for firms to merge. Cross-border mergers and acquisitions, including the purchase by foreign investors of local privatised state-owned enterprises, are new records in the foreign investment volumes. The external factors can be loosely divided into groups such as macroeconomic factors, technological factors, social factors, governmental factors and the influence of the international and/or regional organisations, such as the EU. Other authors as Kang and Johansson separate industry related factors; however, this research does not contain the analysis of the sectored trends[219].

The economic growth, a macroeconomic factor, influences the demand and supply for cross-border mergers. Economic expansion increases earnings and equity prices and as a result the capital availability to invest abroad, this is so call outward transactions. Inward mergers occur through the sale of domestic companies to foreign investors. Inward transactions have incurred in the countries with falling asset prices, changes in business practices and the environment, which is favourable to foreign acquisitions[220]. Furthermore, other macroeconomic factors such as GDP, exchange rate, market capitalisation, stock prices or bond yields may also influence the cross-border merger activities. The scholars have studied the effects of the macroeconomic variables on the trends of the cross-border merger transactions between the US and European countries. For instance, the results suggest that foreign acquisitions appear more frequently when bond yields in the home country are higher than those from the host country (Vasconcellos and Kish, 1998). According to Cosh and Guest, the merger transactions in 1990s were caused by rising stock prices and low interest rates (Cosh and Guest, 2004).

The technological factors have had the following effects in stimulating the occurrence in mergers' activity. On one hand, falling transportation costs and the improvements in communication and information have favoured international firms to exploit their activities. Technological breaks through have eased the way in which goods and services can be moved over large distances. On the other hand, the increased costs in R & D together with uncertainties in the changes in technology, have forced companies to merge in order to fund research expenditures for new products. Furthermore, technological changes may shorten a product's life and promote new entrants with advanced technology (Kang and Johansson, 2000). Merger transactions in turn can be a response reaction to this situation, as they can offer quick access and start up in the market.

[219] This is because the analysis is based on overall substantive issues of merger control regime in the Baltic countries rather than focusing on particular sectors.
[220] Note: for further reading see Kang and Johansson, 2000.

As regards social factors, the empirical studies showed that a high proportion of takeovers occur in the new economies of technology and communication, especially where labour unions are weak (in this case they will not be able to protect the employees with regards to the redundancies). In the growing industry, the unemployment rate will not increase much, as the growth is strong and redundancies are small (Kang and Johansson, 2000).

Mergers are also influenced by political climate: easing of regulations allows better access to the markets of other countries (Cartwright & Cooper, 1996: 19-20). Trade liberalisation and privatisation policy have led to changes in the nature of trading system by contributing the increased numbers of targets for merger and acquisition transactions (i.e. mainly in telecommunications, financial services and energy sectors). The government policy of opening up borders and signing up to the international or regional organisations are further steps towards the occurrence of cross-border transaction' activities. However, there are two different effects of this. On one hand, by opening up the borders, new opportunities for national firms to expand internationally have increased, and on the other hand, national companies suddenly have had to face new competitors. This is because firms try to improve their competitive position by capitalising on advantages of scale and exploit the cost benefit savings, which leads to an excess of capacity (Sleuwaegen, 1998). In turn companies have to find a niche in which to widen export markets in order to realise the over-capacity. Furthermore, the falling tariff barriers also make it easier for firms to cross the borders.

As regards the influence of the international and/or regional organisations, the co-operation among different countries of the world provides an additional impetus to the process of internationalisation. Changing market conditions have opened up unexpected global markets for many companies. The EU with the creation of the Single Market in Europe is the most far-reaching initiative for firms to merge among the Members States. This is due to the creation of a more homogeneous environment with common regulations, standards and fiscal measures (Sleuwaegen, 1998: 1082). The creation of the Single European Market has also stimulated foreign countries to establish an operational basis in Europe, because of restrictive legislation; this was accomplished by merger and acquisition transactions (Cartwright and Cooper, 1996:18). The enlargement of the European Union in 2004 has offered more companies for sales, as companies in Eastern Europe have generated 'willing partners' (Cartwright and Cooper, 1996:19). Furthermore, the EU's single currency 'the Euro' has increased competition by contributing to greater price transparency, by exerting more pressure on firms to restructure and consolidate their operations (WIR2000 as quoted in the UNCTAD, World Investment Report 2000[221]). In general, the regional integration in Europe and the co-operation with the international organisations have had a strong impact on trade flows.

Second, internal factors are inner needs of companies in order to keep them 'alive', i.e. to have a specific competitive advantage against its competitors. The example of internal factors might be managerial ambitions to build an empire. The widely known *WorldCom* case perfectly illustrates the scenario of the personal ambition of a director to build an empire. Mr. B.Ebbers, a senior executive of WorldCom, transformed through no fewer than 65 merger transactions[222] an obscure long–distance phone company into one of the country's fastest growing corporations and at its peak the fourth largest telecommunication company in the world (Eichenwald, 2002). Mr. Ebbers together with other executives were making acquisitions to survive and to cover their personal loans[223]. Another example of internal factors might be a willingness to achieve efficiencies of scale or scope economies from the mergers. This may be the case where a firm does not posses sufficient asset to be competitive and the growth through a merger transaction can solve this problem.

Both external and internal factors may drive both domestic and cross-border mergers to increase. No question arises that globalisation process leads to the augmentation of cross-border mergers. However, this may also be truthful with regard to domestic mergers. Here might be the situation where domestic firms merge in order to be able to compete with global companies, for instance, like a scenario in the Baltic countries.

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[221] Available at http://www.unctad.org

[222] See, for instance, *WorldCom / MCI* (II) case No. M. 1069 (conditional clearance by the Commission), *WorldCom / MCI* case No. M. 1038, MCI / WorldCom / Sprint case M. 1741 (prohibited decision by the Commission).

[223] For further reading on this case, see K.Eichenwald, For WorldCom, Acquisition were behind its rise and fall, The New York Times, August 8, 2002; also see Another cowboy bites the dust, The Economist, June 27, 2002; D.Moberg and E.Romar, WorldCom, Santa Clara University, 2003 available at web-site: http://www.scu.edu/ethics/dialogue/candc/cases/worldcom.html

3.3. Merger movements

3.3.1. Merger movements within a context of the single country or region

The merger movements and their motives have been highly investigated by a number of researchers of various countries during different decades. For instance, Blair (1972), Steiner (1975), Vasconcellos and Kish (1998) and many others examined the emergence of merger transactions in the United States and their expansion outside the borders. Apart from globalisation process and capital mobility, the evolution of the single European market encouraged American firms to establish a presence through merger transactions before the entry barriers intensified and to find factors of production in order to achieve competitive advantages. Many American companies presumed that the only way to participate in a unified Europe was to become an 'insiders' (Vasconcellos and Kish, 1998:448).

The merger waves in the United Kingdom were investigated by Hannah (1976), Newbound (1970), who studied the 1967-1968 merger boom, discovered that fashion, defence and pressure of competition were the reasons for that boom. Despite some common motives to merge as a result of the globalisation process (i.e. with overcapacity, a sluggish market and due to intense foreign competition, firms have to restructure in order to survive), there have been specific implications within a context of a single country. The following sections will include a brief analysis on the impetuses of firms to merge within different countries or regions. The question will be raised as to what motives or forces have led European firms and the firms in the Baltic jurisdictions to merge.

3.3.1.1. Merger movements in Europe

The studies proved that the increase in international trade, capital movements from the US and government policy have had an important influence on merger activity in the peak of the merger wave in 1960s in Europe (Hughes and Singh, 1980:8-11). This might be explained through the auspices of economic assumptions. For instance, if there is an oligopolistic equilibrium by meaning that stable market shares of the largest companies exist within the national economy, then increased imports or entry by big foreign companies would lead to dis-equilibrium. This may cause national firms to merge in order to be able to face increased competition (Hughes and Singh, 1980:9).

Apart from the economic reasons for mergers, a political policy laid the auspicious environment for the occurrence of mergers in Europe. In contrast to American Antitrust law, the merger control in the European Communities only came into force in 1989[224]. Sutherland, the former commissioner responsible for Competition policy in 1986, remarked that the difference in competitiveness between European and American firms in 1960s could be attributed to size, as European firms were just too small to take advantage of an expanded common market and to react to international competition.[225] Similar political policy was led in Europe within single states. In the United Kingdom, for instance, the government established the Industrial Reorganisation Corporate in order to promote mergers, by admitting that British firms in many industries are not big enough and through a merger they can become large enough (McCelland, 1972). The policy of the government in the UK at that time was also in favour of mergers. Notwithstanding the fact that big mergers could be prohibited under the Monopolies and Mergers Act (1965)[226], this had hardly happened (Hughes and Singh, 1980:10). A similar attitude was taken towards mergers in other European countries such as France, Sweden, Italy and elsewhere (Hughes and Singh, 1980:11).

At the end of the 20th and the beginning of the 21st centuries there was a further layout for the occurrence of the merger and acquisition transactions. The adoption of a true single market with a single Euro-zone currency fuelled consolidation through mergers within Europe across a broad range of industries. The enlargement of the European Union with enlarged opportunity to extend a single market is other factor for the merger transactions.

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[224] Except steel and coal mergers, which were included in the ECSC Treaty.

[225] The speech by P.Sutherland was addressed to international Bar Association Committee on Antitrust Law in New York, on the 17th of September 1986. Mergers and Joint Ventures: New trends in European Community Competition policy, Commission press release, IP/86/430, 17/09/1986.

[226] Note: being in use at the time.

3.3.1.2. Merger movements in the Baltic countries

During the last decade the number of transactions in mergers and acquisitions has increased in all three Baltic countries. The activities of mergers in the Baltic states follow the path of stable growth which can be determined by a number of factors.

Before the early 1990s the private sector and foreign investments or any trade relations with Western Europe and other countries apart from the Soviet bloc, were virtually non existent in the Baltic states. However, trade barriers have been easing since free trade and pre-accession arrangements. The integration of the Baltic countries into the world trade system by joining the WTO and the EU has put in place steps towards the emergence of merger transactions. This is due to the economic impact of the EU accession for the economies of the Baltic countries, which might be characterised by the increasing competition and adjustment to the higher regulatory standards. The requirements for the EU involve the removal of barriers to the exchange of goods, services and factors of production between the EU's Member States; the adoption of the common policy principles and norms of behaviour; the existence of a functioning market economy which is developing in such a way that it can sustain the competitive pressure from and in the Single Market and the Economic and Monetary Union (widely known as the Copenhagen criteria). The trends towards the creation of a more homogeneous environment with common regulations in the Baltic states like in the rest of Europe, have increased the interest of the foreign firms to enter the markets of these countries.

The government policy to privatise former state-owned companies and generally liberalisation processes has also put in place steps towards opening up markets for international competition. The gradual process of the integration into the EU started when the first agreements on liberalisation of trade were signed. The Baltic states signed the free trade agreements with the EU in July 1994, which came into force in 1995. On the basis of these agreements, the Baltic countries have become open economies to all Member States with Estonia applying no import duties, Latvia having a four years transition period and Lithuania applying a six years period, during which the import duties were gradually removed. As a result, more than 70% of FDI in the Baltic countries originates from the EU, in particular from the Scandinavian countries (Vilpisauskas, 15/05/2002). The activity of merger and acquisition transactions in Lithuania until 2002 was lower in comparison with other CEECs or even other Baltic countries Estonia and Latvia. This can be explained by problems occurring in the privatisation process. Nonetheless, after the introduction of the Privatisation Act in 1998 in Lithuania and the establishment of the public body responsible for privatisation enforcement the State Property Fund, merger transactions in Lithuania have been increasing.

The achievements in the stabilisation of the economy and the applicability for full membership into the EU have been determining factors in the growing interest in the Baltic states by foreign firms. All three Baltic countries are considered by European investors as new and unconquered markets for their investments (Lisauskas and Tamasauskaite[227], IFLR, 2003). For instance, in Estonia since October 1998, mergers have mostly concerned foreign undertakings acquiring decisive influence over local undertakings both directly and through subsidiaries, the biggest acquirers being from the Nordic countries, from the Netherlands and to a less extent from the USA (Contribution from Estonia[228], OECD, 2001). The removal of the barriers to trade, on the other hand, has also resulted in increased access for the local Baltic companies to the new markets and the new opportunities to expand their activities beyond the national market. However, the local Baltic companies have not yet been able to use this opportunity entirely. For instance, the unknown trade marks of the Lithuanian production to foreign consumers has been highlighted by the Lithuanian producers as the major problem for the expansion of the businesses into foreign markets, especially into Western European markets (BNS, 15/11/2004). Furthermore, the research of the 'Economist Intelligence Unit' showed that the small and medium companies of Eastern and Central Europe are concerned with the increased competition from Western European firms. These concerns are not without a reason as 35% of British firms consider Eastern and Central Europe as a new market for their extension (ELTA, as quoted in DELFI [229] 26/05/2004). Considering that competition was virtually not necessary under central planning

[227]Available at web-site http://www.legalmediagroup.com/IFLR
[228] Available at web-site http://www.oecd.org
[229] Available at web-site http://www.delfi.lt

(as there was no market and companies usually had to meet the quantitative objectives with set allocations of resources), the increased competition has been a big challenge for the local Baltic firms.

The Baltic countries with their prudent conduct of macroeconomic policies, low labour costs (i.e. social aspect) and corporate income tax rate are attractive for foreign investors (World Bank EU-8, 2005). The growth of the Baltic market is another stimulus for foreign firms to expand their businesses. For instance, the real GDP growth in these countries during the period 1996-2003 was 51% for Estonia, 59% for Latvia and 52% for Lithuania[230]. The accession into the EU and market operation under a set of uniform rules and principles is expected to reduce further the investment risks and interest rates (Vilpisauskas[231], 2003 No.3). Furthermore, corporate governance has proven to be a significant factor in the FDI flows associated with merger and acquisition transactions, as most Eastern European Countries, including the Baltic states, are still relatively weak in protecting minority shareholders (World bank[232], Newsletter 1999).

In general, foreign investors are active in the Baltic states and acquisitions of the local Baltic firms by foreign companies have been increasing because of the intensive privatisation programme and a good economic situation favourable for foreign investment.

3.3.2. Different forms of mergers

There are three main types of mergers: horizontal, vertical and conglomerate. A conglomerate merger can be further divided into a pure conglomerate merger, a conglomerate merger with market extension or with product extension.

A horizontal merger involves combinations of two or more similar organisations, which are active in the same industry and at the same stage of production or distribution cycle. In horizontal mergers, involved parties undertake directly competing activities and this produces two basic consequences: first, by

230 Note: for a further reading see World Bank EU-8, Special Topic: The Baltic Growth Acceleration – Is it sustainable?, Quarterly Economic Report, January 2005, part III.
231 Available at web-site http://www.freema.org
232 Available at web-site: www.worldbank.org

reducing the number of firms present on the relevant market and second, by increasing the post-merger market share of merged entity.

A vertical merger is a merger between firms at different levels of the market. Vertical transaction takes two basic forms: downward integration, by which a firm buys a customer (such as distribution network), and upward integration, by which the firm acquires a supplier. Vertical mergers do not reduce a number of direct competitors as is the case in a horizontal merger, but it may still change a pattern of industry behaviour at both levels.

According to the Department of Justice (FDJ) Guidelines, conglomerate mergers are *'[..] mergers that are neither horizontal nor vertical as those terms are defined'*. Thus, everything that is left not covered under horizontal or vertical mergers may refer to conglomerate mergers. So, conglomerate mergers are mergers between firms that have no existing or potential competitive relationship either as competitors or as supplier and customer. There are three main types of conglomerate mergers. Each of them will be defined separately. A conglomerate merger with product extensions refers to a situation where one firm, by acquiring another, adds related items to its existing products. For instance, a product extension merger may expand the product range of the merged firm, thus enabling it to offer a combination of products which downstream agents may be more willing to buy together than separately from the independent firms, before the merger. This may be the case where the combined products are technical complements (for example, when one can not function without the other, such as a computer operating system and a software, internet browser etc.), economic complements (for example, products which are consumed together like coffee and milk or produced together like petrol and diesel oil), commercial complements (for example, when they form part of a range which downstream agents, such as multiple retailers, need to carry, such as spirits, soft drinks, etc). A conglomerate merger with market extensions is when the merged firms previously sold products the same products market extends to different geographical markets. A pure conglomerate is between firms with no functional link whatsoever between them.

3.3.2.1. Waves with different types of mergers

There is a tendency that in different decades different types of merger with various motives based on economic thinking and/or economic situation prevail. The first decade of the 20^{th} century refers to horizontal mergers, about 1920-1930 – the vertical mergers wave. After the dominant pattern of horizontal and vertical expansion, the major wave of merger activity in the 1960- 1980s was one of the conglomerate types. Each wave has different characteristics. Strategic thinking right across the period before 1960s was heavily influenced by mainstream economics theory. Competitive advantage was seen as coming predominantly from greater size in a particular industry. For instance, before 1960s there was domination of horizontal mergers because managers believed that a combination of increased market power and efficiencies of greater size would deliver higher profitability and give a sustained competitive edge (Lees, 2003). Also, this wave was highly influenced by industry revolution; the emergence of heavy industry opened the opportunity for the firms to achieve the efficiencies through horizontal merger transactions. The Sherman Act as well as the Clayton Act was issued in the US as a consequence of this wave of transactions in order to prevent large mergers. Due to restrictions on horizontal mergers, in the period of 1920-1930s vertical mergers were more prevalent.

Weston and Mansinghka, who examined the 1960s conglomerate mergers, found out that the transactions of unrelated diversification was driven by defensive business reasons, in particular: to avoid sales and profit instability; adverse growth developments; adverse competitive shifts; technological obsolescence and increased uncertainties associated with their industries (Weston and Mansinghka, 1971: 928). Another reason for the occurrence of the conglomerate mergers in 1960s was the political one. In contrast to horizontal and vertical mergers, conglomerate mergers were not considered by the Antitrust Authorities as a threat to competition. Conglomerate mergers were ignored because a product and market oriented theory of firms behaviour found a conglomeration as an uncomfortable phenomenon, i.e. not being able to explain it because of the absence of compelling natural advantages (Steiner, 1975: 15). The situation had changed during the recession in the early 1980s where the major motive for merger was to reduce capacity and become more prevalent (Cooke, 1986: 27).

Apart from these three phases, two more recent waves can be distinguished. 1984-1990 is defined as mega-merger time, which was highly influential in Europe. This is because European firms wanted to prepare for the creation of the Single European Market and tried to form national champions that can be later transformed into European or even International champions.

Challenging economic and political changes in the world such as liberalisation, falling tariff barriers, technological advancements, improvements in communication and many other factors have led towards globalisation by accelerating cross-border mergers and acquisitions. Thus, the fifth wave, which is still on-going, can be defined as a cross-border merger[233] epoch. Decreasing communication and transportation costs, regulatory reforms and trade liberalisation have prompted firms to adopt global strategies. Globalisation process leads to the expansion of market; sequentially, firms tend to augment in sizes. Thus, many firms have intended to consolidate world-wide and achieve world scale and become global not just national. The growing similarity in availability of infrastructure, distribution channels, marketing approaches, large flow of funds, and the ease of communication and data transfer between firms of different countries are forces for driving towards cross-border transactions (Porter, 1998:2). This is the wave that the Baltic countries joined.

3.3.2.2. Different types of mergers in the Baltic countries

Considering that the Baltic states enrolled into the international arena during the fifth wave, it is hardly possible (if not impossible) to define the different types of mergers, which prevail over the years in Estonia, Latvia or Lithuania. Merger transactions are a 'new' phenomenon for the Baltic countries in comparison with the rest of Western Europe or American countries. Mergers have occurred in the Baltic countries after re-gaining their independence from 1991 onwards. As a result of being a part of the Soviet Union, growth through internal

[233] Cross-border mergers refer to the situation where two or more firms from different national markets merge or where a merger between two or more domestic firms has spill-over effects into other market (-s). Whereas, a domestic merger is a merger between two or more domestic or national firms with no spill-over effects on the other market (-s).

resources was the main strategy of the firms of the Baltic countries to extend capacity. Thus, the growth through merger transactions is still a relatively new business strategy in the Baltic states.

All three forms of mergers can be identified in all Baltic countries. However, according to the Annual Reports of the Competition Authorities of the Baltic countries horizontal mergers prevail. Horizontal overlaps were considered in a number of cases by the Competition Authorities of the Baltic states. For instance, in the Estonian market horizontal overlaps in soft drinks, bottled water, long drink and cider were analysed in the *AS A. Le Coq / OU Finelin* case[234], in the *Narvesen Baltija / Preses Apvieniba* case[235] in Latvia horizontal concerns were raised because both companies were involved in newspapers and periodicals retail distribution businesses. In the *UAB Mineraliniai vandenys / AB Stumbras* acquisition case [236] in Lithuania horizontal overlaps occurred because both companies were active in the alcoholic beverages market. Vertical links occurred in the *AB Achema / AB Klaipedos juru kroviniu kompanija* case in Lithuania, where the company *Achema*, active in the production of fertilizers acquired the sea cargo company *Klaipedos juru kroviniu kompanija*, in order to get access to the canal to distribute its production worldwide. The conglomerate effects on competition were examined by the Competition Council of Lithuania in the *UAB Rubikon apskaitos sistemos / UAB Vienituras* case[237] or UAB *Achemos grupe /* UAB *Baltijos TV* case[238] with widely spread portfolio starting from the production of fertilizers and finishing with the TV channel.

With regard to cross-border merger effects, there have been two basic trends in the Baltic countries. First of all, cross-mergers have occurred in all Baltic countries as a result of foreign firms with significant market power acquiring local companies. For instance, the Norwegian company *AB Orkla* acquired a Latvian leading firm in sauces market *SIA Spilva*[239]; in Lithuania the major cases involved *Norddeutsche Landesbank Girozentrale (NORD/LB)*

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[234] For a further comment see The Annual Report, 2003, available at web-site: http://www.konkurentsiamet.ee/eng/ (available in English)
[235] See http://www.competition.lv
[236] Decision No. 1S – 107, 02/10/2003, available at web-site http://www.konkuren.lt
[237] Decision No. 1S – 173, 16/12/2004, available at web-site http://www.konkuren.lt
[238] Decision No. 1S – 126, 26/08/2004, available at web-site http://www.konkuren.lt
[239] Decision issued in 30/06/2004, available at web-site http://www.competition.lv

acquiring of *AB Lietuvos Zemes Ukio bankas*[240] *(Bank)*; *Eolian Trading* Ltd acquiring *AB Lifosa*[241]; *ICA Baltic AB* acquiring *UAB Ekovalda*[242]; *Rurgas AG* and *E.ON Energie* consortium acquiring *AB Lietuvos dujos*[243] *(Lithuanian Gas)*[244] etc. Second, there have been the cases where a transaction involved foreign companies with spill-over effects on the markets of the Baltic countries. For instance, the merger in 2002 between Swedish company *Telia Aktiebolag* (thereafter Telia) and Finish firm *Sonera Corporation* (thereafter Sonera) had spill-over effects in Estonian, Latvian and Lithuanian markets through subsidiaries of these parents' companies active in the Baltic markets. The influence on the Baltic market through the subsidiaries[245], in particular the merger between the subsidiary *AS Eesti Statoil* and *Shell Eesti AS* case in Estonia, in Latvia – *Latvia Statoil / Shell Latvia*, and the *UAB Lietuva Statoil / UAB Shell Lietuva* in Lithuania also occurred after the merger transaction of the foreign parents companies, Norwegian *Statoil ASA* and the Dutch *Shell* in 2002.

The latest transaction, with spill-over effects on the Baltic countries, which was referred and approved by the European Commission, involved the Finnish company *Kesko Food* Ltd and the Swedish company *ICA Baltic* AB. Both parties combined their retailing activities in the Baltic countries by establishing a joint venture. Considering the fact that both companies already had subsidiaries active in these markets, this transaction caused some competitive concerns especially in the Latvian market and to a lesser extent in the Estonian and Lithuanian markets[246].

3.4. The internal motives to merge

The following sections involve a critical analysis based on the internal forces, which lead undertakings to merge. The examination of the internal factors

[240] Decision No. 37, 28/03/2002, available at web-site http://www.konkuren.lt
[241] Decision No. 50, 16/05/2002, available at web-site http://www.konkuren.lt
[242] Decision No. 73, 04/07/2002, available at web-site http://www.konkuren.lt
[243] Decision No. 66, 20/06/2002, available at web-site http://www.konkuren.lt
[244] For further comments see the Annual report on Competition Policy Developments in Lithuania, 2002, available at web-site http://www.oecd.org
[245] *AS Eesti Statoil / Shell Eesti AS* case (2002) in Estonia, *Latvia Statoil / Shell Latvia* case (2003) in Latvia, *UAB Lietuva Statoil / UAB Shell Lietuva* (2002) in Lithuania, available at web-sites http://www.konkurentsiamet.ee/; http://www.competition.lv; http://www.konkuren.lt
[246] Case No. COMP/M 3464, available at web-site http://europa.eu.int/comm/competition/mergers/cases/decisions/m3464_en.pdf

is required due to the enforcement policy of the competition authorities. The authorities use a case – by – case analysis and investigate every merger transaction individually, which falls under their jurisdiction. In this case the internal factors play the major role during the merger investigation process, as the motives behind the merger may help to predict possible anti-competitive effects on competition. This is the main task of all competition authorities.

3.4.1. Two basic categories

Basically, the root of most economic studies on mergers' motives is based on the economic rationality assumption, i.e. companies will behave in such a way what seem to them to be appropriate in order to further their own economic interests (Goldberg, 1983: 9). The traditional criterion for firms to merge in the Industrial Organisation is when the profit of the merged entity is higher than the combined profits of the merging firms before the merger transaction (Horn and Persson, 2001). Firms acquire assets in the activities in which they are good at and sell assets related to activities in which their competitive position is weak. Furthermore, firms extend their geographical sphere of operation by buying up firms in other Member States in their core business (Jacquemin, 1990: 19). However, some authors such as Cartwright and Cooper think that apart from rational economic and financial grounds for merge, there might be un-expressed psychological motives behind a merger decision (Cartwright and Cooper, 1996: 21). Therefore, for those who admit irrationality and speculative moods within the economic system, Jong answered by citing Shakespeare '*there is reason in madness*' (Jong, 1990: 51). Others state that there are explicit and implicit motives: explicit being such as synergies, or diversification, which mainly are given by the management of companies, there implicit motives are as a manager hubris, which can be only suspected as they usually are not confirmed by managers and are extremely difficult to evaluate (Larsson and Wallenberg, 2002).

There are a number of reasons why firms merge and very often firms may have more than one motive. Yet, the grouping into basic categories is useful. First of all, two basic groups can be distinguished, i.e. economic motives and socio-political motives[247]. Economic motives, which can be further separated into efficiencies, market power and others, play a major role in the merger investigation process, due to their impact on competition. Apart from economic motives, mergers may impose socio-political aspects and they may provide a further contribution towards social welfare. Both aspects of motives to a merger will be discussed in the following sections.

3.4.2. Economic motives for merger[248]

3.4.2.1. Efficiencies[249]

3.4.2.1.1. General overview

Gaughan (1991) states that synergy is probably the most common motive for entering into a merger according to theorists at large. The basis of synergy is that operating economies of scale may be achieved because existing firms in the industry are operating at a level below optimum and lower unit cost may be achieved at a higher level of capacity (Cooke, 1986:26). The synergy effect is known as the formula '2+2=5' by meaning that economies of scale arise when the cost of producing two products is lower than the sum of costs of producing them as separate entities (Chiplin and Wright, 1987:23). Costs savings, revenue enhancements, process involvements, financial engineering and tax benefits refer to the sources of synergy (Eccles, Lanes and Wilson, 1999). In general, the synergy is about increasing competitiveness.

Economists distinguish short-run and long-run economies of scale. Through merger short-run economies of scale may be achieved from the elimination of a duplication of fixed costs, for instance, administrative and operational costs such as purchasing materials or even duplication in departments

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[247] These two are very general groups. The researcher does not state that a merger transaction always has either of them two. The idea is to show that apart economic aspects, merger transactions may also have socio-political aspects. For instance, firms may have not only economic motives behind the merger, but also political one, as to gain a political power.

[248] Since, domestic and cross-border mergers may share the same motives, it will be not necessary to distinguish them, unless stated otherwise.

[249] The terms 'synergy' and 'efficiency' are used interchangeably in this paper, as some economists refer to synergy others to efficiency for defining the same thing.

(i.e. accounts, law or personnel). Mergers can also gain efficiencies by increasing the bargaining power of the merging firms. This is the case when tariffs discriminate between large and small users and the merged entity may obtain quantity discounts as a result of merger (Ilzkovitz and Meiklejohn, 2001:7). Economies of scale may also be achieved by 'rationalisation' - reallocating production between plants, this means, from shifting output from one plant with a high marginal cost of production to another lower-cost plant, without changing the firms' production possibilities limits (Roeller et al., 2001). The economies of scale cannot only be a plant specific, but also product specific, resulting from longer production runs of a specific product and producing higher output from existing facilities (Weinberg, Blank and Greystoke, 1979:35). Specialization of people and machines may also lead to economies of scale through learning effects. The phenomenon of learning effects associated with increasing experience of production of a good or providing a service. In this case, the cost of producing each extra unit decreases as the cumulative output increases. The occurrence of these improvements is a result of simple repetition of tasks and not of changes in the scale of technology (Weinberg, Blank and Greystoke, 1979:36).

Long-run economies of scale may be realised through a merger in production, for instance, energy requirements for a large machine may be proportionally lower than those of a small machine. Furthermore, in research and development, for instance as the production of the firm increases, it becomes worthwhile to invest more in sophisticated technologies and/or in marketing activities, such as a single brand name being created to reduce advertising expenditures (Roeller, Stennek, Verboven, 2001:9). The merger may also enhance technological progress by increasing the incentives for R & D activities among the merging firms as they may have a capacity to engage in research and innovation. A firm with good ideas and entrepreneurial managers but no money can combine with a firm with a lot of financial resources but no ideas. Replacing poor management with good management through a merger can also increase management efficiency. Economies of scope may arise from the joint production or provision of complementary products. For instance, the same indivisibility can be used at once in the production or distribution of several goods, also by extending its range of products, a firm can thereby reduce its unit costs (Jacquemin, 1990: 8-9). Sometimes, economies of scope and economies of scale are used interchangeably. However, even the two are closely related but the economies of scope refer to the capacity of a company to make use of one set of input to offer a larger collection of products/services.

In general, mergers can yield efficiency gains in various ways such as a better exploitation of economies of scale, economies of scope and learning effects, by enhancing technological progress, by improving the efficiency of management and others. Depending on the case, the efficiencies from mergers can reduce costs, intensify competition, facilitate entry, expand existing markets and/or create markets for new products and services.

3.4.2.1.2. Efficiencies of different forms of mergers

With regard to different forms of mergers, horizontal mergers offer good opportunities for achieving synergies by reducing the costs through combining the operations horizontally and sharing information, knowledge and other resources to gain economies of scale and scope.

Referring to vertical mergers, Sanchez and Heene stated that the minimum efficient scale of production in most industries increases as one goes upstream from the bottom to the top of the vertical structure of an industry (Sanchez and Heene, 2004:175). With regard to downstream vertical integration, the synergies may be created in four different ways: (1) by avoiding market failures because of overcoming the free-rider problem in distribution, retailing, or service and support activities; (2) by gaining access to distribution that may not be available otherwise as through established channels; (3) by improving service, image and personal interaction value in a product offer; and (4) by gaining a better understanding of market preferences by establishing direct contacts with final consumers (Sanchez and Heene, 2004:176-177). Through a vertical integration the economies of information exchange may be gained. This is because common training, experience and the Code of behaviour within the firm facilitate communication among employees (Williamson, 1987:27). Furthermore, a greater sensitivity of control instruments may be achieved through a vertical merger in comparison with inter-firm activities (Williamson, 1987:26). In general, vertical integration can also reduce production costs when production processes require closely integrated steps in the production chain or by getting closer to the consumers in downward streams or to the suppliers in upward streams.

For Cooke, financial synergy is more likely to be achieved by conglomerates, since transaction costs, as a proportion of a new share issue, decrease as the sum raised increases, thereby conferring an advantage to firms raising large sums of money on the capital markets (Cooke, 1986: 27). Conglomerate mergers may also give opportunities for firms to reduce capital costs and achieve efficiencies. Conversely, other authors expressed that a merger in wholly separate markets, producing different products, using different technologies have less potential to benefit in terms of efficiencies because economies of scale in production and distribution are less likely (Steiner, 1975: 51).

Firms may expand geographically in order to achieve efficiencies on a global basis through cross-border mergers. Cross-border mergers may lead to global economy-wide efficiency gains achieved through economies of scale and scope. Furthermore, cross-border mergers may enhance innovation capabilities and give synergy effects in R & D for both host and home countries through global knowledge exchange. Cross-border mergers are considered as channels for complementary technological resources especially in high-technological sectors[250]. Leaning effects may raise social welfare at a global level by equalising knowledge worldwide (Sim and Yunus, 1998 as quoted in OECD, 2001).

3.4.2.1.3. Efficiency motives in the Baltic countries

Efficiency as a basic motive for merger has been claimed in the Baltic countries in a number of merger cases with or without an international element, as a merger transaction between foreign subsidiaries, foreign and local firms or between the local companies. Various aspects of efficiencies motivated firms to merge in the following cases.

In the Estonian jurisdiction, the efficiencies, as a motive was claimed by the parties of two foreign subsidiaries in the *AS Tootsi Turvas / AS Puhatu Turvas*

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[250] For further reading see OECD, New Patterns of Industrial Globalisation: Cross-border Mergers and Acquisitions and Strategic Alliances, 2001.

(2003) case[251]. The AS *Tootsi Turvas* (since 2002 belonging to the Finish group *Vapo Oy* after the previous acquisition) acquired 66.7 % of the shares of AS *Puhatu Turvas*, which is a high potential peat mining company with peat fields. AS *Tootsi Turvas*, meanwhile, is the largest peat mining and processing undertaking in Estonia with two production units and its own peat briquette factory. Thus, the impetus for this merger was to achieve efficiencies from peat production.

In the Latvian jurisdiction, in the case *Latvia Statoil / Shell Latvia*[252], one fuel company 'Latvia Statoil Ltd' would acquire decisive influence over 'Shell Latvia Ltd' on the basis of partnership by acquiring 100 % of the shares. In this horizontal merger case the parties of two subsidiaries of the foreign companies pointed out that the objective of the transaction is to improve quality of the services offered as well as decreasing expenses for services provided by the third persons, maintenance of petrol station indexes network and common and administrative expenses. The motives for the merger transaction were defined as the creation of one effective petrol station network instead of two networks, improvement of fuel quality, the ability to offer fuel for competitive prices, as well as the introduction of more services and programmes, such as fast food, internet kiosks and other services.

In the Lithuanian jurisdiction, the parties in *UAB ZIP3 / UAB Vesiga*[253] case claimed the achievement of efficiencies through the merger. Lithuania's joining of the EU and the growth of international competition, changes of consumers' priorities and tastes are factors that force companies to invest into technology and to improve products' quality and to extend the production range. In this case the parties mentioned that by combining their industrial and financial facilities and intellectual property, they will be able to increase industrial capacity and as a result decrease the costs of production which will give a possibility for the parties to invest in the improvement of the products' quality and advertise the trade marks.

[251] See the Annual Report of 2003, available at web-site http://www.konkurentsiamet.ee/

[252] *Latvia Statoil / Shell Latvia,* 2003.

[253] *UAB ZIP3 / UAB Vesiga*, No 1S - 112, 15/07/2004, available at web-site: http:// www.konkuren.lt

In the horizontal merger case *AB Alita / AB Anyksciu Vynas*[254] the parties of two local companies, active in the alcohol business claimed that *AB Alita* acquires 100 % of *AB Anyksciu Vynas* in order to achieve efficiencies by finding a new niche and extending production capacities in the Lithuanian market with an intention in the near future to reach international markets. The parties also pointed out that this transaction is necessary in order to be able to compete, first of all, with increased competition in the Lithuanian Alcohol market and secondly to face foreign competitors. Competition in the Lithuanian Alcohol market has increased as a result of amendments made to the Alcohol Control law. On 1 January 2004 the exclusive rights of the state monopoly to produce alcohol was annulled by opening up the market for the firms to enter after gaining the licence. As a result of joining the EU and the disappearance of the tariff barriers for alcohol imports, local producer will face competition from foreign countries. Through this transaction, the firms (both active in the alcohol market) by combining their capacities will be able to achieve efficiencies and face competitors[255].

In the *UAB Hronas / UAB Labradoras ir Ko / UAB Baltaura / AB Pagiriu siltnamiai* case[256] the parties claimed that the motive of the acquisition of the joint control of the 100% shareholding of the AB *Pagiriu siltnamiai* was to achieve efficiencies through management rationalisation and the optimisation of production alongside the expansion of the range of production processing by canning, drying and freezing.

The necessity for investment and to expand the production trends in order to reach broad classes of consumers due to the increased competition from foreign entities were mentioned as motives in the UAB *MG Baltic Investment* / AB *Levuo* merger[257] case in the Lithuanian jurisdiction.

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254 Decision No. 1S – 80, 27/05/2004, available at web-site: http:// www.konkuren.lt
255 The motives provided by the parties involved in the transaction. The information was obtained from the file submitted to the Competition Council of Lithuania.
256 Decision No. 1S - 39, 07/04/2005, available at web-site http://www.konkuren.lt
257 Decision No. 1S – 151 21/10/2004 available at web-site: www.konkuren.lt

3.4.2.2. Market power

Firms by bringing economies of scale and scope may be equally attracted by the market power and protection from competition that may accompany such benefits (Bishop, 1993:295-296). Thus, mergers can have antitrust concerns and may pose competitive hazards. Mueller and other scholars state that a merger may increase market power of the firm either by affecting the elasticity of demand for the firm's products or by raising barriers to entry (Hughes, Mueller and Singh, 1980:29). It will allow firms to earn higher profits either by raising their limit price by changing their effective elasticity of demand or by allowing them to earn profits at their present price for a longer period of time. A potential entrant may be discouraged from entering the market if it knows that the merged entity's (which has a single dominance in the market) costs are lower and that the 'dominant' firm would be better able to engage in a competitive price war than the potential competitor itself.

3.4.2.2.1. Market power of different types of mergers

Horizontal mergers of direct rivals may yield single market power or by reducing the number of market players in a concentrated industry may lead to the likelihood that the remaining firms will expressly or tacitly coordinate price and output. Hence, mergers may have unilateral or co-ordinated effects. Unilateral effects arise where the merged entity is able to profitably increase the price by reducing the outcome as well as reducing choice and innovation through its own acts without the need for a co-operative response from competitors. The merger which gives rise to unilateral effects is call to give rise to a situation of single firm dominance. The difference between the unilateral effects and the co-ordinated effect is that co-ordinated effects rely on other firms as well as the merged entity modifying their behaviour following the merger. Such a situation is known as oligopolistic dominance or collective dominance.

As was described above, vertical mergers do not reduce the number of economic entities operating at horizontal level of the market, but it may change the pattern of industry behaviour at both levels as the newly acquired firm may decide to deal only with the acquiring firm, thereby altering competition in three markets: among the acquiring firm's suppliers, customers or competitors. The adjustment toward greater reliance on internal transfers is unremarkable; if efficiencies can be gained from internalisation, one would expect the newly integrated firm to resort more for internal transfers and rely less on open market transactions. In this case, suppliers may lose a market for their goods, retail outlets may be deprived of supplies, and competitors may find that both supplies and outlets are blocked. There is a possibility of creating a situation for collusive behaviour or to foreclose outlets or sources of supply to competitors at both upward and downward levels[258]. A vertical merger may enhance a monopoly power at either an upward or downward market level where the vertical integration raises entry barriers to non-integrated firms. For instance, vertical integration may force other firms to integrate vertically in order to compete; this may delay entry and increase the risk premium for the capital, which such entrants need. However, Bishop and Walker (1999:158-159) stated that anti-competitive effects in vertical restraints are likely to occur only if there is horizontal market power at one or more of the vertical levels. In this case firms with market power can use that power to foreclose market access and raise competitors' costs or even dampen competition.

Conglomerate mergers between firms in different markets, although not directly affecting the market horizontally or vertically, involve the risk of cross-subsidisation within the conglomerate firm, which facilitates predatory pricing campaigns against smaller competitors (Frazer, 1992:68). Also, under certain circumstances, in the case of a product extension merger the combination of such products may give the merged firm the ability and the economic incentive to change its commercial conduct thus altering the structure of the markets concerned. In particular, when a merging firm enjoys market power in one or more of the complementary products, a change in its conduct may be expected to result in the leveraging of its existing market power into one or more of the products that constitute the combined product range. This is known as a 'portfolio power' with the rationale: when the market power deriving from a portfolio of brands exceeds the sum of its parts. The Commission in *Guinness / Grand Metropolitan* case stated that the holder of a portfolio may enjoy a number of

[258] This theory of harm will be further explored in chapter 4.

advantages as *'[..] he will have greater flexibility to structure his prices, promotions and discounts, he will have greater potential for tying, and he will be able to realise economies of scale and scope. Finally the implicit (or explicit) threat of a refusal to supply is more potent'*[259]. This case was highly criticised by economists due to lack of a sound economic basis[260]. For instance, Bork (1978) stated that it is impossible to raise more than one monopoly profit each time[261]. Moreover, some economists further argue that conglomerate mergers, i.e. a merger between firms supplying a range of complementary or substitutable products might enable a firm that is dominant in one market to use its market power to leverage it into another, only when competition in both markets is imperfect (Gal, 2003:198-199).

3.4.2.2.2. Cross-border mergers

Cross-border mergers through horizontal, vertical or conglomerate links may also produce anti-competitive effects on competition in a global market by creating global giants, which may block entry into the market for other companies or engage in other anti-competitive practice. In this case consumers of more than one country might be injured. For instance, if a monopolist exercises a market power in a multinational market, the consumers in all markets of different countries where the monopolist holds its power will suffer due to higher prices (resulted from reduced output) (Mitchell, 2001). Mega-mergers have resulted in the world economy with consolidation of significant shares of the world market, for instance, the *Dasa / Aerospatiale* (1999) resulted in the third largest air and space enterprise in the world; the *Warner / AOL* merger (January, 2000) in the largest combined media and internet access service; the *Vodafone / Mannesmann* (March, 2000) in the largest world-wide telecommunication enterprise and the fourth largest enterprise in the world (Horn, 2001:3).

Furthermore, a cross-border merger may have spill-over effects. This means that a merger between domestic companies may create a company that may exercise market power in foreign countries, especially in small ones (Mitchell,

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259 *Guinness v Grand Metropolitan,* case No. IV/M.938, para 40.
260 See, for instance, Bishop and Walker, 1999, pp. 158-160.
261 A further discussion on market power will be analysed in the chapter 4.

2001). The problem with anti-competitive practice of cross-border mergers is an applicable jurisdiction, meaning that competition laws traditionally focus on keeping competitive market structures 'within the borders' and cross-border mergers extend beyond the limits; as a result the competition authority of affected market can do little from opposing such a merger. However, it is not entirely true as the principle of extraterritoriality with 'effect test' is applied. In this case, the competition authority of the affected market by the merger may still question and block the merger between foreign firms operating in foreign markets but having anti-competitive effects on the domestic market. For instance, the EC Merger Regulation is implicated when the European market is affected; the US Antitrust law when the American market is affected and other national competition laws are applicable when the merger has anti-competitive effects on those national markets. This was the case when the EU had questioned the *Boeing / McDonell Douglas*[262] merger between two American companies or the US Federal Trade Commission investigated the *Ciba-Geigy Ltd / Sandoz*[263] merger between Swiss companies (Horn, 2001: 16).

However, other problems may arise while dealing with cross-border mergers such as gathering evidence in the foreign forum, multinational filings and reporting or protection of the markets in the countries, which do not have competition law. There has been an ongoing process of debates whether bilateral or multilateral agreements can solve all the problems or one international competition authority should be introduced. Furthermore, the international organisations such as the WTO, the ICN, the OECD, the UNSTAD and others consider whether or not there should be international rules on competition applicable to all signed countries, and if yes, which one international organisation is the most suitable and what role should it play in order to enforce the principles of international competition. Despite these debates, the scholars agree that the time is not suitable yet to realise such an idea and there is a long way for such an authority[264] to be built.

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[262] 48 Case IV-M.877 (1997) O.J.C. 136/3

[263] (CC4) 24, 182 (FTC 1997)

[264] The researcher will not continue a further analysis whether there is a need for the international competition authority; or bilateral or multilateral agreements can solve all problems raised by cross-border mergers. For further reading on this topic, see Woolcock S., International Competition Policy and the World Trade Organisation, the paper prepared for the Commonwealth Trade Forum, July 7th-8th 2003; Mitchell, A., Broadening the Vision of Trade Liberalisation,

3.4.2.2.3. Market power - the Baltic countries context

Merger control is a predictive exercise of two players in opposite front-lines: firms with the aim to merge and competition authorities to prevent anti-competitive mergers. These two countervailing forces have different approaches to the effects of merger on competition. Firms attempt to present pro-competitive effects achievable through a merger transaction. Meanwhile, the competition authorities are aimed at preventing any anti-competitive effects of a merger on competition.

Considering that all Baltic countries apply either a 'dominance test' or a modified version of a dominance test in response to the modernisation of the ECMR, the Competition Authorities in Estonia, Latvia and Lithuania are empowered to block mergers, which might increase market power and/or otherwise impede competition. Thus, firms do not disclose market power as a motive for merger. Nevertheless, firms are sometimes open to the press and like to boast that as a result of a merger transaction they will obtain market power. Usually, a press release is one of the sources under which the Competition Authorities may initiate the case. However, the before doing that officials of the Competition Authorities check the reliability of the information obtained from the press.

In the Baltic countries' jurisdictions a presumption of a market power arises if after a merger transaction the merging parties would gain at least 40% in the relevant market. In addition, under the Competition Law of Lithuania each of a group of three or a smaller number of undertakings with the largest shares of the relevant market, jointly holding 70% or more of the relevant market shall be considered to enjoy a collective dominant position. A presumption of both single dominance and collective dominance as motives for merger have been examined by the Competition Authorities of the Baltic states in several cases.

A single dominance was examined by the Competition Council of Lithuania in *UAB Vitoma / AB Antrimeta / UAB Ikrova / UAB Metalo lauzas /*

International Competition Law and the WTO, World Competition 24(3), 2001, pp343-365; Schoneveld, Cartel Sanctions and International Competition policy: Cross-Border Cooperation and Appropriate Forums for Cooperation, World Competition, 26(3), 2003, pp.433-471 and P.Marsden, Antitrust at the WTO, 13/1 Antitrust 78 (Autumn 1998).

UAB Antriniai metalai[265] case. In this transaction the UAB *Vitoma* intended to acquire 70.09% of shares of the AB *Antrimeta*, 70% of shares of the UAB *Ikrova,* 70% of shares of the UAB *Metalo lauzas* and 70% of shares of the UAB *Antriniai metalai.* The concentration was considered to be horizontal with the overlaps in the Lithuanian ferrous scrap metal purchase and processing market. Despite the motivation behind this transaction claimed by the party to be the economies of scale, the Competition Council of Lithuania refused to grant permission to implement this transaction because of the fact that the merged entity would hold around 48% of the relevant market. The elements of economies of scale, advantageous price policy, limited volumes of purchased scrap metal, high cost of acquisition of new technologies, long-term export contracts with a single foreign buyer were considered as the conditions to restrict competition in the Lithuanian ferrous scrap metal purchase and processing market. This transaction was approved by the Competition Authority only after repeated notification by the party with major changes to the former transaction.

Collective dominance by the Competition Council of Lithuania was investigated in *A/S Carlberg / AB Kalnapilis / UAB Utenos Alus / UAB Jungtinis Alaus Centras* case[266], where A/S *Carlberg* intended to acquire the controlling interest of some Lithuanian beer producers. The Competition Council of Lithuania projected that the proposed horizontal transaction in the beer market in Lithuania would be intensified by vertical concentration due to the activity of the UAB *Jungtinis Alaus Centras* and would lead all market participants to gain a collective dominance through having possession of over 80% of the beer market. The acquisition transaction was approved subject to the conditions and the obligations, defined by the Competition Council of Lithuania.

Apart from achieving efficiencies and market power through a merger, firms may have other impetuses to merge.

[265] See Annual Report of Lithuania, 2000-2001, available at web-site: http://www.oecd.org
[266] Annual Report of Lithuania, 2000-2001, available at web-site: http://www.oecd.org

3.4.2.3. Other motives

3.4.2.3.1. The way to enter

A transaction through merger and acquisition is one of the quickest and simplest ways to enter into a new market that confers strategic advantage while time in business is really important. Acquiring or merging with existing companies is often a cheaper and faster means of entering the market than establishing subsidiaries from scratch (Ansoff and others, 1971). Merging with an existing business usually offers the advantage of speed in gaining a market position, technology, new products, customer relationships or contracts with suppliers or other resources that would normally take years for non-merged firms to develop through natural growth. In some cases, especially when the market is already 'saturated' with incumbent firms, it is simply not economically plausible to enter a market through a start-up and merger is the only option for entering the market. A merger/acquisition might be a way to circumvent barriers to enter into an industry, especially in markets where the requirement of a particular licence is essential. With regard to cross-border mergers, a merger or an acquisition is often the easiest and the simplest way to get into another country's market especially in an unknown market. It is a way to 'localise' quicker than through establishment. To enter a foreign market in order to internationalise the operations further might be another reason to merge.

3.4.2.3.1.1. The Baltic countries context

As previously mentioned, foreign companies have been using the merger transactions as a means to enter unknown Baltic countries' markets. The entry has involved the foreign firms acquiring the local companies or subsidiaries of the other foreign parents' companies. For instance, in the *If Skadeförsäkring Holding AB / AS Sampo Eesti Varakindlustus* (2001) case[267], the Swedish company *If Skadeförsäkring Holding* is active in property and casualty insurance markets in Nordic countries and acquired the sole control over the Estonian subsidiary *AS*

[267] For a further comments see the Annual Report of 2001, Estonia, available at web-site http://www.konkurentsiamet.ee/eng/index.html?id=916

Sampo Eesti Varakindlustus that provides property and casualty insurance services in Estonia in order to get access to the market. The motive of the Dutch company *DFDS*[268] was to enter the Lithuanian marine market through the acquisition of the active firm in this market *AB Lisco Baltic Service*. Instead of establishing a new company, which would cost a lot of time and money, this company chose a cheaper and quicker mode to enter the market. Another example illustrates that a foreign company may acquire a local firm in all Baltic countries in order to enter their markets. For instance, 93% of shares of *A/S Rigas Fondu birza* were passed to Finnish firm HEX Plc., which already owns a stock exchange firm in Estonia and is planning to acquire the stock exchange of Lithuania[269].

Depending on the sector, there might be only one way to enter the Baltic market by acquiring an existing company in order to circumnavigate barriers of entry, especially in the markets where the requirement of a particular licence is essential. For instance, there are a limited number of licences to provide mobile connection services in Lithuania.

3.4.2.3.2. Acquiring assets at a discount

Companies may acquire other companies because they can get them 'at a discount', meaning less than their real value, with the intention to sell off some of the assets at a profit in the future or to invest funds somewhere else (Morgan, 1980:40). The basis for this is that the acquirer knows better than the acquired the real value of assets and/or how to exploit it (Jervis, 1971:29). The theory of takeovers also suggests that if the stock market value of a company falls below the value of the outsider firms, the firm will more likely be taken over[270]. Many scholars expressed various situations in which the control of the assets of firms was obtained at a discount. Penrose (1972:160) reported that there might be the situation of undervaluation of publicly traded stock of a company either because of a lack of confidence in its management or a discounting of the marketable

[268] *AB Lisco Baltic Service / DFDS* (2001).
[269] For further comment see the Annual Report 2003of the Competition Council of Latvia, available at web-site: http://www.competition.lv
[270] For instance see Marris's model, in Marris, The Economic Theory of 'Managerial' Capitalism, Macmillan, 1964.

stocks for lack of liquidity[271]. Weinberg, Blank and Greystoke (1979) explained that undervaluation may occur in the situations: when directors of a firm are unaware of the true value of its assets; or because of an inefficient capital structure; or where its shares have a poor market rating; or even because the directors of a firm have failed, generally because of poor management, to put the assets of the firm to its most efficient uses. The latter was the case after WWII, when new industries increased in importance as a result of the rapidly changing economy, while old industries decreased, and the managers of the declining industries were unaware or unable to adjust to the changes[272]. A similar situation occurred in the Baltic countries during the transformation period; where directors of the old style system could not adapt their management and make it fit under a new environment. This resulted in the declining value of the companies (Lydeka, 2001:232-236). These companies have become the targets for acquisition. The majority of foreign investors in Lithuania have chosen to buy firms formed after 1990 as they were estimated at a lower value in comparison with former giant state monopolies with higher assets base.

The example of 'acquiring assets at a discount' might be the acquisition by the consortium *UAB Hermis fondu valdymas*[273] of two in-effective companies *AB Snaige* and *AB Vilniaus vingis*. In a short period *UAB Hermis fondu valdymas* has managed to raise the profitability of these companies and as a result the stock prices of *AB Snaige* and *AB Vingis* have increased.

3.4.2.3.3. Fear to be acquired / a merger to survive

A motive for a merger might be the reaction to a changed environment or due to opportunity, as an appearance of new technology, a fluctuation in competitors' policy and the fear not to be acquired. Fear to be taken over, may encourage managers to take steps to increase efficiencies (Chiplin and Wright, 1987:27). Theoretically, there are scenarios when market conditions change from segmentation to integration. In this case firms, which are active in the segmented

[271] Such kind of the merger promotion was highly important in the past in the United States. As Butters, Lintner and Cary (as quoted in Penrose, 1972), stated in their report that *'[..] the market prices of the stock of so many companies were substantially below their book values, and even more so below the replacement values of the underlying assets'*.
[272] Note: for further reading see Weinberg, Blank and Greystoke, 1979, pp.24-32.
[273] *UAB Hermis Valdymas / AB Snaige / AB Vilniaus Vingis* (2002).

markets, may not survive in a completely integrated market due to the lower price level. As a consequence, the firms have the incentive to merge in order to survive by reducing the competitive pressure in the integrated market and by exploiting economies of scale and saving costs (Ganslandt and Persson, 2003). Moreover, firms believe that the more their market shares are larger, the more control of the environment they have and this can be secured through a merger transaction. In this case, if the firm's market position has reduced in comparison to the competitors, who are merging, the best defence is to follow the competitors' strategy to merge (Newbould, 1970:140).

Due to the globalisation process, domestic markets are more exposed to international competition. Thus, domestic companies might have a desire to protect their market. Mergers may play an important role in such a protective strategy, as it may prevent foreign undertakings from entering into domestic markets (known as a 'perceived potential competition') or from acquiring domestic firms, i.e. 'pre-emptive mergers' (Ganslandt and Persson, 2003). In the theoretical industrial organisation literature has proven that domestic companies may prevent such foreign entry by acquiring the domestic targets themselves (Horn and Persson, 2001).

This motive has indirectly dominated in the local firms of the Baltic countries' merger transactions. For instance, in the case *AB Alita / AB Anyksciu Vynas*[274] (as discussed above) as a motive for merger, the parties pointed out the changes of the environment in the Lithuanian market and a threat from foreign competitors.

3.4.2.3.4. Ensuring raw materials and sales

In some industries the availability of adequate supplies is crucial, especially of raw materials, such as natural resources. In this case, a manufacturer may decide to integrate vertically through upward or downward integration in order to secure a source of raw materials (Jervis, 1971:29). For instance, a paper company requires a continuing supply of timber. Thus, it is common that a paper manufacturer would acquire large timber stands in order to be assured of a supply

[274] Decision No. 1S – 80, 27/05/2004, available at web-site: http:// www.konkuren.lt

of these materials in the future. This also works in downward integration, where manufacturers acquire chains of retail outlets to provide themselves with captive customers (Linower, 1968:52).

As regards the Baltic context, similar cases have occurred in these countries; there one firm acquired another in order to assure the raw materials. For instance, the company *AB Achema*[275] active in the production of fertilizers in Lithuania acquired the sea cargo company AB *Klaipedos juru kroviniu kompanija*, in order to get access to the canal to distribute its production worldwide. This transaction has secured to the *AB Achema* the distribution channel.

3.4.2.3.5. National champion

It may be a policy of a state and the government may allow or encourage merger transactions between local companies that have adverse effects on domestic consumers with the aim of promoting internationally competitive companies[276]. Thus, merger transactions may enable two or more local companies that are performing poorly apart to build a critical mass and to form a 'national champion' able to compete internationally. According to this point, the competition authorities should not block such mergers even if there is a possibility that competition will be reduced as a result of the transaction. However, the European Commission and the Antirust Authorities of the US have different position from that stated above. According to Pitofsky, a former FTC chairman, the 'national champion' argument is not allowed neither in the US courts, nor in the Competition Authorities to influence the decision on a merger transaction (Pitofsky, October 15, 1999[277], as quoted in Ganslandt and Persson, 2003). Similarly the European commissioner, Monti (2001) stated that *'[..] consumers deserve a high degree of protection from dominant suppliers irrespective of the*

[275] *AB Achema / AB Klaipedos Juru kroviniu kompanija* (1999)
[276] Such consideration has been important in several countries, especially in Sweden and France.
[277] Note: for further reading, see Chairman R. Pitofsky, Federal Trade Commission, The Effect of Global Trade on United States Competition Law and Enforcement Policies, Fordham Corporate Law Institute, 26th Annual Conference on International Antitrust Law and Policy, New York City, October 15, 1999.

size of the country' [278]. The priority is on the definition of product and geographical markets despite any consideration whether there is a small or big market. Considering that the Baltic countries accepted the EC competition policy, a similar position is held in all the Competition Authorities of the Baltic countries.

Economists tend to disagree on this argument, as there are different opinions expressed. Some theoretical and empirical evidence suggest that competition is important if not necessary for efficiency and cannot be evaded even for building a 'national champion' (Holmstrom and others, 1989:61-133, as quoted in Ganslandt and Persson, 2003). Along similar lines, Porter's study proves that companies succeed in international trade, if they compete vigorously against domestic opponents (Porter, 1990:662-664). This is because a domestic competition rather than dominance gives impetus for efficiency and innovation, which are very important for successful export[279]. Size is not a prerequisite for competing internationally, as an export is not only the prerogative of big firms. However, Gal's study (on small market economies) proves that in the small market economies, a market may support only one (or a few, depending on market specification and industry) efficient firm (Gal, 2003). This means that efficient size is necessary to enhance export opportunities. According to Gal size may not only affect production and dynamic efficiency but also the relative cost of the accumulation and analysis of the market information. In this situation, small economies have to *'[..] balance the benefits from increased international competitiveness against the costs of the proposed merger in the domestic market'* (Gal, 2003:202).

With regard to examples in the Baltic countries, the 'national champions' in these countries are the former state monopolies (a heritage from the Soviet Union). However, unlike the meaning of 'national champions' in the theory, these monopolies in the Baltic countries have had specific implications due to their inefficiencies, which were covered by State subsidies. As a consequence of the liberalisation and privatisation processes in the Baltic countries, these State monopolies have been disappearing from the markets. For instance, all telecommunication service markets in Latvia are open for competition in

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[278] For further reading, see the speech delivered by the Competition Commissioner Mario Monti, Market definition as a cornerstone of EU Competition Policy, Workshop on Market Definition, Helsinki Fair Centre, Helsinki, 5 October 2001.
[279] For a further reading see M. E. Porter, The Competitive Advantage of Nations, 1990.

accordance with the requirements of the Law on Telecommunications (Economic Reform of Product and Capital Markets, Latvia, 2004). Despite expressing some concerns that national firms require to reach a minimum size to compete beyond national borders, the Baltic countries do not have the promotional policy to create national champions. Nonetheless, there have been cases, where the companies tried to achieve a critical mass through merger and acquisition transactions. For instance, the main strategy to gain a critical mass through 2001-2002 acquisitions of small competitors was of the information technology companies *AB Alna* and *UAB Sonex* in Lithuania.

3.4.2.3.6. Rescue merger

A rescue merger can be defined as a transaction where one or more companies acquire another business entity, which will leave the market in the near future anyway due to financial difficulties. Such a type of merger (acquisition) may serve as an investment purpose in order to keep a 'dying' company viable. Thus, in this case merger and acquisition transactions can be seen as one of the possible ways to recover when companies are in financial distress. Despite the fact that merging a company in distress with another healthy firm may rescue the former, it is not always the case in practice as a strong rescue strategy is required (Stallworthy and Kharbanda, 1988:38). There are a variety of reasons why a 'healthy' firm would acquire a company in financial trouble. For instance, the transaction can strengthen the position of an acquiring company where it has an established product line, especially if the acquired firm has the useful resources; alternatively, there might be a wish by the acquiring firm to diversify into related or unrelated areas and the transaction can fulfil such a desire or even a 'healthy' company may wish to enjoy the prospect of turning around a 'sick' company. Firms may stay viable by acquiring an attractive business. This is because *'[..] someone's trash can be someone else's gold mine: this is a basic principle in the recycling of waste and when this happens everyone gains'* (Stallworthy and Kharbanda, 1988:55). Also, the company in financial trouble may be acquired at a 'bargain price'. Furthermore, the losses of the acquired firm may be offset against the profits of a 'healthy' company that would bring substantial tax savings. There is a policy in some countries where fiscal incentives may be offered for a 'healthy' firm for rescuing an ailing firm (Stallworthy and Kharbanda, 1988:26-27, 38-39).

As regards the Baltic states' experience, some rescue mergers have occurred there. For instance, the *Par SIA Massonyx Ltd / Latvija propane gaze* transaction[280] can be defined as a rescue merger. As a result of the acquisition over *Lavija propane gaze* by the *Par SIA Massonyx Ltd*, Riga Export a gas filling station / terminal is being used again for liquefied gas export and transit after several years of stand still.

3.4.2.3.7. Avoidance uncertainty

Through a vertical merger downstream or upstream links firms may resolve uncertainty. Vertical mergers may give managers enhanced control over the company's activities. This control may lessen the probability of foreclosure or price squeeze. The empirical tests proved that the avoidance of the uncertainty was the main motive for the vertical mergers in the period of 1948-1964. This motive forced conglomerate mergers to increase from 1965-1972 mainly through diversification (Goldberg,1983:52-65).

Avoidance uncertainty may be defined as one of the motives in *AS Tallinna Küte / AS Tallinna Soojus* case[281] in Estonia, where the *AS Tallinna Küte* active distance heating services acquired facilities from *AS Tallinna Soojus* necessary for production and distribution of heat by distance network. As a result of the transaction *AS Tallinna Küte* started to operate the production equipment and distance – heating network in the heat supply market.

3.4.2.3.8. Diversification

Diversification is generally defined as enabling firm to sell new products in new markets (Sudarsanam, 1995:30). Thus, the diversification process occurs when a company extends *'[..] its productive activities whenever, without entirely abandoning its old lines of product, it embarks upon the production of new*

[280] For a further comments see the Annual Report of 2003, Latvia available at web-site http://www.competition.lv

[281] For a further comments see the Annual Report of 2001, Estonia available at http://www.konkurentsiamet.ee/eng/index.html?id=916

products, including intermediate products, which are sufficiently different from the other products it produces to imply some significant difference in the firm's production or distribution programmes' (Penrose, 1972:108-109). Here, the situation is very similar to a conglomerate merger, as discussed above. Some authors use the terms 'diversification' and 'conglomeration' interchangeably[282], others, as such Steiner states that 'diversification' is mistakenly equalised with 'conglomeration', and that 'conglomeration' means something different from 'diversification' (Steiner, 1975:17-19). For Steiner *'[..] diversified firms have well defined and similarly diversified competitors*'. Therefore, conglomerate firms do not have natural limits as they do not have *'[..] a well defined interconnection among the products or services it provides that could be used to predict which products it might add to its line'* (Steiner, 1975:18)[283]. Moreover, some authors as such Morgan and others state that there are two basic types of diversification according to the extent to which new activities are related to existing ones. The 'concentric' diversification, the first type, occurs when there is some relationship between the existing and new products through common marketing channels, material inputs or others. The second type is 'conglomerate' diversification, which refers to moving into completely unrelated areas to the firm's existing activities (Morgan et al., 1980:18-23). Furthermore, the authors admit that when firms diversify so far by including unrelated interests and cannot be referred to any particular activity, they may be classified as 'conglomerates', however, the distinction is not always clear[284].

There is a theoretical possibility that companies through diversification, particularly, diversifying mergers, attempt to pool risk, transfer capital and/or may undertake such form of search for new investment opportunities (Cowling et al., 1980:303-317). A firm may diversify activity in order to obtain greater stability of earnings through spreading its business activities in different industries especially with different business cycles (Weinberg, Blank and Greystoke, 1979). There is a need for firms in the face of product and/or industrial life cycles to diversify their firm life cycles from those of existing activities (Cowling et al, 1980:311). For

[282] The researcher will not try to distinguish 'diversification' from the 'conglomeration' and presumes in this thesis that the firms use the strategy to diversify through conglomerate mergers.
[283] Note: for further reading, see Steiner, Mergers: motives, effects, policies, University of Michigan Press, p. 17-19.
[284] For further reading, see Growth. Diversification and Mergers, prepared for the Course Team by E.J.Morgan, Open University Press, 1980.

instance, a demand in this case for particular products may be unstable, or may grow slow or even decline due to recession in general economic activity or the demand may be depressed because of successful competitors (Penrose, 1972:138-142). Thus, for stability in the face of unfavourable fluctuations in demand or the risk of unexpected adverse conditions in the existing markets, diversification might be a solution to some of these problems as firms may spread their activities, which are expected to reach a peak at different times[285]. For instance, companies may find it profitable to produce other products, especially those are subject to seasonal fluctuations, 'off season' using their existing resources and produce the main products during the peak season (Penrose, 1972:139). A similar situation is with the introduction of a new product at a particular stage in order to achieve the maximum exploitation of the old product. A firm may introduce a new product while the old one is still 'at peak' and by the time the new product will reach a peak, the old product declines. Spare resources, for instance, capital and/or management in stagnation or a dying industry may also cause diversification. There are opinions that diversification is a primary interest of managers, as shareholders can reduce risk more efficiently by dispersing their portfolio (Tichy, 2001, Jervis, 1971). For Tichy, contrary to the 1960s this motive has lost its importance, as the acquisitions in closely related industries or markets are at the best performance[286].

Diversification as a motive can be identified in several merger and acquisition transactions in the Baltic countries. For instance, the *UAB Rubikon grupe ('Rubicon group')* firm became a diversified firm (with 20 unified firms), more likely a 'conglomerate' diversified type firm, in Lithuania though a number of acquisition transactions. The transactions involved acquiring 51% of the transport company *UAB Katra*[287], 100% of the metal-stone company *AB Kazlu Rudos metalas*[288], the television channel *UAB Vilniaus televizija* and others. The motive of these acquisitions was to obtain greater earnings through spreading its

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[285] Note: The product life cycle concept means that every product or line of business proceeds through development, growth, maturity and decline phrases (analysed by the Boston Consulting Group). When a new product is put on a market, there is a slow growth until consumers acquire knowledge and buy that product. The peak is at maturity phrase. After that the market becomes saturated and demand falls.

[286] Note: for further reading, see G.Tichy, What do we know about success and failure of mergers, EUNIpb, 2001.

[287] Decision No. 1S – 35, 12/03/2004 available at web-site: http://www.konkuren.lt

[288] Decision No. 1S – 51, 01/04/2004 available at web-site: http://www.konkuren.lt

business activities in different industries, especially in perspective growing business sectors.

3.4.3. Socio-political motives for merger

3.4.3.1. Theoretical context

Merger control is probably the most sensitive one in the competition policy field. This is mainly because mergers may lead to substantial new investments and national pride, massive lay-offs and so on (Broberg, 1998:1). When companies make decisions about redundancies, they usually take into account the costs, which they will bear directly such as the costs of redundancy. Therefore, companies will not consider the costs imposed on society or the individuals concerned (Cowling et al., 1980:239). Although, the EC merger control regime's major concern is to protect competition, social factors such as the impact of the deal on employees' jobs were considered by the Commission in a several cases, for instance, in *Comité Central d'Entreprise de la Société Générale des Grandes Sources*[289] case. Concern for the environment was a factor raised by the Commission in *Philips / Osram* case[290], in which the Commission pointed out the existence of equipment to reduce emissions at the factory in which the joined entities was to operate[291].

3.4.3.1.1. Employment issues

Theoretically, as regards employment policy, mergers may have two opposite effects. First of all, a merger may cause a decrease in job places, because one company will cease to exist in the market as a result of the merger. Second, a merger may lead to the creation of jobs in several situations: (i) where one company acquires another, which would leave a market any way, for instance, in a failing firm case; or (ii) it may contribute to employment gains in the future, if the owners expand their businesses (Kang and Johansson, 2000).

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[289] Case No. T-96/92

[290] Case No. 5 CNLR 49 1994.

[291] For further comments on this issue, see Steiner and Woods, 2003, pp. 298.

Managers will generally benefit from the increase of a firm through a merger, as more and better jobs will be created. As a result of the increased work, it will be necessary to take on more assistants under the control of managers, in turn the wage of the managers will increase (generally, managers pay depends on the size of the department and number of people under their control) (Jervis, 1971:19).

3.4.3.1.2. Employment and regional policy

A merger may cause concern for a regional policy. For instance, a merger may lead to the rationalisation of existing firms with consequential effects on unemployment and regional vitality (Craig and Burca, 1998:1036). This will be the case where the firm decides to close down one plant with a high marginal cost of production in the area, which has a high unemployment rate. As a result of the closure of the plant the unemployment rate will be even higher and will affect the society negatively. Further, this might cause people to leave the region and 'follow the work'.

3.4.3.1.3. Managerial / personal motives

Firms expand because individuals want them to expand, either from personal ambition in order to promote their own self-interest or through a belief that there is some economic advantage in so doing (Jervis, 1971:16). Through the merger managers may seek to increase market share, management prestige, reduce uncertainty and restore market confidence. For instance, managers may feel a prestige being a 'vice-president' of a large company rather than a small one (Penrose, 1972:163). Newbould (1970:139) also found that a manager's motives for merger are often to increase the acquirer's dominant position in the market and to defend existing market positions. Managers may wish to expand their enterprises; since their salaries, perquisites and status often increase with size or sometimes managers have an ambition due to the prestige being in a large firm (this is largely known as the empire-building syndrome, which was the scenario in the WorldCom case discussed above). Furthermore, managers may have self-fulfilment motives such as willingness to deploy their currently underused managerial talents and skills (Sudarsanam, 1995:16)· The threat of being taking over and a secure job may be another incentive for managers to merge (Newbould, 1970:184-185). The growth through a merger might be a defensive motive of avoiding becoming a takeover target; there is a presumption in a sound economic that it becomes less likely to take over a bigger efficiently operated firm than a small one.

3.4.3.1.4. Political

Issues of social justice may also be relevant in evaluating the effects of a merger, especially when this leads to a dominant position. For example, to allow for a single firm to dominate in an industry might be vital to national security, as it may grant the firm's owners more political power than is in society's interest (Hirsch, 1988:7). In this case, the owners will seek to maximise their own interest without taking into account that it may be a detriment to the whole society's interest.

In addition, a conglomerate merger may reduce the number of smaller firms at different levels and increase the merged firm's power. As a result, this power may be directed towards the financial strength into the political power and in turn through lobbying influence legislation or regulation to their benefits, thereby impairing the social and political goals of retaining independent decision making centres and harming the rest of society.

3.4.3.2. Socio-political motives in the merger cases of the Baltic countries

3.4.3.2.1. Employment issues

Competition policy, in particular vis-à-vis merger control is not directly linked with the realisation of the employment policy. Rules of Latvian competition legislation do not allow setting up conditions on employment or considering other social issues during merger investigation processes (OECD report, 2002). A similar policy is applied in the Estonian and Lithuanian jurisdictions. However, the privatisation process has specific rules set up by the government providing the obligations on employment realisation in a short period in privatisation transactions.

Despite the general policy, some social issues were mentioned in several cases. For instance, in *Latvia Statoil / Shell Latvia* case (2003) with reference to the positive effects of the transaction it was stated that the merged entity would still remain a stable, secure and socially responsible employer and participant of the fuel market. In the *Staburadze / NTBDC L Ltd / stock company 'Laima'* merger[292] (2001) one of the negative aspects of the transaction was that there would be a decrease in the number of employees as a consequence of the operation.

3.4.3.2.2. Political

The policy of liberalisation process is to eliminate the influence of the government on business activity. However, it is important that it works vice versa, so that the business entities do not have an impact on the government policy and/or legislation process[293]. As aforementioned apart from the economic effects, merger transaction may also have political effects. The following example illustrates such a scenario, where a conglomerate firm (which has grown through merger/acquisition transactions) has had a political influence in Lithuania. Lithuanian law enforcement officials (i.e. the Special Investigations Service of Lithuania – a special branch of law enforcement with full investigatory and prosecutorial powers dealing with corruption in government) revealed that over

[292] For further comments on this case, see OECD Global Forum on Competition, Contribution from Latvia, 21/09/2001, CCNM/GF/COMP/WD(2001)3 available at web-site: http://www.oecd.org

[293] An example in Lithuania illustrates such a scenario, which was the first of it's kind not only in the history of Lithuania but also within the European practice of the parliamentary powers. The president of the Republic of Lithuania Mr. R.Paksas was accused and sacked by the parliament after it was revealed that he had links to the Russian businessman Mr. Borisov, who has ties with Russian criminals. Mr. Borisov contributed the equivalent of £217,000 to Paksas's election fund for the 2002-2003 presidential election campaign and as a payback was required to arrange Lithuanian citizenship and a post as a social advisor of the president. Furthermore, a parliamentary investigation claimed that a firm 'Almax', which also funded the election campaign of the former president Mr. Paksas, was a front of Russian intelligence and was also trying to 'influence political processes in Lithuania' (Guardian, April 7, 2004). As regards the violation of presidential duties, Mr. Paksas also illegally pressured private individuals to sell their shares of the road building firm '*Zemaitijos keliai*' to persons close to Paksas's inner circle for a significantly lower price than one determined by the market (Girdzijauskas, April 7, 2004). As a result the former president of Lithuania Mr. Paksas was accused of six charges, including endangering national security, leaking state secrets and failing to prevent the abuse of power.

one year executives from the *Rubicon group* (one of the biggest company groups in Lithuania) gave politicians about one million litas (£1=5.0089 LTL[294]): a part of the money was paid to the political parties legally as official contributions, however, another part was paid in cash directly to certain politicians for the enforcement of favourable laws to the company. Law enforcement officials believe that some Lithuanian parliamentarians, in particular Mr. V.Andriukaitis, Mr. V.Kvietkauskas, Mr. A.Vidziunas and others, were on the Rubicon's secret payroll to introduce two laws: one on centralized heating and another one on the taxation of petroleum and natural gas resources, which were successfully pushed through parliamentary committees and adopted by the parliament. Furthermore, the mayor of Vilnius, the capital of Lithuania, A. Zuoka has also been involved with the Rubicon group. There have been constant reports over a year on the corruption involving the firm *'Rubicon group'* and the Vilnius municipality, mayor's office and the parliament[295]. The *Rubicon group* together with over 20 companies belonging to the group is one of the biggest company groups in Lithuania that develops and invests into prospective business fields and offers new solutions and services for the Lithuanian market. In general, the companies belonging to *'Rubicon group'* are engaged in the fields of industry, utilities, real estate and entertainment. By 2004, sales of the company expanded by 48%, as a result of the acquisition of six new companies[296]. One of the companies belonging to the *Rubicon group* is UAB '*Rubikon apskaitos sistemos' (*now *'Rubicon city service* [297] *'),* whose several acquisition transactions were notified to the Competition Council of Lithuania for approval. These include the acquisitions of 51% of shares of UAB '*Livesta serviso centras*'[298], 51% of shares of the UAB *'Katra'*[299], 100% shares of the AB *'Kazlų Rūdos metalas'*[300] and 100% shares of the UAB '*Vienituras*' [301] in 2004. All these acquisition transactions were

[294] At the exchange rate dated 31/03/2005 by the Bank of Lithuania.
[295] Note: for further information, see web-site http://www.laisvaslaikrastis.lt (available in English), dated on the 29th of June 2004. See also www.DELFI.lt (15/07/2004, 18/07/2004), ELTA 'Lietuvos Zinios' 28/07/2004 etc. The latest news revealed that A.Zuoka, a mayor of Vilnius municipality, passed a land worth millions litas to the *Rubicon group*. The investigation continues.
[296] For further reading on *the Rubicon group*, see web-site: www.rubicongroup.lt
[297] The title was change as stated in the press release of the company's web-site: www.rubicongroup.lt dated 22/12/2004
[298] Decision No. 1S – 25, 19/02/2004, available at web-site: www.konkuren.lt
[299] Decision No. 1S – 35, 12/03/2004, available at web-site: www.konkuren.lt
[300] Decision No. 1S – 51, 01/04/2004, available at web-site: www.konkuren.lt
[301] Decision No. 1S – 173, 16/12/2004, available at web-site: www.konkuren.lt

considered as conglomerate and were approved without any conditions by the Competition Council of the Republic of Lithuania as having no significant impact on competition. However, as was stated above, mergers, especially conglomerate mergers with their ability to accumulate big financial power may be a threat to the political impartiality. As the illustration in Lithuania shows big conglomerate companies such as *'Rubicon group'* may influence legislation in their favour without any consideration of the society as a whole. The Competition Authorities in the Baltic states have no authority to prevent it as the consideration of any social or political issues falls out of their jurisdictions. Similar policy is applied in the Competition Authorities of Estonia and Latvia[302].

3.5. Merger motives trends in the Baltic countries

Although the impetuses to merge in the Baltic countries are not entirely different from the theory, three trends of merger motives can be distinguished in the Baltic countries. As regards a domestic merger, the companies merge nationally in order to achieve efficiencies and as a result of it being able to compete internationally, for instance, *AB Alita / AB Anyksciu Vynas.* As regards cross-border mergers, foreign companies acquire or merge the national Baltic firms for an easy and quick way to enter in the unknown market. For instance, *ICA Baltic AB* acquiring local company in Lithuania *UAB Ekovalda*; *Rurgas AG* and *E.ON Energie* consortium acquiring the Lithuanian firm *AB Lietuvos dujos (Lithuanian Gas)* etc. Another international trend is the spill-over effects on the Baltic countries' markets as a result of the merger or acquisition transactions between parents companies, where the transactions involved had impact on three Baltic markets (i.e. *Statoil / Shell; Kesko / ICA*; or *Telia Aktiebolag / Sonera Corporation)* or on one market of the Baltic countries. Furthermore, as a case in Lithuania it shows merger transactions in the Baltic countries may have some social and/or political impact, however, these aspects fall outside the jurisdiction

[302] Although the researcher acknowledges possible socio-political effects of a merger transaction, especially in conglomerate merger cases, the research does not aim to prove whether these aspects should be (or not) taken into account by the competition authorities in merger analysis and this issue will not be further explored.

of the Competition Authorities of the Baltic states and will not be further examined.

It is not the task of this thesis to find out all possible motives as to why firms merge. The focus of the thesis is to examine the rationale behind the mergers in order to understand their effects on competition. This chapter examined the impetuses for firms to merge in the Baltic countries. Also, it checked whether these motives have specific implications within the Baltic states in comparison with theory. Although the impetuses to merge in these countries are not entirely different from the theory, three main trends can be distinguished, as discussed above. The chapter also revealed socio-political aspects of merger effects in the context of the Baltic states. However, despite some socio-political effects of merger transactions, especially of conglomerate mergers, the research is not aimed at proving that these aspects should be considered in merger analysis.

The following chapter will provide a further analysis on two main motives depicted from this chapter due to their controversial effects on competition. They are efficiency gain motive with so called 'positive' effects on competition and market power with 'negative' effects on competition.

Chapter 4. ECONOMIC APPROACH TOWARDS MERGERS

'A lawyer who has not studied economics [..] is very apt to become a public enemy' (Justice Brandeis, 1916 as quoted in Bishop and Walker, 1999:9)

The importance of economics in merger analysis cannot be challenged, as the merger control rules are heavily reliant on economics. Industrial economics is the area of economics that is most important for competition law, as this branch of the science exercises micro-economic tools, such as an individual's preferences for apples over pears and to wider market situations (Furse, 1998: para 1.4.2). This chapter involves the analysis of the economic theories of a merger transaction's effects on competition. According to an economic standpoint, mergers have immediate effects on the market's structure. First of all, they are about growth and/or may offer the immediate freedom from the nuisance of having to compete with each other, and may provide a 'lazy' way to the creation or strengthening of market power. In this case merger transactions may make market structure more concentrated. Competition authorities have a task to prohibit potentially anti-competitive merger transactions in order to prevent the creation of market power or the significant impediment of effective competition. Secondly, mergers are not always about the harm on competition. These transactions may help to realise efficiencies, for instance, they may present the chance to re-combine assets in more efficient ways and/or to re-place poor management whose performance is inadequate or they can provide other allocative, productive and dynamic efficiencies, which will be further discussed in this chapter. Thus, mergers may help to realise efficiencies and make market more competitive.

The previous chapter explained that one of the motive trends for merger in the Baltic countries is to achieve efficiencies. However, there is no statutory provision as regards merger–specific efficiency gains in the competition laws of each Baltic state. Taking into account the economic theories including one with specific implications on small economies (what is applicable for the Baltic countries), the researcher argues that not enough support is given by the Competition Authorities of the Baltic states to the merger's motive to achieve efficiencies. This chapter aspires to prove that merger–specific efficiencies play a tremendous role in merger analysis due to their ability to offset market power. The researcher considers that further analysis is required on two countervailing motives discussed in the previous chapter with opposed effects on competition, because there is a trade off between them. They are efficiencies with a positive impact and market power with a negative impact on competition. The theory of harm of horizontal, vertical and conglomerate mergers will be discussed separately, as they might cause slightly different anti-competitive concerns. The aim of this chapter is to demonstrate that analysis of efficiencies is a necessary tool in the investigation of merger cases, because for economic theories the merger-specific efficiencies may offset market power. Furthermore, in the case of small economies, for instance in the Baltic countries case, market power may be a necessary evil that leads to a form of economic efficiency (Bork, 1978, Gal, 2003).

4.1. Efficiencies from an economic perspective

4.1.1. Types of efficiencies

Efficiency may be simply defined as getting maximum output from the resources available to the economy (Agnew, 1997:135). There are three basic types of efficiencies usually distinguished in economic theory: allocative efficiency, productive efficiency and dynamic efficiency. Additionally, transaction efficiency is listed as a distinct type of efficiency by some scholars (see for instance, Kolasky and Dick 2002, Ross 2004), which will be further discussed.

Allocative efficiency is achieved when the existing amount of goods and productive output are allocated through the price system precisely to buyers' wishes, as to those buyers who value them most, in terms of willingness to pay or willingness to forego other consumption. In this situation, market prices are equal to real the resource cost of producing and supplying the products at an efficient outcome. This means that producers cannot affect the market price and set their output at the point where marginal costs and marginal revenue coincide. Sometimes allocative efficiencies are referred to as Pareto efficiency, because in perfect competition economic resources are allocated in such a way that it is impossible for anyone to be better off without making someone worse off (Whish, 1998:3).

Productive[303] efficiency is achieved when goods by a particular firm or industry are produced using the most cost-effective combination of productive resources available under existing technology, as products are produced at the lowest possible cost. Thus, productive efficiency is achieved when output is produced in plants of optimal scale (or a plant's minimum efficient scale, thereafter MES - this is the smallest output produced to minimise the long run average costs) given the relative prices of production inputs. According to Gal, a productive efficiency in small economies usually implies a situation, where less MES firms compare with large economies can be supported by the market because of a limited demand in small markets (Gal, 2003:Ch.6)[304]. In general, the goal of productive efficiency implies the situation, where more efficient companies should not be prevented from taking business away from less efficient ones (Van den Bergh and Camesasca, 2001:5). Allocative and productive efficiencies may also be achieved through cross-border merger transactions, by reallocating static resources. For instance, cross-border mergers may free up unproductive resources for more effective use elsewhere, i.e. in another country (OECD, 2001). If each country produces the particular goods or services in which it has a comparative advantage (the relative costs of production of the country is lower compare with the other countries), the global output of goods and services will increase (Mitchell, 2001:344). Both allocative and productive efficiencies are of a static nature, where the technology is fixed and costs are related to a certain level (Jones and Sufrin, 2004:11, Hildebrand, 2002:8-9). There is also no time dimension in a static analysis as it checks only the equilibrium situation. However, in reality markets are rarely static. Many markets are dynamic, which evolve over time due to the introduction of new and improved products/services and new technologies.

Dynamic efficiency is achieved over time through the invention, development, and diffusion of new products and production processes that increase social welfare. Thus, dynamic or innovative efficiency is related to the

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303 Or technical efficiency, as defined in other sources. See, for instance, Van den Bergh and Camesasca, 2001, pp. 5.

304 In this case, the presumption is that the export is limited.

ability of a firm, industry or economy to exploit its potential to innovate, develop new technologies and expand its production possibility frontier. As was mentioned above, cross-border mergers may also have dynamic long-term benefits through technology and knowledge exchange and building up global R & D networks etc. In general, dynamic efficiency provides consumers with new and/or developed products in order to win the consumer battle. In this case, competition may have the desirable effects of stimulating technological R & D (Whish, 1998:4). Thus, innovation generates welfare gains because of the realisation of dynamic efficiencies.

Finally, transactional efficiency acknowledges that firms spend resources in order to define and protect property rights and mergers, for instance, they can mitigate the costs necessary to do this. Ross (2004) provides an example to illustrate this transactional efficiency. A firm which is about to issue a new product usually needs additional services, such as marketing or distribution in order to bring its product to market successfully. It may seek these services to be provided from specialist 'partners'. However, there is a risk for the firm to lose profits to former partners who may copy its ideas and use for themselves, after it was revealed in the course of the partnership. Consequently, the innovating firm may undertake less innovative activity or it may spend inordinate sums to protect its ideas, or it may decide not to tell its partners all it should. Therefore merger in this case between these partners could create efficiencies by keeping all these services 'in-house' and reducing any concerns about such 'opportunistic behaviour'[305].

The problem is that allocative, productive and dynamic efficiencies cannot be simultaneously realised. As a result of this, competition authorities face a complex trade-off of expected static and dynamic efficiencies against expected anti-competitive effects. Thus, a proper welfare analysis of market power has to take into consideration both static and dynamic efficiency gains and also any trade-off between them (Hildebrand, 2002:8-7). Before analysing the trade-off, possible anti-competitive effects caused by merger transactions ought to be discussed.

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[305] The transaction efficiencies will not be further explored as the researcher considers that they can be covered under the other types of efficiencies.

4.2. Market power and the theory of harm

A merger transaction may cause concerns because of the possibility to enhance market power, which in turn may lead to a decrease in social welfare. In perfectly competitive markets, a firm selling homogeneous products cannot affect the price (in a way that the price never exceeds marginal costs). This is because any attempts to increase price would result in loosing its customers. On the contrary, a firm in a domain of market power is able to raise the prices above the competitive level without loosing its consumers. Thus, mergers may have anti-competitive effects if it results in a significant increase in market power leading to price hikes (with the assumption that there are no offsetting efficiency gains) and a decline in output at the expense of consumer welfare. This is the scenario when the merged entity acts in a less competitive way than two or more pre-merger firms would have acted. The term 'market power' in this case refers to *'[..] the ability of a firm or group of firms to raise price, through the restriction of output, above the level that would prevail under competitive conditions and thereby to enjoy increased profits from the action'* (Bishop and Walker, 2002: para 3.04). Hence, is recognised that market power for competition policy purposes matters in the situations where a firm or firms is able to maintain prices noteworthy above the competitive level for a sustained period of time and thereby earning significant profits (Camesasca, 2000:60).

Merger transactions may give fears about increased market power because of two main effects on market structure: (i) by increasing market concentration (as post-merger market share is larger than the pre-merger) these transactions may increase market power to a degree that varies according to the amount of price co-ordination already presented between firms; (ii) by reducing the number of effective players (competitors) in a market these transactions may make price co-ordination easier to achieve (Neven, Nuttall and Seabright, 1993:25-26, Camesasca, 2000:60-61). Market power matters because it may lead to allocative inefficiency and because it may worsen productive efficiencies. With regard to allocative inefficiency, a monopolist adjusts price or quantity to achieve the maximum profit. Since A. Smith (1723-1790) and D. Richardo (1772-1823), who described for the first time the price mechanism and which was further developed by other scholars, it has been known that if prices are raised above the competitive price, some customers who would normally buy the product if it was available at competitive price, will not pay a higher price and as a result will spend money buying something else (here allocative inefficiency occurs). Furthermore, a dominant firm, which will raise prices, will have to produce less than it would otherwise have done. Thus, the monopolist expands output up to the point where the marginal cost of one extra unit is just equal to the marginal revenue, which that extra unit brings[306]. The monopolist's marginal revenue is below the market price; it means that the quantity of products to supply will be less than if it would be provided on a competitive market and thereby prices are higher than those in a competitive market (Jones and Sufrin, 2004:9).

The outcome set by monopolist above the competitive level is electively inefficient since there still remains opportunities for profitable trade, as there are still buyers willing to pay more for an extra unit of output than it costs to produce (Enterprise paper No. 11, 2002:11). If no firm in the market has a market power, firms are forced by competitive pressure to minimise costs and if they do not minimise costs, they may be forced to leave the business. In contrast, if a firm has a market power and its owner (-s) are not subject to external competitive pressures (e.g. from rivals, potential entrants or customers), they can relax and will not put effort into trying to minimise costs and to maximise profits in order to survive in a market, and, as a result, X-inefficiency[307] or organisational slack can occur (Martin, 2002:392-399)[308]. This will lead to productive inefficiency. According to Posner (1976:ch.1), the more important concern over high price is the waste of resources spent on acquiring and maintaining a market power, as these resources can be better spent on producing more goods and providing more services to consumers. There is a possibility recognised by economists that dominant firms may spend anything up to the value of their monopoly profits on, for instance, excess advertising, investment in excess capacity, brand proliferation, lobbying, or R & D. Some expenditure might be entirely unproductive, such as lobbying,

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[306] Note: In economic terminology, profit is maximised at the point where marginal cost equals marginal revenue. Both competitive and monopolist firms maximise profit the same, one difference is that they face a different demand curve. The competitive firm is a price taker, as it cannot affect the price by changing its output. Meanwhile, a monopolist firm can affect it.
[307] Or 'X-efficiency', as defined by Leibenstein, who described international inefficiencies and rising costs, because of high wages, excessive perks etc. See Leibenstein, 1966, pp. 392-415.
[308] For further reading of X-inefficiency, also see Martin, Advanced Industrial Economics, 2nd ed., Blackwell, 2002, pp. 392-399.

but other expenditure such as R & D might benefit consumers (Enterprise papers No.11, 2002:12-13). However, the market power on R & D otherwise on innovation remains controversial. The next paragraph explains this.

There are different opinions on the impact of market power on innovation. Schumpeter (1942, 1977), who was the champion for the notion that market power is basically good for innovation, claimed that monopoly power is much more important than static price competition providing the climate under which innovation occurs. Furthermore, a monopolist may be more willing to bear the costs and risks of new investment. New products/services or improved products/services will not be introduced unless it appears profitable to do so. Firms have incentive to innovate, if they expect to increase their profits. Even in competitive markets firms invest in new projects, if the net present value of future returns comes along with the investment outlay and initial losses. Furthermore, new or improved products occur only, if firms earn more than just enough to offset their investment (Hildebrand, 2002:8-9). According to Hildebrand, firms also try to make some profits from investments, where such profit means *'[..] pricing above short run minimal average total costs either because there are barriers to entry or because the innovating firm has market power'* (Hildebrand, 2002:8-9). Moreover, if the market functions well, then the creation of a temporal dominant position and the profits of a dominant firm attract other competitors, which bids away the excessive profit resulting in the marginal investment being just offset by the present value of future normal profit. This is because other firms will imitate new products and will take rewards from innovation. Only a firm, which can attain temporary market power, and delays the imitation of competitors, may make innovation attractive[309]. IPR[310] in this case can play a role, as the grant of exclusive right can offer investor to exploit the invention for a limited period of time in order to reduce the risk of devaluation of the investment in R & D by free raiders and therefore provide an opportunity for the IPR owner to recoup investments at a higher level than would have been the case in a fully competitive market (Anderman[311], 1998:5-6).

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[309] For further discussion, see Hildebrand, 2002. Also see, For the customer's sake: The competitive effects in European merger control, Enterprise Papers No., 2002 pp. 13-14.
[310] Referring to Intellectual Property Rights.
[311] Professor Anderman in his book discusses the relationship between intellectual property rights and the EC competition law with emphasis being placed on articles 81 and 82 of the Treaty.

As regards mergers, some authors consider that the incentives to invest in R & D may increase because a merger transaction may help to secure sufficient rents to make it profitable to invest in innovation. This is because of monopoly gains, which provide a strong incentive for the competitors to imitate and capture a piece from the monopoly gains. The innovation, investment and other dynamic changes are the means for a monopolist to have a competitive advantage[312] (Chiplin and Wright, 1987:78). However, a recent study (Cohen and Levin 1989, Scherer 1992 and Cohen 1995) proved that there is little support for the claim that large firm size or high concentration is strongly associated with a higher level of innovation. R & D is taken strategically in response to the actions of competitors. Considering that R & D involves a high risk, a dominant firm would rather enjoy the current monopoly rent than invest in R & D (Ilzkovitz and Meiklejohn, 2001:5). Thus, recent empirical studies suggest that neither monopolists nor fierce competitors would definitely lead to increase in dynamic efficiency gains. The researcher agrees at this point with Prof. Whish that the presumption, which states that only monopolists can innovate, is incorrect (Whish, 1998:4).

Since different forms of merger may have distinctive anti-competitive concerns, a further analysis involves discussion of each of them.

4.2.1. Horizontal mergers

In assessing horizontal mergers, two principal categories of competitive harm may occur: unilateral or co-ordinated effects. The legal concept of a single firm dominance has often been equated with unilateral effects whilst co-ordinated effects have been matched with the concept of oligopolistic (or collective) dominance[313]. Unilateral effects are analysed in the 'one-shot game' framework by meaning that *'[..] firms do not take into account how their own actions of*

Although the researcher acknowledges the relevance of IPR in merger cases, the thesis is not aimed to cover this specific issue.

312 Presuming that there are no entry barriers.

313 Oligopoly in a sound economy is a market structure, which lies between perfect competition and monopoly on the spectrum. Oligopoly is defined as an industry with a few firms and many buyers, where the number of firms should be small for there to be 'conscious interdependence' as each firm is aware that its future prospects depends not only on its own policy, but also on those of its rivals. See Griffiths & Wall, 1995, pp. 115.

today will affect competitors' behaviour of tomorrow' (Hofer, 7-8 October 2004). According to the theories of the co-ordinated effects, mergers may lead to 'regime shift' where competitors adopt a 'live – and – let – live' strategy[314]. The distinction between unilateral and co-ordinated effects hinges on the reactions of firms initiating price increases. A firm with unilateral effects does not depend on the reaction of its rivals to the pricing policies. Meanwhile, co-ordinated effects arise in a situation where firms are concerned about the reaction of their competitors (Geroski, 2005:73). The importance of this distinction lies within two main questions, which need to be answered to explore the merger's effects: (i) will a merger transaction result in unilateral effects? if not, then (ii) will it lead to the more conducive market structure with the exercise of co-ordinated effects? (Geroski, 2005:74). Since the distinction between unilateral and co-ordinated effects has been drawn, the following sections involve the analysis of each of them separately.

4.2.1.1. Unilateral effects

A firm is supposed to have single firm dominance, when it has unilateral effects, meaning that such a firm may increase prices profitably without relying on contra-responses from the remaining competitors. Two Cournot and Bertrand classical static models can help to explain the unilateral effects. Cournot's model assumes that firms compete by setting output to maximise profits assuming that the output of other companies is constant[315]. By contrast, Bertrand's model of pricing assumes that firms choose price but not quantity to maximise profits[316]. The price competition is often called strategic complements, due to the fact that the price increase of the merged entity would lead competing firms to increase their prices (probably to a lesser extent). This positive response from the

[314] For further reading, see speech of Hofer, Use of economics in merger control, delivered during the conference organised by the European Institute of Public Administration (EIPA), Maastricht, 7-8 October 2004.
[315] Explanation: first, firm decides the quantity, as how much output to put into market and then the interaction of demand and supply curves determines the market-clearing price. For further comments, see P.Hofer and M.Williams, Horizontal merger assessment in Europe, The European Antitrust Review, 2005.
[316] Explanation: first, firm decides the charge for its products and then supplies the quantity, which is demanded at that price, which accordingly depends on the price set by its competitors. For further comments, see P.Hofer and M.Willaims, 2005.

competitors, will in turn lead to further price increase of the merged entity. Quantity competition, which is called strategic substitutes, refers to a situation where a reduction in the output of the merged entity, would lead the competing firms to expand their own output, although not up to the initial output level (Ivaldi, et al., European Commission, November 2003:23-24). Both models demonstrate that the merging parties will have an incentive to raise the price above the pre-merger level, because of the reluctance of their rivals to undercut the price rise as they will be happy to follow any increases in price (Hofer and Williams, 2005). As a result, theoretically the models predict that all horizontal mergers will lead to price increases and if taken literally all mergers would deem to be prohibited. However, the economists suggest that these models provide only '*a schematic representation of a particular mode of competition*' and it would be a mistake to assume that all firms compete only on output or price in reality (Ridyar, Bishop and Baker, January 2003).

The economic literature recognises two theories of unilateral effects, as they may arise in two basic markets: (i) with differentiated products (each product is not a perfect substitute for another); and (ii) with relatively homogeneous products (near perfect substitutes). In the first market, where goods/services are differentiated, a unilateral price increase may result depending on the 'closeness' of the merging firms to each other. The closer substitutes products/services produced by merging firms are, the more likely a merger will result in a price increase (Ivaldi, et al., November 2003; Bishop and Walker, 1999). This is because if buyers see the products of the merging entities as very close substitutes, for instance, their first and second choices, it may be profitable for the merged firm to raise the price of one product, as its closely competing substitute will capture a significant run-off from the price increase. Another relevant factor is the number of firms, which are close competitors to the merging entities. For instance, if there are a number of firms that are close competitors, then the merger between two of them will not raise prices significantly. However, if there are only two close competitors, then the merger between them may lead to increase price significantly (Bishop and Walker, 1999:146-147). For instance, the EC Commission in the case *Volvo / Scania*[317] was concerned by the high degree of

[317] Case IV/M. 1672, [2001] OJ L143/74.

substitutability of products produced by both merging companies. Further concerns of the unilateral effects of the proposed transaction were also based on the fact that Volvo and Scania were main competitors in the Swedish heavy truck market.

With regard to the second market, where products are relatively homogeneous, unilateral effects should not generally arise. This is because of intense competition: if one firm raises its price, it loses a tremendous amount of business to other competitors (with lower price) (Vistnes, 2005:88). However, unilateral effects may still arise if the capacity of other firms is constrained and they will not be able to increase output. As a result consumers will be unable to switch off from the merged entity to the rest of the firms[318]. Thus, the competition authorities have the hypothetical question whether limitations on competing firms to serve the market would enable the merged entity to retain sufficient diverted sales to make the price increase profitable. While assessing whether a firm will have unilateral effects, many factors should be taken into consideration, such as the relationships between: the merging entities, the merged entity and the rest of the competitors and the customers of merging entities. For instance, if competitors are capable of repositioning their differentiated products or otherwise competing with the merged entity, or if there is a sufficient number of consumers, which are able to find economic alternatives for the products of the merged entity, then the anti-competitive effects of merger transaction should be mitigated.

4.2.1.2. Co-ordinated effects

If there are several big players in the market, unilateral effects are less likely (although not impossible) as oligopolistic dominance with co-ordinated effects are more likely to occur. By its nature, where firms know each other's identity and are affected by each other's decision on output and pricing, oligopolistic or collective dominance[319] refers to the situation where the structural changes of the market caused by the merger raise the competing firms' ability to

[318] For further reading, see Bishop and Walker, The Economics of EC Competition Law, Sweet & Maxwell, 1999, pp.145-149.
[319] Collective, joint or oligopolistic dominance will be used interchangeably in this research. See, for instance, Whish, R., Collective dominance, as published in O'Keefe D., Andenas M., Liber Amicorum for Lord Slynn, Kluwer, 2000.

co-ordinate or to tacitly collude[320] their behaviour. Thus, such collusion not necessarily amounts to an express co-ordination, which would be prohibited by the cartel provisions but rather tacit collusion. However, economists recognise that a merger's impact on the scope for collusion is delicate to evaluate. This is due to controversial effects: as some merger transactions may facilitate collusion and in contrast, some mergers may make it difficult to achieve (Ivaldi, et al., November 2003). On one hand, a merger transaction may make firms more asymmetric, making it harder for firms to reach a consensus on the behaviour required as well as to discipline one another from the deviation of such behaviour[321]. On the other hand, by reducing a number of players in the market, a merger transaction may make tacit collusion easier to plan[322]. According to Geroski, the hallmark of tacit collusion is a common interest, which encourages companies to override the short run gain available to them by undercutting competitors through increased prices (Geroski, 2005:72). In this case, tacit collusion contains monopoly elements, as the competing firms will determine their actions interdependently by concurring their strategy (i.e. to set up the higher price as near to monopoly levels[323]) with the firms involved[324] (Camesasca, 2000: 62-63). Meanwhile, in competitive markets the firms would be constrained from being involved in this strategy due to the presence of competitors, which would loose sales for the firm that increases prices. However, a problem occurs, when the best strategy for the post-merger firms is to keep higher prices but not to compete. In this case, such co-ordinated effects would result in a loss of consumer welfare, as consumers would be forced to either pay a higher price or the same

[320]The term 'tacit collusion' does not require involvement in any kind of 'collusion' in a legal sense, as there is no need to involve any communication between the parties. See Ivaldi, Jullien, Rey, Seabright and Tirole, Interim Report for DG Competition, European Commission, November 2003.

[321] For instance, firms may engage in Bertrand price competition with equilibrium being such that each firm cannot increase its own profits by changing its prices given the competitors' prices – this is so called Nash-equilibrium or the Prisoners' dilemma. This Prisoners' dilemma model shows despite the fact that both firms prefer a situation in which both firms charge a higher price, the incentive for one firm to charge a low price while its rival charges a high price will result in both firms charging a low price (Nash, 1951, as quoted in Bishop and Walker, 1999:23).

[322] For further discussion, see Ivaldi, et al. Interim Report for DG Competition, European Commission, November 2003.

[323] Some scholars (i.e. Gal (2003), Lindsay (2003), ICN Merger Working group (2005) etc.) also refer to decrease in quality, leaving the price unchanged.

[324] The assumption exists that there are significant entry barriers; otherwise, tacit collusion would be pointless since it would be undermined by new entrants. See Ivaldi, et al. Interim Report for DG Competition, European Commission, November 2003.

price but for reduced quality. The occurrence of co-ordinated effects depends on the firms' ability and incentives to act interdependently. The economic literature has produced various economic models of oligopoly in order to explain, why this occurs and what problems they can cause to competition[325]. Identifying the factors, which would likely lead to co-ordination are the controversial task for the competition authorities. The ICN Merger Working Group (2005) suggests three main conditions for 'the successful co-ordination': (i) the market's participants must be in a position to bring into line their behaviour either by co-ordinating on price, or quality, or output; (ii) it must be costly for the firms to avoid the co-ordination, as it will be a common interest for everybody to go along; and (iii) any competitive constraints (i.e. possible market entrants) must be weak.

Economists agree that there is a correlation between the number of firms in a market, the size and the likelihood of collusion. For instance, the greater the level of concentration after the merger and the greater degree of equality between the shares of the larger firms, the more likely that those firms will tacitly collude their behaviour (Sleuwaegen, 1986, as quoted in Bishop and Walker, 1999:151). Apart from the level of concentration, the following factors should be taken into consideration in order to indicate the likelihood of the co-ordinated effects. These are:

i) inelastic market demand (when market demand is inelastic, then demand will not increase much even if firms lower the price);
ii) information of the market conditions (the more transparent the market, the easier to spot the collusion);
iii) homogeneity of firms and products (the more homogeneous firms and products are, the easier to agree among them);
iv) the presence of maverick firms;
v) the buyers power;
vi) excess capacity (i.e. if firms have excess capacity, that gives them more desire to raise output and undercut the price);
vii) the ease of entry;

[325] For discussion, see, for instance, Jones and Sufrin, 2004, Oxford University press, Ch. 11.; Bishop and Walker, 1999.

viii) size and frequency of the transactions (if transactions are large and rare, then collusion is harder to sustain than small and frequent transactions) (Bishop and Walker, 1999:151-152).

Also, the role of innovation should be added, as there is little scope of collusion in innovation-driven markets. The variety of economic models shows that an increase in concentration does not *per se* mean an increase in the ability to achieve higher prices through tacit collusion. The ability and incentive of a merged entity to be involved in tacit collusion has to be evaluated carefully by taking into consideration all the factors discussed above.

Difficulties of assessing co-ordinated effects, which are recognised in the EC competition law, have occurred in several cases. One of the first Commission's cases with the analysis of co-ordinated effects was *Nestle / Perrier*[326], where Nestle had made a bid for 100% of the shares of Perrier, the major French bottled water company. In this case the Commission argued that as a result of the transaction, the merged entity together with BSN, the second main supplier of French bottled water, would be jointly dominant, as the remainder of the market was shared by a number of much smaller competitors. By this case, the Commission proved that it is ready to prevent the creation or strengthening of a dominant position not only by a single firm but also of a dominant position held jointly by a number of firms, in this case Nestle-Perrier and BSN. Another highly cited case for co-ordinated effects is *Kali and Salz / MdK / Treuhand*[327], where the transaction was prohibited by the Commission because of the concern that the merged entity and SCPA, a French potash producer would have about 80% of total Community production. The Commission's decision was annulled because of the alleged existence of structural links between Kali and Salz (thereafter K + S) and SCPA, which is not a sufficient condition for the existence of oligopolistic dominance. In its judgement the Court stated that the Commission is under an obligation to assess whether the transaction *'[..] because of correlative factors which exist between them'* will create the necessary conditions for firms to co-ordinate their behaviour successfully[328]. Following further annulments of the

[326] Case [1992] OJ L356/1.
[327] Case IV/M.308 [1994] OJ L186/30; appeal C-68/94 and C-30/95.
[328] See paras 221 and 222.

Commission's decisions, i.e. *France / Commission*[329], *Gencor / Commission*[330], and *Airtours, plc / Commission* cases[331] due to a series of errors in the assessment of whether a collective dominant position might be created, three criteria were set out for finding a collective dominance. The first one states that there must be sufficient market transparency to enable each firm of the dominant oligopoly to be able to know how the other members are behaving and to monitor whether or not they are adopting a common policy. The second, the situation of tacit co-ordination must be sustainable over time, as the existence of deterrents to ensure that there is a long-term incentive not to withdraw from the common policy. The third, it must be established that the foreseeable reaction of present and future competitors and consumers would not jeopardise the common policy (Jones and Sufrin, 2004:939-940).

These errors in assessment of the cases discussed above have raised various opinions with regard to the substantive criteria of the ECMR to catch co-ordinated effects. Some authors expressed the view that the old ECMR was broad enough to catch mergers, which would create incentives and ability for the firms to sustain tacitly collusive agreements. Other authors in contrast stated that it was not broad enough to cover the creation or strengthening of collective dominance[332]. Nevertheless, the new ECMR and Guidelines of Horizontal Merger clarified the notion, that merger transactions in oligopolistic markets, which reduce the competitive constraints of the firms involved in the merger together with a reduction of competitive pressure on the remaining competitors may, even without likelihood of the firms of the oligopoly co-ordinating their behaviour, result in a significant impediment to effective competition[333].

4.2.2. Non-horizontal mergers

Vertical and conglomerate mergers are sometimes referred to in the category of non-horizontal mergers. However, they do not simply exist as a miscellaneous group of non-horizontal theories of competition harm (Priddis,

[329] Cases C-68/94, C-30/95; see also *SCPA / Commission* [1998] ECR I-1375, [1998] 4 CMLR 829.
[330] Case T-102/96, [1999] ECR II-753, [1999] 4 CMLR 971.
[331] Case T-342/99, [2002] ECR II-2585, [2002] 5 CMLR 317.
[332] Further discussion on these issues is provided in chapter 6.
[333] See ECMR, recital 25 and Guidelines para 25. For further discussion, see chapter 6.

2005:222). Like horizontal mergers, non-horizontal mergers may cause anti-competitive concerns due to the fact that they can increase a market power in different levels. Also, as in the case of horizontal mergers, non-horizontal merger transactions may create or strengthen market power because of unilateral or co-ordinated effects. Unilateral effects may occur if the products of the competitors after a merger transaction become less attractive substitutes as to how they were before the merger due to the higher prices, lower quality and/or the restrictions of entry. This leads to the creation or increase of market power of the merging firms. Co-ordinated effects, meanwhile, might appear if after the transaction it is easier for the remaining firms to enhance co-ordination and the collective exercise of market power. It means that by acting collectively firms will exercise more market power than acting on their own. (Church, September 2004). The co-ordinated effects depend on two main factors, which are: (i) there must be repeated interaction between the firms (they must compete over prices or quantities more than once); and (ii) firms must value future profits. Economists suggest that information of repeated interaction and the ability to react tomorrow to a rival's choice today provides an opportunity for firms to adopt history-contingent strategies in dynamic settings and that in turn may permit greater co-ordination and facilitate the exercise of collective market power[334].

The anti-competitive rationale of unilateral effects is based on identifying the ability and incentive of the merging companies to enhance their market power after the transaction. Meanwhile, in the context of co-ordinated effects the question arises whether such a transaction makes it easier for the remaining firms to co-ordinate their behaviour and it enhances the exercise of market power or in general, whether after the transaction the remaining firms will have the ability and incentive to collectively exercise market power.

The presumed competitive harm of each category will be discussed in the following sections, as the researcher considers that the distinction between vertical and conglomerate mergers is necessary and should be discussed separately.

[334] For further discussion, see Church, 2004.

4.2.2.1. Vertical mergers. Theory of harm

4.2.2.1.1. Unilateral effects

The anti-competitive effects of vertical mergers on competition are widely disputed. According to Bork *'[..] in the absence of a most unlikely proved predatory power and purpose, antitrust should never object to verticality of any merger'* (Bork, 1978:245). Further to his finding, *'[..] all so-called vertical merger cases should be handled through the application of horizontal merger standards'* (Bork, 1978:238). Froeb (Bureau of Economics, FTC, 2004) mentioned that vertical mergers may soften horizontal competition. The traditional concern is that vertical mergers may deny horizontal competitors access to the vertically related good or allow access but on terms which marginalise the horizontal competitors (Lofaro, 2004). Some authors believe that vertical integration through a merger causes firms to behave differently as it would in the absence of transaction. However, Bork proves such a presumption to be wrong, by stating that *'[..] vertical integration does not affect the firm's pricing and output policies'* (Bork, 1993:228). If a firm operates at both the manufacturing and retailing levels as a result of a merger, it maximises overall by setting the output at each level where the units were independent from each other. It is not economically profitable for the firm to sell to its own retail subsidiary for less than it sells to outsiders, unless the efficiencies of integration lower the cost of selling to its own retail unit. The reason behind it is a real cost of unit, which is the opportunity forgone. For instance, a firm will not sell to itself for less than it sells to outside firms, because the real cost of any transfer from the manufacturing to the retailing unit includes the return that could have been made on a sale to an outsider[335]. As a result, the artificially low price would force increased output at higher costs and the vertically integrated firm would pay more for the retailing function than it would if real costs were recognised and operated at a smaller scale on the retail level (Bork, 1993:228). For this reason Bork and Chicago School in general supported the view that vertically related monopolies can take only one monopoly profit, notwithstanding that a vertically integrated firm has monopoly

[335] Thus, Bork emphasised to focus on opportunity cost rather than on book values.

positions in both manufacturing and retailing industries. If each level tries to maximise profit by restricting output, the result will be a price higher than the monopoly price and an output smaller, the result being less than a full monopoly return. Even if there is a monopoly in both manufacturing and retailing sectors, the monopolist will still face the same consumer demand and the same costs at both levels. This is because the new retail subsidiary will not be permitted to act independently and further restrict output since that would result in an output lower and a price higher than the maximising level. In this case it is not profitable to gain a second monopoly vertically integrated to the first one as there is no additional profit to be taken (Bork, 1993:229). In the view of Chicago School theorists, vertical mergers do not create or increase the firm's power to restrict output and generally enhance welfare. However, the Chicago School's 'one monopoly profit' story has been criticised because of over-simplicity. This single monopoly profit model is based on restrictive assumptions, i.e. fixed proportions of production, homogenous uses downward and the absence of price regulation.

Recent modern theories of anti-competitive effects of a vertical merger assume imperfect competition up and downward before the transaction and are able to address the effects of the merger on competition (Church, 2004). The two basic theories are determined by either raising the costs or reducing the revenue of rivals, which involve customer foreclosure. The increase of rivals' costs involves input foreclosure. Input foreclosure occurs when the vertically integrated company after the merger either stops supplying competing downward firms (so called complete foreclosure) or supplies at a higher price (partial foreclosure), in both cases resulting in an increase in the price of the upward input and raising the costs of competing firms downward, thereby significantly impeding competition in the downward market. Customer foreclosure occurs when after the merger transaction the integrated firm downward stops sourcing supply from the independent upward firms. Both input and customer foreclosure were analysed in *Skanska / Scancem* case [336], where the Commission concluded that given Scancem's current dominant position, there would be significant scope for the merged entity to raise the costs of its competitors. Also, the merged entity may affect the sales of competing producers by reducing purchases from them. In

[336] Case IV/M.1157, [1999] OJ L183/10.

contrast to the Chicago school theory, the input foreclosure hypothesis assumes that the integrated firm after the transaction has an incentive to change its behaviour, because it will internalise the effect on downward prices when setting its optimal price in the market for the input[337]. For instance, the Commission in *Boeing / Hughes* case[338] identified six potential effects of the transaction and further examined whether the merged group would have an incentive and ability to engage in upward foreclosure. The Commission in this case raised the questions whether the merged entity would engage in upward foreclosure in order to maximise the profit and if so whether it would be practicable to implement such strategy. In particular, as regards this context, the Commission stated that *'[..] it is necessary to examine whether the merged entity would gain more through additional launch service contracts than it would lose through lost satellite contracts, if it were to engage in such behaviour'*[339] .

In general, the strategy of upward foreclosure may be profitable because of the following factors. First, it may force downward competitors to leave the market this in turn reduces the competitive constraints on the merged entity in the downward market and enables it to exercise market power in its own right by profitably raising prices. Second, it may raise the cost of marginal industry production, which in turn may force downward rivals to reduce their output and increase their prices, enabling the merged entity to gain downward market share by undercutting its competitors. Also, it can profitably augment its prices at a downward level in the 'shadow' of its downward competitors' price increases. Third, it may deprive competitors at the downward level from the economies of scale by increasing their marginal costs (Lindsay, 2003:368-369).

However, the economists admit that if the merged entity lacks substantial market power in the upward market, then in this case any attempt of the merged entity to engage in upward foreclosure will be overwhelmed by, for instance, switching of consumers to suppliers who have a spare capacity and can supply at the pre-merger price[340]. Bearing in mind this theory, Lindsay (2003:375) argued

[337] The assumption is that there is an additional benefit from the increase in input price, which is higher downward profit from the increase in prices and also market power downward.
[338] Case Boeing / Hughes, COMP/M.1879.
[339] Comp/M. 1879, Para 83.
[340] See Bishop and Walker, 1999, pp. 157-158; Lindsay, 2003, pp.373, Viscusi, Vernon and Harrington, 2000, pp. 223-229.

the Commission's reasoning in the *Vivendi / Canal + / Seagram* case[341] at this point is not clear *'[..] why downstream competitors of Canal + in the supply of pay-TV services could not simply obtain content from one or more of the other six major studios'*, if as proved by the Commission the merged entity did not hold a dominant position in the upward market[342].

The second part of the theory of harm by vertical merger transactions is the reduction of rivals' revenues, which involves customer foreclosure. It may lead to a reduction in sales volume and this reduction in turn may cause an increase in the marginal (or average) costs of the rivals upward depriving them from achieving economies of scale. As a result the integrated firm will gain greater market power upward and higher input prices due to the reduction of the competitive constraint on the integrated firm. The higher input prices may result in input foreclosure downward. This input foreclosure gives the vertically integrated company a further cost advantage downward and increases its market share. By contrast, the increase of the market share of the integrated firm reduces the demand for its competitors upward[343]. The difference between the input and customer foreclosures is that under the input foreclosure the vertically integrated firm stops supplying downward firms thereby creating market power for its competitors upwards, which leads to the increase in its market power downward. Meanwhile, the task of the customer foreclosure is to create the market power upward; therefore, an increase in prices downward may also occur. In both cases of input and customer foreclosure, the traditional anti-competitive concern is that a vertically integrated firm with market power in one market after the transaction may leverage that power into a separate market. Bishop and Walker (1999) also support the view that vertical mergers may raise competition concerns only if one or more than one party involved in a merger possess a market power at the horizontal level[344].

[341] Case COMP/M. 2050.
[342] See para 43, where the Commission referred that a refusal to supply by upward operator (without dominant position) can strengthen a dominant position held by the merged entity in a downward market.
[343] For further analysis, see Church, September 2004.
[344] This is because vertical integration involves complementary products and with complementary products each firm wants the other to lower the price of its product, for further reading see Bishop and Walker, pp.86-101.

A vertical transaction may create barriers to enter if there is a need to enter two markets instead of one. This might be a severe problem when economies of scale are significantly different in two levels (Areeda and Hovenkamp, 2002: para 755c as quoted in Lindsay, 2003:387). This theory was applied in the EC practice in the *Nordic Satellite Distribution* case[345]. The Commission prohibited the transaction because the vertical transaction would enable the merging parties to be able to foreclosure the Nordic Satellite TV market for its competitors and also obtain a gate-keeper function for the Nordic market for satellite TV broadcasting.

To date there are no Guidelines from the EC with regard to vertical and/or conglomerate merger transactions[346]. The US Non-Horizontal Merger Guidelines provide that three conditions must be satisfied for a vertical transaction to create barriers to entry. The first condition is that there is a necessity for a new entrant wishing to enter the primary market to enter the secondary market simultaneously. The second condition is that the need of entry at the secondary market must make entry at the primary market significantly more difficult and less likely to occur. The last condition is that the structure and other characteristics of the primary market are otherwise conducive to non-competitive performance that the augmented difficulties of entry are likely to affect its performance[347].

Economists admit that to date they still have an incomplete understanding of the motivations and effects of vertical merger transactions, and there is no over-arching principle to identify specific circumstances where a vertical foreclosure is rational and thereby is likely to occur (Caffarra, 2005:224-225, Tirole, 1998:193).

4.2.2.1.2. Co-ordinated effects

Economists suggest that unlike unilateral effects, co-ordinated effects from a vertical merger are small and recent. The economic literature recognises the following co-ordinated effects of vertical merger: (i) a vertical merger transaction may eliminate a disruptive buyer and enhance incentive to co-ordinate; (ii) it may put steps towards upward firms' ability to monitor each other's pricing and identify deviations from co-ordinated outcomes; and also (iii) a vertical

345 Case IV/M.490.
346 There is a promise from the Commission to issue such Guidelines in the near future.
347 See The US Non- horizontal merger guidelines, available at web-site: www.usdoj.gov/atr/public/guidelines/2614.htm

transaction may increase transparency by creating a conduit (i.e. the downward subsidiary) for the exchange of information between upward firms (Church, 2004:241-242). Vertical merger transactions may eliminate disruptive buyers (a buyer which is able to obtain lower prices from its supplier before the transaction) and it will likely have an incentive to co-operate with the other upward firms to raise input prices upward rather than push it down for lower prices in the input market providing with a competitive advantage downward, which is the behaviour of the disruptive buyer[348]. Co-ordination at the upward level may be difficult if prices are not transparent. Therefore, vertical integration may provide a firm with information on the costs of retailing, allowing more information to be obtained about wholesale prices from retail prices.[349] As regards the last factor, a vertical merger may create a more transparent environment for the exchange of information regarding prices and other information. For instance, presuming the downward subsidiary after the transaction continues to purchase from the rivals upward of the vertically integrated entity, there is the potential for the downward firms to transfer information regarding the prices and offers of those rivals to its upward division. Moreover, Riordan and Salop (1995:558-560) state that there are certain conditions for information exchange under these circumstances in order to facilitate co-ordination. These conditions are that the information has to be project-able, unique and the input market must be conducive to co-ordination[350].

However, economists further argue that there is another side to the story. A vertical merger in a relatively un-integrated vertical structure can destabilise and reduce the extent of co-ordination upward. This is due to the fact that the vertically integrated firm creates a maverick by forming asymmetries between upward firms[351]. A vertical merger can be pro-competitive, if it has an incentive and ability to expand its sales secretly through its downward subsidiary. Also, the incentive to increase sales arises if the vertical merger eliminates double marginalisation[352].

The most recent studies of vertically co-ordinated effects are presented by Nocke and White (2004). They identified two reasons why co-ordination is more

[348] For further discussion, see Church, 2004, pp. 247-249.
[349] For further discussion, see Church, 2004, pp. 249-250.
[350] For further discussion, see Church, 2004, pp. 250-252.
[351] Situation is similar as discussed about horizontal mergers.
[352] The US Antitrust authorities take into account this theory, see the US Merger Guidelines, Section 2.1.2.

likely due to integration. The first one is outlet effect, where an un-integrated rival finds deviation from the co-ordination less profitable if there is a vertically integrated rival. This is because it cannot replicate the monopoly profit when it deviates because it is not able to sell to[353]. In this case foreclosure from the vertically integrated firm's downward division makes deviation less profitable. The second reason is the so called reaction effect, because the vertically integrated firm can react to the deviation in the same period in which it cheats. Thus, the deviating firms can be punished as the integrated firm can expand output in the cheating period thereby reducing the incentives for cheating. Also, Nocke and White were able to show that the outlet and reaction effect always exceed the punishment effect and vertical integration makes co-ordination easier[354].

4.2.2.2. Conglomerate mergers. Theory of harm

4.2.2.2.1. Unilateral effects

Conglomerate mergers, like vertical mergers also raise different opinions between scholars with regard to their effects on competition. The Chicago School scholars suggest that unlike horizontal mergers, conglomerate mergers do not conventionally raise competition concerns. Similar to vertical mergers, conglomerate mergers do not put together rivals and do not restrict output through an increase in market share and therefore, do not threaten competition (Bork, 1978:248). Also, the Chicago School theorists supported the view, that there is no incentive for a conglomerate merger to be involved in tying or bundling because of 'one monopoly profit'. However, this may be true in only some circumstances[355].

As regards recent theories, there are two different opinions on the practice of bundling. In the US the current opinion advocates a 'laissez faire' approach towards bundling practice. Ahlborn, Evans and Padilla (2003) suggested a so

[353] For further discussion, see Church, 2004, pp. 252-253, as Nocke and White based their theory in the existence of certain conditions.
[354] See Church, 2004, pp. 254. However, they admitted that there is not clear how the result will generalise if there is more than one vertically integrated entity.
[355] Lindsay (2003) gives an example, when one monopoly profit is true. For instance, a situation where an attempt to tie from a monopoly market to a competitive market with constant return to scale. For further comments see pp.399.

called modified 'per se legality' rule of bundling on the basis that the efficiency gains of bundling are ubiquitous, meanwhile, the anti-competitive effects of bundling are highly non-robust. Another group of economists admit possible anti-competitive effects of conglomerate merger transactions, which may have unilateral or co-ordinated effects. The researcher does not support the view that the 'laissez faire' approach towards bundling should be taken. In contrast, taking into account the current state of economic literature, the author tries to present the situations when anti-competitive effects as a result of conglomerate merger transactions may occur and further if they can be offset by efficiency gains.

There are three types of anti-competitive activity in which a conglomerate firm may be involved; these include tying, bundling, or foreclosure[356] (Church, 2004). Tying[357] occurs in the acquisition of complements. For instance, when purchases of product A (the tying product) also requires buying product B (the tied product) now and in the future. Tying is most profitable in the situation where consumer valuations of the two products are positively correlated, as where the consumers giving the greatest value on product A also place the greatest value on product B (Lindsay, 2003:397). There are two types of bundling. Pure bundling arises when products cannot be sold individually but are required to be bought collectively as a group of products. Pure bundling is the most profitable in a case where consumer valuations of the two goods are correlated and negatively and if the marginal costs of production are low. If marginal costs are low then the producer has an incentive to increase output through the sale of the bundled product (OECD, (2002)5:35). In a mixed bundling situation[358] consumers may purchase individual products separately, or pay in total a lower price but only if the products are purchased as a bundle. Mixed bundling as the key element was

[356] There are other theories of leverage with a similar effect to tying or bundling, such as full-line forcing, exclusive dealing, cross-subsidisation, predatory pricing, and control of information. These theories will be not discussed in this thesis due to their similarities with the effects of tying and bundling in the sense that they may eliminate or marginalise competitors. See Lindsay, 2003, pp.408-409.

[357] Traditionally, in the literature tying and bundling are used interchangeably, as there is an assumption that consumers demand a single unit each of two products A and B and in this case make a tie indistinguishable from a bundle. However, Church (September, 2004:xx) states that there is a difference between a tie and a bundle, because the former is more likely to involve divisibility. For example, a tie, which requires a purchase of two units of B with every unit of A is not the same as offering to sell a package of four units of B and two units of A.

[358] An example of mixed bundling as presented by Lindsay (2003) pp. 398, is an offer of a restaurant to customers to buy a set and an *a la carte menu*.

analysed by the EC Commission in *GE / Honeywell* case[359]. The Commission claimed that the merged firm would have incentives to bundle its avionics, for instance, aircraft communication and navigation equipment, and non-avionics products, such as wheels, lights and other parts, with engines, at a discount to single product purchases, which competitors would be unable to offer. This in turn would mean competitors being unable to cover their fixed costs due to deprivation of revenues and as a result it would affect their spending destined for R&D on the next generation of products, meaning that they will not be able to compete effectively with respect to future platforms. In general terms, the Commission in this case feared that the strength of the combined positions of the merging entities would allow GE to engage in exclusionary product bundling with the ultimate effect of a foreclosing market for single product line competitors, namely Rolls Royce in aircraft engines and Rockwell Collins in aerospace components (Grant and Neven, 2005:595-633[360]).

Foreclosure occurs when after a transaction, a firm has a greater variety of products, providing the opportunity to foreclose by not making its products compatible with the products of its rivals. In this case, the firm will have a portfolio advantage (Church, September 2004). The main concern of the 'portfolio' doctrine is that a firm acquiring different brands competing in separate markets may acquire a market power in excess of the sum of its parts.

Conglomerate mergers by uniting complementary products in which at least one enjoy significant market power (the 'tying' market) may leverage its power into another market (the 'tied' market). As a result a sufficient number of competitors may be forced to leave a market. Thus, there is a possibility that the forced tying and pure bundling may have negative effects on welfare, especially in the long term. A scenario very similar to this is portfolio power. The merged entity with a wider portfolio of products than its rivals, can force them to leave the market as a result of lost business, if the competitors cannot match the merged entity's portfolio and customers are likely to switch to the merged entity's portfolio because they prefer it. As a consequence of this, customers will be worse

[359] Case COMP/M. 2220, 05 February 2001. The Commission also placed some emphasis in this case on pure bundling as theoretical future behaviour of the merged entities in relation to new generations of aircraft.

[360] This case was highly criticised by a number of scholars for not sufficiently robust theories and evidences that the Commission relied on. See, for instance, Grant and Neven, 2005, pp. 595-633. Also, see Pflanz M. and Caffarra C., The Economics of *GE / Honeywell*, 23 ECLR 115, 2002.

off because the merged entity will be able to profitably raise prices or otherwise harm consumer welfare due to weakened competitive constraints (with a presumption that rivals have left the market) (Lindsay, 2003:413). The concept of portfolio power, as mentioned in chapter 3, was defined by the Commission in *Guinness / Grand Metrolopolitan* case[361]. However, the Commission's decision has been highly criticised by some authors not for definition of portfolio power, but for failing to support the notion, why it is wrong for a firm to gain a wider portfolio (Jones and Sufrin, 2004:963).

The probability of reduction of welfare is higher depending on the following elements:

i) market power (the higher the degree of a market power in the 'tying' product);

ii) the weaker the efficiencies;

iii) rivals' costs (the greater increase in competitors' cost resulted from the merged entity's tying strategy);

iv) buyer power (the larger number of buyers interested in purchasing only the tied product);

v) reaction of rivals (the more rivals find it impossible or unprofitable to match the tying or bundling behaviour of the tying firm);

vi) increase in price (the more certain that the price will eventually rise above pre-merger levels due to foreclosure effects, i.e. buyers will be unable to prevent such a price rise, companies will be unable to profitably enter the market after prices have risen above pre-merger levels, and the tying firm will have an incentive to raise prices above pre-merger levels);

vii) the more the expected long period price increases above pre-merger levels will be sufficiently large, quickly realised and durable that the tying firm will be able to re-coup any opportunity losses due to reducing its rivals' sales.

[361] Case IV/M. 938, [1998] OJ L228/24.

As a result of these factors buyers will suffer a net loss in the long-term despite any initial post-merger drop in prices[362]. However, the problem that the regulatory authorities have to deal with is that foreclosure in conglomerate mergers may have much more indirect effects even than in a vertical merger case.

Moreover, Kuhn, Stillman and Caffarra (September, 2004) suggest three elements rule for competition authorities in determining when intervention against bundling is justifiable as a matter of economics. The first element is a 'safe haven' rules when intervention should be avoided. The intervention should take place only if the following conditions are met: (i) the firm in question has a dominant position in one market which is affected by bundling, (ii) the bundled products are complements, and (iii) it is significant and costly to overcome asymmetry in the product lines of the dominant firm and its competitors[363]. The second element refers to the cases, which fall outside the 'safe haven'. During this stage the anti-competitive effects should be determined. Lindsay (2003) suggests using the three-step analysis for the investigation of conglomerate mergers, which can be applied in this stage. First, the merged entity has to have the incentive and ability for leveraging. Second, this leveraging has to have a significant effect through elimination or marginalisation of the competitors (i.e. the exclusion issue). Third, there must be a causal link between the merger transaction and the adverse effects identified in the first and the second steps[364]. The third and final element of the whole analysis of conglomerate mergers is the evaluation of potential efficiency benefits arising from a conglomerate transaction.

The Commission also considered possible anti-competitive effects imposed by conglomerate mergers in the *Tetra Laval / Sidel* case[365]. In this case the Commission argued that as a result of the transaction, the merged entity would be able to exploit its dominant position on the carton markets by leveraging into the market for PET packaging equipment in order to dominate it. However, the Commission's decision was annulled by the ECJ on the basis that the Commission

[362] For further reading see OECD, Portfolio Effects in Conglomerate Mergers, DAFFF/COMP(2002)5.
[363] Note: Kuhn, Stillman and Caffarra state that the more homogenous the components are, the fiercer price competition becomes component by component and as a result the benefits of a bundling strategy become minimal. Products are 'complements' when an increase in the price of one decreases the demand for the other.
[364] This approach was used by the Commission in T-5/02 Tetra Laval BV case.
[365] Case T-5/02, [2002] ECR II-4381, [2002] 5 CMLR 1182.

had failed to establish foreseeable conglomerate effects to the requisite legal standard. Also, the Court distinguished mergers where the conglomerate effects would be structural, as arising directly from the created economic structure and mergers, where the conglomerate effects might be behavioural, as arising only in a case if the new entity engages in certain commercial practices[366], to which the Tetra Laval case referred, where future conduct was in question rather than market's structure. It was necessary for the Commission to prove that the merged entity's ability and incentive to leverage and the consequences of this must be plausible and occur in the near future, as competition will be significantly impeded in the near future[367]. Moreover, the Advocate General stated that while evaluating the Commission's assessment of the likelihood of the merged entity involvement in anti-competitive behaviour, *'[..] the Commission had assessed the economic incentives for engaging in such conduct, so it ought to have taken into consideration the possible disincentives in that respect of the unlawful nature of the conduct in question'* (Opinion, 25 May 2004: para 123).

4.2.2.2.2. Co-ordinated effects

The theorists recognise that a conglomerate merger will introduce a multi-market contact[368], which in turn will enhance co-ordination and augment the scope of punishment. The empirical studies presented by Greve and Baum (2001:6) define the importance of multi-market contact for *'[..] higher prices, lower production volumes, higher profits, and lower failure rates for incumbent firms'*. There have been a number of studies done by several scholars, which demonstrated that multi-market eases co-ordination. For instance, Scott (1993, 2001) states that multi-market contact facilitates to reach a tacit agreement or to identify the co-ordinated outcome in the market. Matsushima (2001) shows that multi-market contact competition facilitates the detection of deviations when monitoring is not perfect otherwise prices are not observable. Bernheim and Whinston (1990) have examined the effect of multi-market contact on the scope

[366] See para 147.
[367] See para 153, as a second part of the substantive test of old ECMR.
[368] Note: multi-market contact occurs in the situation where firms compete against each other in multiple markets, i.e. either by competing in different product markets or different geographic markets.

for punishment and hence sustainability. In general, multi-market contact as presented by a number of scholars makes co-ordination easier, i.e. by reaching an agreement easier or making enforcement more effective, in the presence of certain circumstances[369].

4.2.3. Constraints on market power

Despite negative effects of market power on competition, a firm in a domain of market power cannot vegetate, as there are the factors that may constrain its market power. A dominant firm will not be profitable unless there are barriers to entry on the supply side of the market and no adequate substitutes for the product supplied on the demand side. As regards the demand side, customers may be sensitive to price increase, for instance, if the price of meat increases, customers may choose to buy fish instead. From the supply side, if, for instance, there is one successful firm that profitably produces some products or provides services, its profits may be noticed or guessed at by other firms, which are encouraged to enter the market and to produce or provide something similar (Lane, 2000:9).

Thus, the theory suggests that not only the present competitors in the market may discipline dominant firms in their market behaviour, but also the potential competitors, especially in a situation where sunk costs of production in a market are very low. Moreover, a merger, which increases market power and may lead to a rise in price and reduction in output, may be offset by any cost reductions associated with the merger transaction.

4.3. The trade-off between efficiency and the choice of welfare standard

The comparison of the length to which mergers extend market power against gaining efficiencies has been recognised as a highly complex and controversial subject. Even the impact of mergers on all three types of efficiencies is unlikely to be in the same direction or magnitude (Mano, 2002:14). Hence, the competition authorities face complex trade-offs.

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[369] For further discussion, see Church, 2004.

Economists recognise two basic types of efficiency trade-offs: (i) allocative versus productive efficiencies; (ii) static versus dynamic efficiencies. Firstly, a static perspective refers to the statement that mergers often lead to both reductions in allocative efficiency and increases in productive efficiency. Secondly, mergers can have both static and dynamic efficiencies that may work in opposite directions: a merger can lead to immediate overall anti-competitive effects and at the same time enhance consumer welfare in the long run (Mano, 2002:14).

The trade-off between allocative and productive efficiencies is considered in a widely recognised model developed by Oliver Williamson (1968:18). On Williamson's view for the net allocative effects to be negative *'[..] a merger which yields non-trivial economies, must produce substantial market power and result in relatively large price increases*' (Williamson, 1987:8). This model would permit a merger that increases 'total surplus'[370] notwithstanding an increase in prices above the competitive level. The cost savings resulting from efficiency gains generated by the merger must exceed the 'dead-weight loss' caused by the price increase. For Marshall (1966: ch.3 and 4) 'dead weight' refers to the situation, where consumers lose and this loss is not gained by the other group of society. It means that society is worse off as a whole, because those who continue to buy the product at a higher price have less money to buy other products compared to the pre-merger situation and those, who no longer buy the product after the price increase spend their money on less valued products. The size of the 'dead weight loss' is a function of the elasticity of demand for the relevant product and the anticipated price increase. The model typically requires calculations over a range of possibilities, because those values cannot be precisely known.

In general, Williamson's Naïve trade-off model[371] hypothesises that horizontal mergers are generally beneficial, because the loss suffered by consumers resulting from an increase in price is more than outweighed by gains to

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[370] Total surplus is the sum of producers' surplus and consumers' surplus. Producer surplus is the variance between the price in the market that producers collectively receive for their products and the sum of those producers' respective marginal costs at each level of output. Meanwhile, consumer surplus is the difference between what a consumer is willing to pay for a good and what the consumer actually pays when buying it.

[371] For further reading see Williamson, O., Antitrust Economics: Mergers, Contracting, and Strategic Behaviour, Basil Blackwell, 1987, pp.1-23

producers; otherwise, the gainers gain more than the losers loose. According to his consideration *'[..] a relatively large percentage increase in price is usually required to offset the benefits that result from a 5 to 10 per sent reduction in average costs*[372]' (Williamson, 1987:23). This model welcomes efficiencies, as the realisation of efficiencies through a merger may increase total economic welfare. It is unnecessary to pass on efficiency gains directly to consumers as the aggregate social welfare is already augmented by achieving efficiencies within the firm[373]. Williamson's total welfare model requires relatively large price augments for the net allocative effects to become negative.

However, Williamson's model has been criticised by other authors. Given the simplicity of Williamson's model, the application of the theory in practice requires a more complex analysis by taking into account various other factors such as pre-existing market power, differing demand assumptions and other firms' competitive reaction to increased market power. Considering a wealth transfer from consumers to producers, it is not clear, to what extent a merger, which results in a price increase, should be permitted under Williamson's model, provided the resulting efficiencies are potentially sufficient to compensate consumers for any harm caused (Mano, 2002:16). As mentioned above, Williamson's model has only a static approach and it does not take into account the dynamic nature of competition, for instance, consideration of the effects of a merger on technological progress: the model also does not have any concern in practice, which lies with the future development of the market. Economists recognise that in a dynamic economy competition in product or process innovation may have a more significant effect on welfare whether positive or negative, at least in the long run, than does any likely variation in price (Mano, 2002:17). Even if dynamic efficiencies benefit consumers no less than productive efficiencies, they are inherently more difficult to measure, thereby making their use more problematic in the trade-off analysis implicit in the defence (OECD, 1996). Therefore, Williamson's model can be called 'naïve' because demonstrating that a merger is likely to bring about greater efficiencies that the

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[372] Note: this conclusion is absolute: a variety of qualifications such as timing, incipiency, income distribution, political considerations, technological progress and managerial discretion, and others may upset this in any particular case.

[373] For further reading, see Camesasca, 2000, pp. 42-46. This model does not distinguish which one society member will gain more.

dead-weight loss believed to result from the merger will be more difficult than suggested by his model. Nonetheless, Williamson's model served the purpose that the potential benefits resulting from merger transactions should be recognised in addition to their costs (Gal, 2003:200).

The analysis above shows the trade-off between the allocative and productive efficiencies, but does not explain what kind of mergers would be socially desirable. Williamson's model evaluates the efficiencies from unit cost savings over the total industry output, in the assumption that all firms in the industry participate in the merger, though in practice this is rarely the case (Roeller, Stennek and Verbove, December 2000:32). Farrell and Shapiro (1990) proposed a methodology to evaluate externality created by a merger transaction without a need to rely on internal efficiency claims. Farrell and Shapiro (1990) in their model assumed a merger to be privately profitable and showed that it is a sufficient condition for a merger to be socially desirable, if its net external effect is positive. The external effect in this case is referred to as the sum of the change in consumer surplus (which is usually negative) and the change in competitors' profit (which is usually positive). According to Farrell and Shapiro's analysis, privately profitable but price-increasing merger will also be profitable socially as far as the initial joint market share of the merging parties does not exceed some upper limit. (This upper limit is a weighted sum of the market shares of competitors, where the weights are the expected changes in competitors' output as a response to the merger. If the competitors expand their output in response to the merger transaction, then a significant welfare gain can be provided[374]). In this case, a positive external effect signifies an increase in social welfare. Thus, if externality is positive, then the merger transaction must also increase total welfare since the proposed transaction may be expected to be profitable (Roeller, Stennek and Verbove, December 2000:32). However, Neven, Nuttall and Seabright (1993) in commenting about this model raised the question as to whether and how a negative external impact of a merger should be evaluated against any potential efficiency gains to the merging entities[375]. Moreover, substantial empirical studies

[374] Note: Farrell and Shapiro proved that the more concentrated level among remaining firms, the more it is likely that the merger transaction will enhance welfare externally.

[375] Note: considering the restriction of the analysis that the only gains which can be traded off against a loss of consumers surplus are increases in competitors' profits excluding any private gains to merging parties.

have presented doubts on this assumption that only mergers, which can be expected to be privately profitable, will be undertaken (Neven, Nuttall and Seabright, 1993:35-36). Nevertheless, Roeller, Stennek and Verboven (2000) suggest not underestimating Farrell and Shapiro's contribution because they pinpointed the importance of the effect of a re-allocation of output to competitors, which was traditionally ignored. They also showed that due to this effect merger transactions may even be beneficial when no internal efficiencies are achieved.

4.3.1. Total welfare standard

Total welfare standard as already described above corresponds to Williamson's model. According to this model, the main objective of antitrust law is to increase total welfare by allocating resources through the price system to those users (either producers or customers) who value them most (Brodley, 1987:1020, as quoted in Camesasca, 2000:43). In this case, even mergers, which lead to higher prices, should be approved by the competition authorities if the efficiency gains achieved by producers outweigh the losses experienced by consumers. For this standard both producer and consumer welfares have the same value to society as a whole. Some economists recognise that intolerance to re-distributive effects of mergers has good reasons. First of all, it is difficult to determine the ultimate rate of wealth re-distribution as a result of a merger. Secondly, bearing in mind, that winners and losers can be identified, there is no basis which one group deserves more. An example to support this standard, is that very often many consumers are also indirect shareholders, for instance, through pension funds (Mano, 2002:18-19).

4.3.2. Consumer welfare standard

An alternative to the total surplus standard is the consumer welfare standard. The consumer welfare standard states that the goal of competition policy is to prevent increases in consumer prices, because of the exercise of market power of a dominant firm. According to the consumer welfare standard a merger ought to be authorised, if the gains in productive or dynamic efficiency are so substantial as to ensure that the price will not increase and that the merger will not result in a wealth transfer from consumers to producers. Thus, unlike the total welfare standard, the consumer welfare model considers the re-distribution of welfare from consumers to producers harmful rather than neutral. This can be explained by the Pareto optimum, where it is impossible to change so as to make at least one person better off without making another one worse off (Camesasca, 2000:42).

As regards efficiencies, this model is more critical of efficiency claims than the total welfare model due to the fact that efficiency gains must be passed on to consumers, for instance, in the reduction of prices. In other words, the test under the consumer welfare standard is whether, after accounting for cost savings and other efficiency gains the post-merger profit maximising price[376] is not higher than the pre-merger price. As stated by Mano (2002) the producers will not increase prices above the pre-merger price, because the new efficiencies are so large as to cause their profit maximising price to be no higher than the pre-merger price. This is because the extra production becomes smaller due to efficiencies; the total net effect becomes positive, because the added revenue from the price decrease exceeds the added production cost. Thus, producers can still increase profits by reducing the price, causing marginal revenue and marginal cost to be equal at a higher level of output (Mano, 2002:19).

In general, there are three components of consumer welfare (Lindsay, 2003). As mentioned above, the first component is value for money. Consumer welfare enhances if the price of goods/services is reduced or the quality of those goods is increased whilst the price is not changed. Price and quality are connected where a price means the sum payable for a good/service of a particular quality. However, a consumer is not interested in the quality of a good/service, unless the consumer also knows its price (Lindsay, 2003:3). Quality is important because if prices in a market reach marginal costs, this may lead to a switch from higher quality to lower quality goods/services; indeed, this situation depends on the consumers and their sensitivity to price. The second component is consumer choice. For instance, if consumers have different tastes, then consumer welfare may increase if they can choose from a wider variation of products. The last component is innovation. Consumers may benefit and consumer welfare may

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[376] Note: in economic terminology profit is maximised at the point at which marginal revenue equals marginal cost.

increase, if new products are developed, on the basis that there is actual or potential demand for the new products (Lindsay, 2003).

4.3.3. Balancing weights standard

As well as the total and consumer welfare models, there is also a balancing weights approach. In contrast to the total welfare standard, the balancing weights standard is based on distributional issues. The idea of the balancing weights model is that it takes both consumer and total welfare into consideration, but places greater value on losses of consumer welfare than on gains in producer welfare. Theoretically, a merger according to this model should be approved if the weighed sum (reduction in consumer welfare and increase in producer gains) is greater than zero. This model was applied in the Canadian jurisdiction in the case *Superior Propane*[377]. In this case the Court in overturning the Tribunal's decision, which was based on the total welfare test, stated that this standard was too narrow and advised using a balancing weights test; and this test take into account a deadweight welfare loss and give a value to the re-distributive effects of the merger transaction. The biggest shortage of this model is that the EC competition policy is not equipped to address such distributional concerns (Mano, 2002:23).

4.3.4. The trade-off of efficiency of vertical and conglomerate mergers[378]

4.3.4.1. Vertical mergers

Economists agree that like horizontal mergers, vertical mergers may also increase efficiencies. There are opinions that the motivation for non-horizontal mergers is to realise efficiencies but not to enhance market power (Sunshine, 1995, Riordan and Salop, 1995). Vertical mergers may enhance efficiencies and thereby benefit consumers, because of the following factors, which can be distinguished into three main groups: (i) production efficiencies and savings; (ii) internalisation of vertical externalities and alignment of incentives; and (iii)

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[377] *The Commissioner of Competition / Superior Propane Inc.*, April 2002

[378] According to Williamson, vertical and conglomerate mergers may be treated under the general framework as horizontal by applying the same formula as in the Williamson's Naïve model (Williamson, O., 1987:22-23, 24-38).

transaction cost savings[379]. The scholars point out a number of different production efficiencies and cost savings, which arise because of the enhanced co-ordination[380] as a result of transaction. Vertical merger may eliminate inefficient input substitution, which results in lower costs (Church, 2004:17-23). For instance, if there are two inputs (monopolistic and competitive) and these two inputs are substitutes for each other and can therefore be used in variable proportions, then an upward monopoly firm has an incentive to integrate vertically. This is because the upward monopolist's intention to increase prices will result in switching to the alternative input supplier at the downward level. Vertical merger transaction will result in increased efficiency in input choices in this situation; however, economists admit that the implications of it for consumer welfare are ambiguous (Lindsay, 2003:364). Furthermore, Riordan and Salop (1995:523-524 as quoted in Church, 2004) stated that efficiency gains achieved from co-ordination in both the design and production of vertical mergers involve lower costs, increase quality, make shorter lead times, improve quality control, reduce cost of inventory and optimise production runs etc.

As regards vertical externalities[381] and exclusivity, advantages from enhanced co-ordination from exclusivity may arise from the alignment of incentives with the vertical level, prevention of free-riding, quality certification and creation and maintenance. For instance, due to integration, producers can share information regarding market conditions and their promotional plans with their retailer and be less concerned of leaking information to competing producers. Exclusivity may also eliminate any incentive of a retailer to lower its costs and thereby increase its profits by substituting lower quality products. In general, a vertical merger aligns more closely the welfare of a downward firm with the upward. In the absence of vertical merger, the producer's incentive to invest in the retailer and/or its products is reduced because of free-riding[382] of other producers[383].

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[379] This grouping is presented by Church. Others like Lindsay distinguish three main sections: transaction costs, double marginalisation and variable proportions.

[380] Note: here, the referral is on common ownership but not on co-ordination that gives co-ordinated effects concern.

[381] Externalities in this context mean that the actions of one entity have direct affects on the welfare of another entity.

[382] Free riding here means benefits attained by other firms without putting any efforts or bearing any costs.

[383] For further discussion, see Church, 2004, pp. 284-285.

Through a vertical merger, transactional efficiencies may be attained in a case of purchasing an upward monopoly supplier to avoid or mitigate its opportunistic behaviour. Transaction costs tend to be high when opportunistic behaviour is likely, for instance, if a firm is dependent on a monopoly supplier of an essential input. Also, transaction costs may be high when there is substantial uncertainty or when extensive co-ordination is required, for instance, in combining R & D activities (Lindsay, 2003:360-362). In general, according to Lindsay (2003) transactional efficiencies facilitate for firms to achieve allocative, productive and dynamic efficiencies.

Moreover, vertical mergers may lower price because of internalisation of a vertical pricing externality, otherwise, double marginalisation. Double marginalisation occurs when downward firms mark up over their marginal costs, because of a market power upward exceeding the marginal cost of the upward producer. This means that there is a mark up on a mark up or otherwise, double marginalisation. In this situation a vertical merger would eliminate the wholesale market transaction and one mark up, thereby reducing the marginal cost downward, resulting in both a lower price downward and increased profits (Church, 2004:iv).

This section has showed that vertical mergers may increase efficiencies. The proposed framework introduced by Church (2004), who discussed the most recent theories on vertical and conglomerate mergers, pointed out that non-horizontal mergers require, after the indication of anti-competitive effects, to give an opportunity to the parties involved in a transaction to demonstrate that the possibility of the efficiencies gained from the transaction to offset the harm associated with market power.

4.3.4.2. Conglomerate mergers

As with other types of mergers transactions, conglomerate mergers may also have potential anti-competitive and/or pro-competitive effects on competition. After discussing anti-competitive effects of conglomerate transactions, this section involves the analysis on pro-competitive effects. Conglomerate mergers may provide benefits by revitalising ailing companies and industries, improving management efficiencies, transferring technical and/or marketing know-how across traditional industry lines and/or simply by providing financial support for firms, that need it the most. Economists distinguish two main categories of benefits achieved through the efficiencies arising from the production side, and from the consumption (Kuhn, Stillman and Caffarra, September 2004). The production side efficiencies may arise only, if consumers have an interest to buy products together. There might be a case when there are economies of scope in the assembly of complementary parts of a product. For instance, it would be cheaper for manufacturer to assemble a car rather than for an individual customer buying the parts separately and assembling it by him/herself. The economies of scope in consumption arise when there are advantages for consumers to buy complementary products from the same firm rather than from two or more separate suppliers. The motivation behind this is transaction cost savings. For instance, a consumer may benefit from shopping costs, for example buying various types of goods at department stores or supermarkets (so called 'one-shop-shopping') rather than shopping in several different shops.

Hence, conglomerate mergers may achieve economies of scope or transaction economies and as a result reduce prices or provide other advantages for buyers. Despite that, the concerns of the authorities are that efficiencies gained by conglomerate mergers will be used to induce competitors to leave the market. New entrants will be unable to enter the market because of the cost level and the strategy of the tying firm, buyers will not have countervailing powers to lower prices and as a result the merged entity will be able to raise prices above the pre-merger level. In this case the competition authorities will be forced to balance short term gains against long term losses of buyers (OECD, (2002)5:7-11). However, some scholars are of the opinion that these theoretical assumptions hardly work in practice. For Bork, conglomerate mergers do not create the ability to restrict output (Bork, 1993:249). Furthermore, economic theory does not define that tying always or nearly always will lead to anti-competitive effects. The arguments that monopoly power through tying[384] can be extended from one market to another have also been discredited (Bishop and Walker, 1999:158-160).

[384] tying and bundling here are applied interchangeably.

4.4. Implications on small market economies

There are a number of criteria to define a market's size. Population or GDP are normally the most common criteria to define a market size or one of the relevant measures of smallness in a conventional sense. The meeting of the OECD Global Forum on Competition in 2003[385] raised a variety of definitions of small markets and divided the substantive issues into three categories, which are: (i) based on economic factors; (ii) based on 'political' considerations; and (iii) based on special enforcement issues.

The first category attributes to the tendency of small economies to have high levels of concentration and domestic firms operating at less than minimum efficient scale. This definition may need to include measures of concentration and entry barriers, and even some measures of smallness such as population or GDP. Furthermore, this tendency may mean that competition rules in these economies should be more tolerant to mergers, which may increase efficiency.

The second group according to the OECD relates to the competition law enforcement implications of small size in the conventional sense such as population or GDP. The issues, which may arise from this aspect of smallness, relate to enforcement problems, such as the scarcity of qualified staff, the costs of an enforcement agency, evidence gathering problems and so on.

The last category addresses the implications of the legal, institutional, and economic issues, and is common for developing or transition economies. In contrast to developed countries, competition culture and competition law and policy of developing or transition countries is still in its infancy.

On one hand, the Baltic countries are defined by scholars as belonging to small market economies (Venesaar, Hachey, 1995; Haavisto, 1997). On the other hand, the Baltic countries have been analysed as economies in transition. The Baltic countries can be defined by all features found the three groups as described above. They have high concentration levels in some industries, i.e. the dairy industry, small population and that they still belong to transition economies. Gal (2003) argues that there is no need for all industries to be highly concentrated for an economy to be considered small, as some industries in small market economies

[385] See CCNM/GF/COMP(2003)5.

may be competitive, as for instance, retail services. In general, a small economy is an independent sovereign economy and can support only a small number of competitors in most of its industries (Gal, 2003:1). According to Gal (2003, 1-2) market size can be influenced by many factors such as population size, population dispersion, openness to trade being the main factors, and others such as consumption patterns, taste preferences, income levels and the availability of technology being supportive factors. As regards the Baltic countries, they have a small population, which in Estonia is only 1.3701 million, in Latvia 2.3774 million and in Lithuania 3.484 million (2000 round of population, 2000/2001 statistics). The Baltic states do not have population dispersion over a large geographic area and in this case it does not create several small local markets within a geographically large jurisdiction. Furthermore, the size of an economy is also influenced by other factors, i.e. geographic, economic, technological, legal, cultural and political, which may create market borders. The Baltic countries are not geographically isolated markets, unlike, for instance, Malta, Jersey or New Zealand. However, the political situation has played a significant role in isolating the Baltic countries, as a part of the USSR, from Europe and the rest of the world by closing certain passages to trade and by preventing trade between adjacent jurisdictions. Thus, until 1991 foreign trade was nonexistent in these countries as they were a part of the Soviet Union. The Baltic countries are not integrated to each other, as the heaviest ties were with the Soviet Union/Moscow and regard themselves more as competitors than partners in the world economy (Lainela and Sutela, 1994:119). After re-gaining their independence the Baltic states had to build their entire foreign trade systems from scratch. The Baltic states expressed the desire to integrate their economies with the rest of the world, therefore the governments in these countries started to dismantle the restrictive and inefficient trade regimes inherited from the Soviet Empire. All Baltic states apply a liberal foreign trade system in order to attract foreign investors, Estonia being the leader with no import licensing and import tariffs since signing the free Trade agreements with the EU in 1994. These countries have turned foreign trade from the East to the West. However, it has been a difficult task for local producers to break through the ice to Western markets due to unknown brand names and unknown trade-marks. As regards entry barriers, there was an exclusive prerogative of the State in Lithuania to produce alcohol until 1 April 2004 (the new law had changed it). Furthermore, national markets can still be defined due to differences in cultural aspects or taste, despite the integration policy of the EU's Single Market and markets becoming more international. The researcher does not consider that the Baltic markets are already highly integrated within the EU, as the integration is still an on-going process and domestic markets can still be distinguished in the Baltic states[386]. For instance, different taste in the Baltic countries and cultural preferences may also slightly affect trade levels.

The main difference from large economies is that small economies with small population size limits demand and reduces the number of firms that can serve the market efficiently. The next section involves analysis of efficiency gains in small market economies.

4.4.1. Efficiencies in small market economies

Merger control is an important mechanism for small market economies because of two main reasons. First of all, merger transactions increase concentration in a market structure. For small market economies, which are usually defined as having concentrated markets, mergers may lead to a further concentration, simply because these transactions reduce the number of market players and increase market shares of merging entities. Also, merger transactions may facilitate tacit collusion or co-operative behaviour. Second, merger transactions may enhance efficiencies, which were not attainable in the pre-merger situation. The technology of production may be such that average costs decrease over the entire range that encompasses the market demand and as a result the lowest unit costs are achieved only when one seller serves the market (Kwoka, Lawrence and White, 1999:13-14). For instance, mergers may allow firms to overcome insufficient size to achieve the efficiencies, which may arise in oligopolistic structures of small market economies. In some markets the MES of operation can be achieved by one or two firms with approximately 50% of market share, where the situation is close to natural monopoly. According to economists, a natural monopoly occurs when given the current technology of the industry the demand conditions allow no more than one firm to cover its costs (Lipsey and

[386] The geographical market definitions in the majority of merger cases have been defined as national ones.

Chrystal, 2004:186). Furthermore, in a natural monopoly case there is no price at which two firms can both sell enough products or provide services to cover their total costs. For instance, suppose there is an industry's technology where a firm's minimum achievable average cost is £10, which is reached at an output of 10,000 units per week. Assume that at this price (£10) the total quantity demand is 110,000 units per week. In these circumstances only one firm can operate at or near its minimum costs[387]. Whish (1998:8) further suggests that where natural monopoly situations exist, it is inappropriate to attempt to achieve a level of competition and as a result to destroy the efficiency, which the merger transaction entails.

Moreover, Gal (2003) also stated that smallness has adverse effects for domestic market structure and performance. In some industries size really matters, particularly where limited demand constrains the development of a critical mass of domestic productive activities, what is necessary to achieve the lowest costs of production. However, in small market economies even when productive efficiency is achieved, these economies still cannot support more than a few market players in most of their industries. In this case concentrated market structure may need to become further concentrated in order to achieve minimum efficient scales. Even a merger to monopoly can lead to reduction in prices. Bearing in mind that competition policy's concerns are to prevent creating anti-competitive market structures, as in monopoly or oligopoly situations, which may lead to an adverse impact on prices and output, finding the balance between productive efficiency gains and competitive conditions in small market economies is challenging (Gal, 2003:4-5, Ch.6).

Furthermore, rigid policy toward mergers may prevent desirable efficiency–enhancing merger transactions in small market economies to take place and instead entrench inefficient market structures. This rigid merger control policy is especially undesirable when economies become increasingly exposed to international competition[388]. According to Gal (2003) there is a need for firms to merge in order to increase their international competitiveness. Merger policy in this case should not prevent local firms in small market economies from

[387] For further reading, see Lipsey and Chrystal, Economics, 10th ed., Oxford university press, 2004.
[388] See Gal, 2003, Ch. 6 for further comments.

overcoming competitive disadvantage, which results from limited domestic demand. As is the case in the Baltic states, after re-gaining their independence and after joining the EU, local firms in these countries have faced international competition. This in turn leads to the assumption that merger transactions between domestic firms are the best response for the Baltic countries to meet their foreign rivals. Thus, a merger of domestic firms should be treated favourably even if they increase the level of concentration within the market (Gal, 2003:2001). The protection of competition in this case may prevent local companies achieving the minimum efficient scale necessary to face competition with foreign firms.

The earlier approach towards merger control in the EC, which prohibited concentrated market structures that may have anti-competitive effects without taking into consideration offsetting efficiencies, has changed. The modernisation of the ECMR has explicitly introduced the relevancy of efficiency issues in merger investigation [389]. Apparently, this approach is still applied in the Competition Authorities of the Baltic states, as there is no explicit efficiency defence in these countries. There are some thoughts that for large economies the efficiencies may still be created as most of their industries include a large number of companies which have already realised their economies in scope and scale. Meanwhile, for small market economies the adoption of such a policy would result in the prevention of many beneficial mergers (Gal, 2003:196).

4.4.2. Welfare standard for small market economies

As discussed above there are two basic welfare standards applied in competition policy. They are total welfare and consumer welfare standards. A balancing welfare standard can also be added, which has a part of each total and consumer welfare tests. Gal (2003) suggests that the total welfare standard should be in favour in small market economies for several reasons. Firstly, considering that most markets in small economies are concentrated, it will mean that a high standard of consumer welfare[390] may lead to market stagnation of oligopolistic structures that not only charge supra-competitive prices, but also do not achieve

[389] Further discussion will continue in chapter 6.
[390] Note: high standard in this case means that consumer welfare standard requires benefits passed on to consumers unlike total welfare standard.

productive efficiency. The total welfare standard, meanwhile, will reduce productive and dynamic inefficiency. Secondly, the consumer welfare standard may conflict with the other goals, such as increasing the international competitiveness of domestic firms. Furthermore, the consumer welfare test may not achieve distributional goals, in the sense that for the consumer welfare standard test there is equal treatment between the loss to each consumer and the benefit to each shareholder.

However, the total welfare standard also has its limitations. Bearing in mind globalisation processes and the increase in cross – border transactions, the total welfare standard might reduce rather than increase domestic total welfare. It may be the case, where the merging parties of one or both of them being foreign owned or is in the general control of foreign shareholders or production facilities are located outside national jurisdictions, then the total welfare approach, which ignores the nationality element of owner or shareholders, may increase the total welfare but rather international than domestic, as the cost savings and profits from the merger transaction may accumulate elsewhere outside the national jurisdiction. In this case, the wealth will go from domestic consumers on to foreign producers (owners/shareholders) and as a result international total welfare will be maximised rather than total domestic welfare. This problem can be partly overcome as suggested by Gal (2003:204), if local economies create incentives for foreign producers to invest locally and these foreign producers re-invest their wealth in the domestic jurisdiction. Alternatively, this total welfare standard may be applied in such a way, where only efficiencies receivable for domestic firms or consumers are taken into account in merger investigation. Australia has applied this qualified total welfare approach in its jurisdiction, where welfare benefits receivable to foreign producers are not taken into account in recognising the merger's benefits. However, this solution cannot be applied in the Baltic countries' jurisdictions. This is because the different treatment of domestic and foreign producers will contradict the policy of the EU. Moreover, as regards domestic producers, there is no certainty that domestic producers will re-invest their wealth gained as a result of the merger transaction in the domestic economy and thereby there is no certainty that the total welfare will actually be maximised. Despite some shortages of the total welfare test, Gal (2003) suggests that this standard is more suitable to small market economies than the consumer welfare standard, because it is more favourable and most consistent with promoting efficiency gains in contrast to the consumer welfare standard, which is stricter towards efficiency gains (due to its condition that efficiency must be passed on to consumers) and may preclude many enhancing domestic efficiency gains mergers [391]. Despite the advantages offered by total welfare test, the Baltic countries committed to the application of the EC policy, which employs consumer welfare rather than total welfare.

4.4.3. Approaches towards merger control with regard to efficiencies in small market economies

There are three basic approaches towards merger control vis-à-vis efficiency gains. The first one is the absolute value approach. According to this approach, all merger transactions that are likely to reduce competition are prohibited without consideration of efficiency gains that a merger may create. The second one is the balancing approach. According to this approach, the anti-competitive effects of a merger transaction are balanced against the efficiency gains created by the merger. The third one is the so-called invisible hand approach, where merger control is left to the market. This approach is barely used nowadays in any jurisdictions, as the importance of competition policy and law has augmented, including merger control regime. This invisible hand approach was used in Estonia until 2001, when the new Competition Act empowered the Competition Board of Estonia to challenge anti-competitive transactions. Before 2001 larger merger transactions [392] only had an obligation to notify the Competition Board about the proposed transaction without having concerns to be prohibited or otherwise restricted. The idea behind this policy held in Estonia was to understand the Estonian markets and prepare for the future work. The researcher agrees with the OECD's opinion that such a policy held in Estonia was a useful tool to gain information about its markets in transition for the time being. However, the Estonian Competition Board can be congratulated for changing its policy in 2001, as the researcher considers that a merger control policy is a useful

[391] For further discussion, see Gal, 2003, pp. 202-205.
[392] The thresholds set were quite low at the time. See chapter 1 for further discussion.

and a necessary means in the regulation of markets and thereby cannot be left without intervention.

The absolute value approach places decisive concern on the reduction of actual and potential competition, which might result from the creation or strengthening of a dominant position. This approach is based on the paradigm that the more concentrated markets are, the poorer industrial performance is, as it is profitable for firms to be involved in monopolistic or oligopolistic behaviour. Efficiency gains play a small role in merger analysis or do not play a part at all. The consideration of efficiency might be involved in setting the thresholds for illegality and in predicting the post-merger situation rather than counter-balancing anti-competitive effects. Any efficiency effects gained from merger transactions are taken into account to the extent if it influences the ability and incentive for firms to compete in the relevant markets. Unless efficiencies create incentives for new or existing competitors to increase competition, any efficiency gains even, if they increase consumer or total welfare, will be prohibited as they might create or strengthen market power of the merging parties. This is because the merged entity will have costs advantages and it can limit its competitors to achieve similar advantages. This approach was applied in the US, the EU and other large jurisdictions. The assumption that there is no need for a high concentration level in order to achieve efficiencies, and such concentrations should be prohibited, might be true in large jurisdictions, however, according to Gal (2003) it may be an erroneous assessment in small economies. The introduction of the absolute value approach in small market economies *'[..] would necessarily produce harmful results, given that its inflexibility does not allow competition agencies and courts to screen only non-efficient mergers'* (Gal, 2003:214). As a result of this approach, many mergers with possible anti-competitive effects, and at the same time with merger-specific efficiency gains, would not be approved. Furthermore, Gal suggests three basic reasons why the absolute value approach is inappropriate for small market economies. The first is high concentration levels, which are the feature of small market economies, that may be necessary to realise scale and scope economies. Secondly, internal growth as an option for mergers may be prevented in small market economies in oligopolistic markets by co-operative profit maximisation. Some potential efficiency gains in small market economies might be achieved through merger transactions with anti-competitive effects, which lead with higher market concentration. Thirdly, in some markets, with a positive atmosphere for co-operative conduct, there would be no big difference in consumer welfare between one or three competitors because of strong mutual tolerance[393]. However, this absolute value approach as recognised by Gal (2003) can be mitigated by wide safety zones. For instance, the Federal Act on Cartels and Other Restraints of Competition of Switzerland[394] does not have an efficiency defence, but instead applies an extremely high threshold for dominance, which as a result captured only large merger transactions. A similar policy was applied in the Latvian jurisdiction, where the Competition Law of Latvia caught only very large mergers, as one of the threshold conditions was possession of a market power by one of the merging parties. However, this notion of a safety zone can only partly solve a problem, as industry specific market characteristics and efficiency gains that affect market power may differ significantly from case to case (Gal, 2003:215-216). The balancing approach is considered to be the most suitable for small market economies.

The Balancing approach is the most suitable for small market economies, because it recognises an efficiency defence as any merger transactions should be permitted, if the efficiency gains achieved through the merger are great enough to offset any anti-competitive effects. According to this approach, the regulator of competition authorities is empowered to balance in each merger case the anti-competitive effects against the efficiency gains resulting from the merger transaction. Moreover, the efficiency gains cannot be estimated apart from the anti-competitive effects as each affects the likely magnitude of the other (Gal, 2003:216). This approach is applied in the current US jurisdiction, Canada and the EU after 2004, when new Merger Regulation came into force.

At present all Baltic countries apply the absolute value approach, as none of them have a statutory efficiency defence, as any efficiency gains are assumed for merger transactions up to a limit of dominance, which was the policy of the EU until at least 2001.

[393] For further discussion, see Gal, 2003, pp. 214-216.

[394] AS 1996 546.

4.4.4. Approaches towards the assessment of the merger-specific efficiency gains

Theoretically, three approaches towards the evaluation of efficiency gains through a merger can be distinguished (see Camesasca, 1999, Roeller, Stennek and Verboven, 2000, Ilzkovitz and Meiklejohn, 2001). The first one is a **case – by – case approach**, which explicitly analyses the magnitude and effects of merger-specific efficiencies in every single merger case. The problem with this approach is that it contains high information costs in measuring efficiency gains and their effects. The second is a **general presumption approach**, which uses general structural indicators such as market shares or a concentration index together with an implicit recognition of the existence of average efficiency gains in merger transactions. The potential problem of the general presumption approach is that there is a lot of uncertainty concerning efficiency gains from a merger transaction and also that the structural indicators are not perfect tools to predict the net benefits from mergers. Bearing in mind the problems of these two approaches, the third, so called **'sequential' approach** is designed to combine the extremes of both of those approaches. It includes two steps, first of all for the initial decision structural indicators as market shares or concentration index are used and then a more detailed investigation of an efficiency defence steps in.

The **case – by –case approach** explicitly recognises the efficiencies, assesses them and market power individually in very single case, and then balances efficiency gains against anti-competitive effects. In this case efficiency gains achievable through a merger transaction has a fully integrated way of analysis. As mentioned above the problem with this approach is that it is difficult to implement as it involves very high information costs and may raise other methodological and practical problems[395]. As regards the information costs, there is a need to gather two types of information: these are the information concerning market power effects and efficiency effects on competition. First of all, it is necessary to quantify the effects of market power as a result of the merger. Second, there is a necessity to identify and measure efficiency gains associated

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[395] For further discussion on methodological and practical problems, see section 3 of European Merger Control: Do we need an efficiency defence? the paper prepared by F.Ilzkovitz and R.Meiklejohn for the 5th Annual EUNIP Conference, 29 November – 1 December, 2001.

with a merger transaction. Roeller, Stennek and Verboven (2000) warned that the gathering of both types of information may encompass significant costs as there is a lot of uncertainty associated to future effects and in this case the merging entities are likely to be in a better position than the competition authorities to assess aspects of the merger effects[396]. Regardless of these shortages, this model is applied in the jurisdictions of the US and Canada. Scholars admit that from the theoretical perspective, this approach is better founded than the general presumption approach due to its quantification of the market power and efficiencies effects, which involve uncertainties.

The **general presumption approach** relies on general presumptions about potential efficiencies' effects realised through a merger transaction. It makes a merger approval contingent on some indicators, which are based on past experience regarding the magnitude and the effects of the merger-specific efficiency gains. This approach implicitly considers that below a certain threshold for structural indicators, efficiencies are always sufficient to outweigh the anti-competitive effects resulting from the merger transaction. In this case, the structural indicator may determine the upper limit for the acceptance of merger transactions on the assumption that up to this limit mergers are efficiency–enhancing or at least neutral. This approach eliminates the drawback of the case – by – case approach, which are high information costs of the assessment of efficiency effects on a single case basis. However, this approach is based on the assumption that the set of structural indicators contain information (which might be imperfect) about the likely net effects of mergers, where the problems might occur for the structural indicators in indicating the 'right' level of assessment. For instance, if the threshold is fixed at a low level, it will respond to strict merger policy, as efficiencies will have a low average. On the other hand, if the threshold is fixed at a high level, this implies that the competition authority believes that efficiency gains have a high average and moreover, that they can dominate up to the high level of market concentration. According to Ilzkovitz and Meiklejohn (2001:22), the former EU model (as before an explicit efficiency defence came into force) wrongly belonged to this approach. This is because the EC merger

[396] For further analysis, see sections 1.2 and 1.3, Working paper No. 543, 2000, Efficiency Gains from Mergers, by Roeller, Stennek and Verboven, The Research Institute of Industrial Economcs.

regime without having the explicit efficiency defence before 2004, had a relatively high threshold for structural indicators, which theoretically means that merger transactions usually generate large efficiency gains.

The third **sequential approach** is an intermediate approach, which as mentioned above combines both approaches. The idea is to limit the number of cases of efficiency defence and identify those cases, which require an in-depth efficiency investigation. First of all, like the general presumption model, this approach also has structural indicators, therefore two rather than one. These are the structural indicators with a low and a high threshold. A low threshold determines to what level efficiency gains are more important than anti-competitive effects. In this case, merger transactions, which do not exceed a low threshold, are automatically accepted without a further investigation. The high level shows above which level anti-competitive effects dominate and mergers are always rejected, for instance, a competition authority will never allow a merger to a monopoly or close to a monopoly position. It means only the intermediate level allows the assessment of efficiency defence. However, this is not entirely true as even when the high threshold is exceeded, the merging parties are not excluded from invoking the efficiency defence. The danger with this is that the competition authorities would consider the efficiency gains achievable through merger insufficient to counterweight the anti-competitive effects and as a result it would put a high burden of proof on the merging parties. Furthermore, when low and high thresholds move close to each other, then the scope for an efficiency defence becomes more limited, or disappears at all if both thresholds equalise. In this case a general presumption approach is applied. In the other extreme scenario, where low threshold is very small and upper threshold is very large, almost all merger transactions will require efficiency considerations. Roeller, Stennek and Verboven (2000) stated that this two-sided efficiency defence of the sequential approach would reflect the belief of the competition authorities that the structural indicators operate well, except in borderline cases.

Many scholars based their research on the sequential model. For instance, Mano (2002) in the methodology for the evaluation of efficiency claims, relied on the sequential approach of the efficiency appraisal[397]. According to Ilzkovitz and Meiklejohn (2001:23), the sequential approach has advantage as it can balance the degree of uncertainty of structural indicators against the magnitude of information costs. This approach has an efficiency defence with not significant information costs as an in-depth analysis in a case – by – case basis is carried out only in 'problematic' cases, presuming that this is particularly relevant. In this case, the approach works as a filter, where the first stage acts as a screening test to identify the 'borderline cases', which require a further investigation of the efficiency gains. In this case, high information costs are saved, as only a limited number of merger cases require an in-depth analysis. This is why Ilzkovitz and Meiklejohn (2001:24) supported the idea that an explicit efficiency defence should be analysed under a sequential rather than case – by – case model. Meanwhile, Roeller, Stennek and Verboven (December, 2000) suggested a case – by – case approach, in particular modified a case – by – case approach with the construction of an information – economising framework for evaluating merger transactions. It contains two stages. The first stage is where the evaluation of notified merger transactions are assessed with modest information requirements, without an efficiency defence. Meanwhile, in the second stage mergers, which did not pass the first stage, will be further investigated, and this time an efficiency defence will be included.

Moreover, Ilzkovitz and Meiklejohn (2001) referring to the sequential approach suggested three stages: the screening tests, the qualitative analysis of efficiency gains and the quantitative cost-benefit analysis, which according to the authors still possess some unresolved problems. The aim of the screening tests is to minimise the errors of selection and economising the information costs. Both scholars admitted that the potential problem with this approach, as similar to the general presumption approach, is to define adequately the criteria for the screening test in the first stage. The criteria must be set up in such a way that leads to the minimisation of the two basic errors by the competition authorities. These are the acceptance of merger transactions having net harmful effects and the rejection of mergers with net beneficial effects. The first stage does not contain explicit analysis of efficiency and structural criteria are used to identify merger

[397] See for further reading Mano, For the customer's sake: The competitive effects of efficiencies in European Merger control, Enterprise Papers, No. 11, 2002, pp. 40-53.

cases, which will go to a further stage. It is because there is no need to have an in-depth analysis, if a merger transaction does not cause anti-competitive effects. Furthermore, criteria such as market share or concentration index cannot be considered alone as providing a reliable evidence of the existence of market power. Thus, other indicators such as entry barriers, existence of sunk costs, in-elasticity of demand, the degree of differentiation of products, indicating a risk of market power or the likelihood of efficiency gains should also be considered. For instance, in a market with rapid technological development the market share of firms offering new or improved products may be high due to the fact that there are no other competitors on the market.

The next stage is the qualitative analysis of efficiency gains. In this stage the parties have to prove that the efficiencies through a merger transaction are sufficient to counter-balance the anti-competitive effects. Both authors point out the importance of the rationale behind the merger transaction by analysis of the motives for the merger and as to whether the merger takes place because of the realisation of efficiencies or to extract market power. Here, a notice or guidelines should be provided to the merging parties by explaining how efficiencies are handled by the competition authorities. Thus, for the sake of transparency, the competition authorities should define the information they require for proving the efficiency gains and also name the approach they are going to take to assess the case.

The final stage is the complex quantitative cost-benefit analysis, which quantifies the net beneficial effects of the merger transaction on competition by comparing the anti-competitive effects due to the increase of the market power of the merging parties and pro-competitive effects as a result of the realisation of efficiency gains. Roeller, Stennek and Verboven (1999, 2000) suggested the analysis of two components at this stage. These are the calculation of the minimum efficiencies required to compensate the anti-competitive effects; and the measurement and verification of actual efficiency gains. This efficiency investigation should balance these two components in a way as transparently as possible (Roeller, Stennek and Verboven, 2000:92). In order to define the minimum required efficiencies it is necessary to check the effect of a merger on price, which can be distinguished into three components. The first component is about the price increase stemming from an increase in market power, leaving the cost of the merging parties constant. The second, there is a possibility of price reduction arising from the cost savings due to the merger transaction. The last component is about the degree of pass-on of cost savings through mergers into consumer price. The minimum cost savings, which are necessary to outweigh the anti-competitive effects of the merger transaction, is represented by the per cent price increase divided by the pass-on elasticity. Ilzkovitz and Meiklejohn (2001:26) provide an example, if 50% of the cost savings are passed on to consumers, then a merger transaction decreases price only, if the realised cost savings are larger than twice the price effects occurred from the increased market power. Apart from this model, different methods can be used to calculate the minimum required efficiencies. After the quantification of the minimum required efficiencies, they have to be compared with the potential efficiency gains realised by the merger[398]. Here, the information of the expected efficiencies is based on the data provided by the merging parties at the previous stage. According to Ilzkovitz and Meiklejohn (2001:27), the competition authorities could give different weights to the efficiency claims depending on the source that certifies the validity of the information.

4.4.5. Appropriate approach towards the evaluation of efficiency gains for the Baltic countries

At present the Baltic countries can be referred to as having a general presumption approach, as the Competition Laws of these countries do not contain any explicit provisions on efficiency defence. Any efficiency gains achievable through a merger transaction are up to the limit of dominance. It means that the structural indicator determines the upper limit, which is the creation or strengthening of a dominant position in this case, for acceptance of merger transactions on the assumption that up to this limit mergers are efficiency–enhancing or neutral. The market shares are usually used as general structural indicators in the Baltic jurisdictions. However, in the Lithuanian jurisdiction the concentration index was also used in the *Carlsberg* case (2000).

[398] For further reading, see European Merger Control: Do we need an efficiency defence?, prepared by Ilzkovitz and Meiklejohn, November 29- December 1, 2001, pp.26-27.

However, it can be argued that a general presumption approach towards merger–specific efficiency gains is not suitable for the Baltic states. This approach has been highly criticised by other scholars as aforementioned for its reliance on the set of structural indicators, which quite often contain imperfect information. A case – by – case approach will not be the most suitable approach for the Baltic countries due to its high information costs. Considering that the Baltic countries are still 'young' and inexperienced in applying the merger control rules and lack resources as well as having some difficulties in obtaining the necessary information for the evaluation of mergers, a case – by – case approach would place an unnecessary burden on these countries. Furthermore, the researcher disagrees with Gal's theory (2003) on this point that the efficiency issues in small market economies should be analysed from the beginning of the merger analysis. Neither the policy expressed by some economists, for instance with Lofaro (RRB, 2004) that the efficiency gains achievable through a merger should be evaluated together with an overall competitive assessment due to their ability to offset anti-competitive effects should be applied in the Baltic jurisdictions. Bearing in mind there is little experience and knowledge of the Baltic Competition Authorities, the researcher supports Kuhn, Stillman and Caffarra's (September, 2004) idea that efficiency gains should be taken into consideration at the very last stage, when anti-competitive effects of a transaction have been found in order to avoid an unnecessary burden of proof on the merging parties and on the competition authorities. It brings to a conclusion that a sequential approach is the most suitable for the Baltic countries, particularly a modified version of a sequential model.

This model contains two main stages. The first stage works as a filter: larger merger transactions, which meet the thresholds set by the Competition Authorities of the Baltic countries, are examined by the regulators by using structural indicators, which do not require high information costs and do not consider any efficiency issues. Efficiency issues at this stage are presumed as neutral or sufficient enough to outset any anti-competitive effects; thus, mergers are approved. Only those merger transactions which cross the upper threshold set up in the first stage, go for a further examination into the second stage. Here, the efficiency gains are examined. However, the upper threshold in the second stage can be introduced, but without a strict policy, where crossing the upper line would mean that a merger is automatically rejected, for instance a merger that creates a monopoly or close to a monopoly position. This condition should be rejected due to the specification of small market economies, where merger transactions quite often involve a merger close to a dominant position, because of a limited number of market players. A merger that creates a monopoly or close to a monopoly situation should not be automatically rejected but nevertheless a higher burden would be placed on the merging parties to prove efficiency gains, which will offset the anti-competitive effects.

In conclusion, the modified sequential approach is the most suitable for the Baltic countries. On one hand, it will limit a number of cases, which require in-depth analysis though as a result will save high information costs. On the other hand, this approach also allows an in-depth analysis for some 'problematic' merger transactions, which might have high concerns of sufficiently realising efficiency gains to offset the anti-competitive effects.

Unlike cartels, merger transactions may have both positive and negative effects on competition. On one hand, mergers may lead to markets becoming more concentrated. On the other hand, these transactions may make markets more competitive. This chapter proved that any efficiency gains achieved through all types of mergers play an important role in merger analysis and cannot be ignored. The economic theories discussed above show that under certain circumstances efficiencies might offset any anti-competitive effects.

Furthermore, horizontal, vertical and conglomerate mergers have to be analysed separately as they might place different anti-competitive problems. However, like in horizontal mergers case, vertical and conglomerate mergers may also enhance efficiencies, which cannot be isolated from the merger analysis.

Moreover, this chapter also presented specific implications of small market economies based on Gal's theory. The limited measures in small market economies augment the need for optimal merger control. Efficiency considerations in small market economies must play an important role, considering the fact that merger transactions may help the realisation of potential efficiency gains, for instance, in oligopolistic markets, which would otherwise remain unexploited due to lack of their optimal size.

The conclusion in this chapter is made that the balancing approach should be introduced in the jurisdictions of the Baltic countries together with a possibility for merger-specific efficiency gains to outweigh any anti-competitive effects imposed by merger. With regard to the assessment of the merger-specific efficiency gains, it was stated that the sequential approach offers the most advantages for the Baltic countries.

Since the competition policy determines which mergers might be considered harmful and which ones beneficial, the next chapter is based on competition policy and its goals vis-à-vis merger control.

Chapter 5. COMPETITION POLICY

'Competition assumes the freedom of economic actors; freedom from constraint is the source of its strength. But laws constrain conduct and reduce freedom, and thus they appear inconsistent with the dynamics of competition' (D.Gerber, 1998:9)

Competition law exists to protect the process of competition in a free market economy. In economic terms, a free market economy is relatively free from control by the central authorities and in such an economy the allocation of resources is determined by supply and demand. The basis of a free market refers to the situation where there is competition between firms, which helps to deliver efficiency, low prices and innovation and as a result brings the greatest benefits to society. There is a paradox here - competition law seeks to control and interfere with the freedom of conduct of firms in the cause of promoting the free play of competitive forces in the market. For instance, on one hand, the European Communities promote the freedom of movement of capital and, on the other, blocks mergers (form of the investment or movement of capital), which may significantly impede competition, for instance, by the creation or strengthening of a dominant position.

In order to understand the rationale behind the Merger Regulation of the EC, it is necessary to define the policy and law of competition with reference to a merger control. Bearing in mind, that merger control policy is a part of the competition policy, this chapter's attempt is to identify the objective or objectives of the EC's competition policy and the competition policy of the Baltic states and what these jurisdictions are trying to achieve. The Baltic countries' experience has been to follow dictation from above: as regards the EC competition policy (especially the merger regime), the Baltic countries have attempted to apply and explore those rules without questioning whether and to what extent those rules reflect the interests of the Baltic countries.

This chapter is structured as follows. In order to understand the competition policy, it is useful to be aware of its economic background. Thus, the first part of this chapter involves analysis of the traditional economic theories on competition, including the Classical theory, the Neo-classical theory, the Harvard School, and the Chicago School, which provide useful information for competition policy. The second part will be based on the development of the European School as regards competition policy. Further emphasis will be based on comparative analysis of the objectives of the EC competition policy and the competition policy of the Baltic states, as to what extent the objectives of the Baltic countries are in conformity with the objectives of the EC competition policy and to what extent they underline the interest of these countries.

5.1. Economic thoughts towards competition policy

5.1.1. Classical theory

The roots of the concept of competition can be found as early as in the classical theory. The main classical theorists A. Smith (1723-1790) and D. Richardo (1772-1823) described for the first time the price mechanism, where the concept of competition was based on a concept of freedom. The freedom of competition and the freedom of consumers of being able to choose the alternatives offered by the market are considered as natural freedoms of a human being. The freedom of competition entitles every economic entity to get what it deserves (Hildebrand, 2002:110). Furthermore, A. Smith suggested that the forces of competition, so called the 'invisible hand', could reconcile private, self-interested behaviour with a general social goal. In this context, the 'invisible hand' produces harmony of all interests. By contrast, state intervention could only intrude this harmony (Schmidt, 1993:3). According to the '*laissez-faire*' principle introduced by the classical economists, a competitive economy will achieve efficiency without government intervention. However, it does not mean that the State does not have any function at all. On the contrary, the State provides the appropriate framework for facilitating the functioning of the markets, for instance, by reducing monopolistic behaviour. A. Smith, the leading representative of classical theory, argued against monopolies, which narrows competition and is always against the interest of public and serves only the dealers[399] by enabling them to raise their profits. According to A. Smith '*[..] the price of monopoly is upon every occasion the highest which can be got. The natural price, or the price of free*

[399] The term used by Smith, which can be referred to broader term in our days, as sellers.

competition, on the contrary, is the lowest which can be taken, not upon every occasion indeed, but for any considerable time together' (Smith, 1776, as quoted in Scherer, 1993:12). However, Smith distinguished between permanent and temporarily limited monopolies. He opposed permanent monopolies because they limit the 'natural' freedom of individuals which results in a decrease in welfare. On the contrary, Smith supported temporary limited monopolies due to the fact that they are caused by building up trade relations with foreign countries. In a situation where '*[..] a company of merchants undertake, at their own risk and expense, to establish a new trade with some remote and barbarous nation, it may not be unreasonable to incorporate them into a joint stock company, and to grant them, in case of their success, a monopoly of the trade for a certain number of years. It is the easiest and most natural way in which the state can recompense them for hazarding a dangerous and expensive experiment, of which the public is afterwards to reap the benefit*' (Smith, 1776 as quoted in Scherer, 1993).

5.1.2. Neo-classical economics

Quite often economists place a high value on the economic models: beginning with assumptions and then working through these assumptions to finish with conclusions. The neo-classical economists, Walras (1874) and Marshall (1890)[400] focus on two polarised models of market structure: the model of perfect competition and pure monopoly. According to the model of perfect competition there is an infinite number of independent equal strength producers (as none can influence price by changing output), they supply identical products to consumers, all players have complete and perfect market information, also there is a presumption that all firms are trying to maximise profits and there is no entry into industry restrictions. In this environment the economic efficiency will be achieved automatically, as the prices are set equal to the marginal cost of producing the optimal quantity and consumers would pay the real resource cost of producing the good and no business entity would have profits above the competitive rate of return. This means that in the perfect competition model under certain conditions (such as the absence of external effects and increasing returns of scale) a general

[400] They both are the founders of the 'general equilibrium' and 'partial equilibrium' variants of neo-classical economics.

equilibrium of all markets will be associated with a 'Pareto-optimal allocation of resources', where no person will be better off without simultaneously making another worse off (Burton, 1994:5, Rodger and MacMulloch, 2001:9-10).

In contrast to the perfect competition model, there is the pure monopoly model. According to the monopoly model there is only one producer in a market and there are entry restrictions. Partial equilibrium analysis of perfect competition and pure monopoly establishes that perfect competition is good and monopoly is bad by contrasting the price-output outcome under both cases (Burton, 1994:6). This is because the monopolist can raise its price by restricting the output without loosing its profit. Thus, the monopolist will always charge a higher price than the competitive price if demand at the competitive price is inelastic. It will depend on the intensity of consumer preference for the monopolised product in relation to its costs (Posner, 1976:8-9). Meanwhile, under the perfect competition model price is equal to marginal cost. This means there is an overall loss of welfare to consumers and society due to prices exceeding marginal costs in the monopolist situation.

Both static perfect competition and pure monopoly models were proved that they cannot depict real life, mainly because they are restricted by the assumptions such as there is no competitive rivals at all in the perfect competition model, also technology is taken as a 'given' and other factors, which do exist in real life. However, despite these shortages, the scholars admit that the theory of perfect competition and pure monopoly is not designed to describe real situations, but nevertheless provides useful information in explaining the economic behaviour and consequences of changes in the different variables contained in the model (Hildebrand, 2002:113). Moreover, the perfect competition model has had a profound background influence upon the formation and the enforcement of competition policy in North America, Western Europe and the United Kingdom (Burton, 1994:4)[401].

In general, both models of perfect competition and monopoly can be used as a tool in providing the understanding of markets operating in certain conditions. The theory is a useful starting point in identifying the main concerns of competition policy. A theoretical monopoly situation is hardly likely to occur in real life, whereas competition policy has tended to use the principles of theory,

[401] To some extent, this model is applied in the Baltic countries as well. It will be discussed in the later sections.

for instance, in relation to a high degree of concentration in a particular market. A firm with a high market share in a market may behave similarly to a monopolist described by the model. Thus, competition policy can prevent such behaviour.

5.1.3. The Chicago school

This school is named under the University of Chicago's Department of Economics and its Law school, which adheres strictly to Neo-classical price theory in its economic analysis, 'free market' libertarianism in much of its works and shows antipathy to government interference. According to the Chicago school, competition in industrial markets even with a high concentration ratio function is good because of the self-regulation powers of uninfluenced industrial markets with the condition that there are no barriers to entry. Different concentration ratios are the result of different cost structures, particularly the economies of scale (Kantzenbach and Kallfass, 1981:119, as quoted in Hildebrand, 2002:144)[402].

For the Chicago school the ultimate goal of competition policy is consumer welfare, which is expressed by efficiency. It has been commented that antitrust should be guided solely by the economic efficiency consequences of structural changes and the conduct of firms. For instance, R. Bork and other members of the Chicago School equate maximisation of economic benefit to consumers and economic efficiency[403]. According to the Chicago school, economic efficiency is the primary cause of concentration and sees concentration as absolutely necessary to achieve economic efficiency (Hildebrand, 2002:146). Basically, Bork in his book *'Antitrust paradox'* (1993) emphasised that the central goal of the anti-trust policy is the promotion of consumer welfare, better known as efficiency. Further, Bork contended that protecting small business is not a goal of anti-trust policy and therefore some forms of anti-competitive behaviour may in fact be consistent with competition law (Greaves, 2003).

[402] Note: Thus, it shows that the Chicago school presented the reverse causation argument of the Harvard school's the structure – conduct – performance paradigm, by stating that business performance may have effects on market structure. The Harvard school will be discussed in the next section.
[403] See, for instance, Bork, Antitrust paradox, 1978, pp. 51, 90-91

The Chicago school also has an assumption that competition among a few firms may be just as effective as competition among many firms (Baldwin, 1987:320). As regards merger transactions, the Chicago school supported the view that mergers are almost always pro-competitive as the cost savings more typically flow from mergers and outweigh price effects (Kwoka, Lawrence and White, 1999:8). The Chicago theorists admitted that mainly horizontal mergers may have some anti-competitive concerns therefore vertical and conglomerate mergers do not cause such problems.

5.1.4. The Harvard school

The Harvard School puts emphasis on markets: market structures, market conduct or behaviour and market performance. Thus, the economists of this school, firstly E. Mason (1939), gave rise to the structure – conduct – performance paradigm, i.e. the structuralist approach to industrial economy. The main idea is that there is a causal link between the structure of the market in which companies operate, the conduct as behaviour of the companies in that market and performance in terms of profit, efficiency, and the satisfaction of consumer desire (Burton, 1994:9). Mason stated that structure exerts a major influence on business conduct and described the structural conditions under which the impact on conduct would be the greatest[404]. Furthermore, the concentration doctrine was developed by the economists of the Harvard school, which have emphasised industrial concentration as the primary determinant of economic performance and have examined the relationship between the concentration and profits. Concentration with the numbers and relative sizes of buyers and sellers is one aspect of structure, however this is crucial in oligopoly theory, since control of a large share of a market by a small number of market players is necessary but not sufficient to sustain prices above costs and restrict output. Other factors of structure such as barriers to entry, degree of product differentiation and economies of scale are also associated with concentration. In this case, for the concentration doctrine theorists a concentration index often serves as a proxy for a set of limiting exercise of market power (Hildebrand, 2002:132-133). Bain (1956), the

[404] For further reading, see Mason, 1939, pp. 69; also comments on his theory by Sheperd, 1986, Baldwin, 1987, Hildebrand, 2002

other Harvard school theorist, studied the measurement of entry barriers to industry. According to his reasoning, industry profitability, otherwise a measure of performance was positively and significantly correlated with the seller concentration ratio and subjectively estimated the height of barriers to new entry (Scherer, 1986:6). Meanwhile, the Chicago school opposed it by stating that there are no indications that concentration is the reason for oligopolistic restraints on competition and competition leads to the success of the efficient firms on the market that in turn leads to concentration. In contrast to the Chicago school, the Harvard school requires state intervention. This approach on anti-trust policy involves prohibitions or strict scrutiny of all arrangements and practices, including vertical and conglomerate mergers (Hildebrand, 2002:134).

Both the Chicago and Harvard schools have provided their completely different lines of thought, there the former believe that concentration may be the result of a positive competitive process, i.e. efficiencies, meanwhile, the latter sees concentration as the ability of powerful firms to acquire and use painful and costly monopoly power. Despite 'extreme' Chicago and Harvard positions their empirical work [405] has had a profound influence for the development of competition policy, which firstly was highly influential in the US Antitrust law, but also to some extent impact has been seen at the European level as well. For instance, the Chicago school approach was adopted by the US Government in 1980 to curtail the Government's role in business (Rodger and MacCulloch, 2001:16). Also, the US Supreme Court since the early 1970s has increasingly taken more of an economic and efficiency-based approach to anti-trust law[406]. In contrast to the EU competition policy, which is known for its multi-goal approach, the US has quite often been defined as having the 'singular' objective of

[405] It was not an aim of the researcher to discuss all schools. For instance, the researcher also acknowledges the importance of the post-Chicago school in the development of the competition policy, for instance, by bringing game theory.

[406] Bork in his book 'Antitrust Paradox' (1978), which is considered as the most influential antitrust book in the last 30 years, argued that the main goal of the Sherman Act is the promotion of consumer welfare known as efficiency. R. Pitofsky (from 1979 onwards) and L. Schwartz (1979) sharply criticised the historical context of Bork's book referring that the Sherman Act grew out of significant concern as regards the rise of large trusts (powerful business organisations) and combinations, and there were clear political goals by the Congress. However, Greaves (2003) concluded that although Bork got the history wrong, he nonetheless won the ideological war. For further discussion see Greaves R., Competition Law, Ashgate, 2003.

economic efficiency[407]. However, the other scholars disagree at this point, by stating that the US antitrust law has never had one goal[408], or it had before, but not at present. As was expressed by Foer (2005) [409] 'why not to admit that there are multiple goals?'.[410]

In contrast to the earlier schools, new industrial economics, which is in a domain now, does not stream from a basic competition policy assumption like the market power thesis of the Harvard school or the efficiency thesis of the Chicago school. The common ground of new industrial economics is the use of the same methodology and economic welfare as the objective (Christiansen, 2005). There is no exact economic theory of competition and there is unlikely to be one in the future either; *'[..] there are good reason for sustaining the plurality'* (Christiansen, 2005:12).

5.1.5. The European school

The idea to develop a general law to protect competition in Europe started in the 1890s in Austria as *'[..] a product of Vienna's extraordinarily creative intellectual life'* (Gerber, 1998:6). The task of the competition law proposals was to protect the competitive process from political and ideological onslaughts and they relied on bureaucratic application of a 'public interest' standard. Despite the political events in Austria, which blocked further development of the competition law ideas, the inspiration to form the competition law was debated in Germany. Here, the Freiburg school and its ordoliberal concept of competition had played a major role in the evolution of German thought about economy and society. According to the Freiburg School the only way to achieve economic performance

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[407]See, for instance, Veljanovski, EC Merger Policy after GE/Honeywell and Airtours, Antirust Bulletin, 2003. See also, Gerber, Fairness in Competition Law: European and U.S. Experience, speech delivered during the conference March 5, 2004, in Kyoto, Japan.
[408] See the speech delivered by Debra A. Valentine, Federal Trade Commission, the Goals of Competition Law, during PECC conference on Trade and Competition Policy, May 13-14, 1997, Canada.
[409] Foer, The Goals of Antirust: Choosing the Definition of Consumer Welfare in the U.S., AAI, the speech delivered during the Trans-Atlantic Antitrust Research Chapter Author's Symposium, 11 May 2005 (participated by the researcher). During the debates there it was clearly stated that the US like the EU does not rely on a singular competition goal.
[410] Considering that the thesis does not aim to analyse the convergence and divergence between the EU and US, the following sections will focus on the EC competition policy and its development.

and stability was through an economic order based on competition. Eucken and the Freiburg School introduced a new concept of an economic order – this is '*die Wettbewerbsordnung*' meaning 'the order of competition'. In this order the state has to provide the structures in which the economic process works, and the state also has to establish and sustain the conditions for competition (Oswalt-Eucken, 1994:38-45). The scholars of the Freiburg School supported the conceptions of liberalism in considering a competitive economic system to be necessary for free and equitable society, with the condition that such a society could develop only where the market was embedded in a constitutional framework. Thus, the ordoliberal thought added a new legal dimension to liberal tradition, which requires law to protect the market from the destructive influences of political and economic power (Hildebrand, 2001:158-161). It means that market could not be allowed to functions without any control (Gerber, 1994:25).

German ordoliberal thoughts of the Freiberg School extended beyond Germany and had direct and obvious influence in forming the EC competition law. Economic analysis is necessary to supply rules for the market to function effectively. Economic analysis provides the standards for most economic policy decisions; meanwhile, legal orders serve to assure that the government translates this economic model into reality. For instance, in ordoliberal language, economic policy decisions are dictated not by powerful institutions but rather by general principles chosen by the Community and designed to integrate the market into society (Gerber, 1994:67, see also Hildebrand, 2001:161). Despite the influence of ordoliberalism in the drafting of the EC Competition law, the Commission took the initiative itself and developed a conceptual framework of competition policy.

5.2. The EC's Competition policy

In the post-war years, Europe was rebuilding after depression and war. There was a need to develop economies and to control state monopolies. Thus, the EU's institutions were created in the context of state intervention through ownership and control over trade and prices. The designer of the new post-war political economy framework in Europe, stated that competition policy would be a necessary element of the new structure in order to expand and integrate markets and sustain development (OECD, 2005). The European Commission with support by the ECJ and CFI has developed the framework for competition policy in Europe, by building on a conceptual and legal foundation of promoting market opening and strengthening the institutions of the Community.

Competition policy is important, because it cuts prices, raises quality and expands customer choice. Also, competition allows technological innovation to flourish[411]. However, competition policy alone cannot ensure overall economic growth, stability and competitiveness, and cannot solve all social problems. This is why the European competition policy is quite often viewed in the overall objectives of the European Community. The aims of the European Community's competition policy can be described as economic, political and social (Van Miert, May 5 1993). Furthermore, according to Van Miert (1995) competition policy can be seen as one instrument among others, which fosters the achievements of the basic objectives of the European Community. It must also take into account its effects on other areas such as industrial, regional, social and environmental policies. Thus, in turn it means that competition policy plays a role in the preparation and introduction of other policies (as quoted in Hildebrand, 2002:11). For instance, the EC Merger Regulation[412] is important in coping with different objectives, such as encouragement of open market economy with free competition and the further development of the internal market[413], promotion of dynamic competition and the competitiveness of European industry, by improving the conditions of growth and raising the standard of living in the Community[414], protecting the interests of the intermediate and ultimate consumers[415], the issues of technical and economic development[416] and consideration of efficiencies achievable through merger transactions[417].

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[411] See http://europa.eu.int/pol/comp/overview_en.htm
[412] No. 139/2004.
[413] See Recital 2, 3, he ECMR No. 139/2004.
[414] Recital 4.
[415] Art. 2 1 (b).
[416] See art. 2 1 (b).
[417] Recital 29, see also Guidelines on Horizontal mergers (2004/C 31/03).

5.2.1. Political objectives

It is obvious that the EU competition policy comprises of a number of objectives. The European Community's refusal to adopt the Chicago school approach with sole basis on efficiency can be linked with the broad objectives applied in the EC competition policy (Rodger and MacCulloch, 2004). The key role of the EC's competition policy in the construction of a single market is to guarantee a fair level field for firms operating in Europe. The promotion of an open market has been acknowledged already from the foundation of the European Communities. The founding Member States saw the integration as, *inter alia*, engendering rapid economic growth in order to recover after the damage caused by WWII (Gerber, 1994). The competition rules[418] were included in the EC Treaty as a means to achieve economic integration. The EC Treaty embedded a set of wider policy goals orientated towards the objective of European economic integration. For instance, the Preamble to the Treaty refers to the need to guarantee *'[..] steady expansion, balanced trade and fair competition'*[419]. Also, article 3 (1) (g) of the Treaty states that a system has to ensure *'[..] that competition in the internal market is not distorted'*. Article 4 (1) provides that the activities of the Member States and the Community are to be conducted in accordance with the principle of an open market economy with free competition. However, in accordance with the principles of subsidiary and proportionality (Article 5), the Community by setting out the rules must not go beyond what is necessary in order to achieve the objective of ensuring that competition in the common market is not distorted.

The multi approach has also been expressed by the Commission in its IIXX Report on Competition policy by stating that firstly the competition policy must enable *'[..] to perform its traditional role in helping to improve the allocation of resources, increase businessmen's capacities for adjustment and*

[418] Within the exception of merger control rules. The merger control rules were not introduced in the EC Treaty, because of political reasons. The idea was to create suitably sized firms that could operate on world markets, especially to counter the strong American firms. The ECSC Treaty was an exception.

[419] Korah (2004) argues that the term of 'fair competition' is not clear. As should small companies be helped in order to compete against supermarkets, even if they are less efficient or if one firm has invested in promotion for a benefit of a brand as a whole, is it fair to let other firms to take advantage of this investment for free? See further discussion, Korah V., An Introductory guide to EC Competition Law and Practice, Oxford – Portland Oregon, 2004, pp. 12.

better satisfy the requirements of consumers; secondly, it must reinforce the unity of the Community market by eliminating obstacles to trade between the Member States'[420]. It means that the EC competition policy not only deals with the competitive issues, such as the prevention of the restriction of production to raise prices, for instance, but also it has a broader objective to encourage the integration of the market. According to Gerber (1998:334), the Community's competition policy has been understood primarily as a means to achieve the specific goal of unifying the European market and then to obtain the generic benefits associated with competition, such as lower prices, better quality products to consumers and technological progress. Also, Wilks and McGowan (1996:238) mentioned that the goal of provoking the creation of competition policy within the EU is multiple, and includes the control of big business, the promotion of free market, the pursuit of competitiveness and the protection of consumers through priority is given to integration.

Likewise, integration as the primary goal can be found in the Court's and Commission's practice. For instance, in the *Continental Can* case the Court, by extending the scope of the article 82 to stop further acquisitions by a dominant firm, stated that both articles 81 and 82 should be interpreted in a manner with conformity to the aims set out in articles 2 and 3 (g)[421] of the Treaty and not to jeopardize the proper functioning of the Common market. Hence, the promotion of integration into one unified and open common market can be considered as a primary aim and the most original feature of the EU Treaty, which has also become an important objective of the Community's competition policy.

Competition policy is an essential feature of a single market due to the fact that it provides a 'fair level playing-field' to prevent restrictive practise, abuse of a dominant power, anti-competitive mergers and nationally granted subsidies. The goal of market integration can be defined as the elimination of economic borders between the economies, where neither the Member States, nor private enterprises can engage in practices that are in conflict with the unification of the common market (Van den Bergh and Camesasca, 2001:2). Moreover, the role of the EC competition policy as an instrument of single market integration is absolutely essential in order to understand the competition law (Jones and Sufrin, 2004:36).

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420 IIXX Report on Competition policy, pp. 12.

421 3 (f) at that time.

As stated by the Commission, competition policy is crucial not only because of the idea that competition and competitive markets are the principal way to serve the economic aims of the Treaty, but also the establishment of the Internal Market may have unsatisfactory results if restrictive business practices or merger transactions could form barriers against competition from the other Member States (European Commission, 1993:69). On one hand, the internal market is an essential condition for the development of a competitive and effective industry. On the other hand, competition policy is an important tool to achieve the goal of, and maintain, an internal market, in particular via the enforcement of rules, which ensure that the regulatory barriers to trade that have been removed are not replaced by private or other public restrictions having the same effect (Competition Report, 1995). It means that the EC competition policy serves two masters: one being 'competition' and the other - the imperative of single market integration (Jones and Sufrin, 2004:36). The second goal can sometimes even spur the development of entire law, as in the case of vertical restraints[422], or the reform of law, as in respect to the EC Merger Regulation[423].

After 40 years of signing the Treaty, this objective is still important, as the expansion of the EU is still in progress. The last enlargement of the EU was on 1 May 2004, when ten new countries joined the Union, including former socialist countries Estonia, Latvia and Lithuania. As a result of the expansion, the European Union not only increased its surface area and its population, but it put an end to the split in our continent – the rift that, from 1945 onwards, separated the free world from the Communist world. Hence, the last enlargement of the EU has a political and moral dimension. Bearing in mind that implementation of competition rules is a pre-condition for the membership into the EU, these rules play an important role in order to achieve economic integration. The Commission on many occasions has expressed that the consolidation and the extension of competition policy enforcement throughout Central and Eastern

[422] For further discussion, see Jones A., Sufrin B., EC Competition Law, 2nd ed., Oxford university press, ch.9.

[423] According to Gonzales-Diaz F.E.G, former Head of Unit Merger Task Force (European Commission), the reform of the EC merger control regime was initially aimed to equip the enlarged EU with a modern and more flexible legislation in order to ensure effective, efficient, fair and transparent merger control at the most appropriate level. For further discussion, see Gonzales-Diaz, The Reform of European Merger Control: Quid Novi Sub Sole?, 2004, World Competition 27(2), pp. 177-199.

Europe, is its significant achievement. The enlarged EU will expand even further in 2007, when Bulgaria and Romania join. Negotiations with Croatia and Turkey also continue[424].

5.2.2. Economic objectives

The basic economic principles entrench that competition and merger control policy is one part of the general economic policy of the Community. The regulation of the agreements and behaviour of firms is an interference with the free market in an economic context (Singleton, 1992:3). However, in a competition context such regulatory rules are necessary to deal with market imperfections, bearing in mind that a perfect market is like a textbooks' model, but not real life. If firms are left alone to determine their own conduct, they are likely to combine, collude or enter into other anti-competitive behaviour, which are profitable to those firms, but might be detrimental for consumers or consumer welfare as a whole. As result of collusion, for instance, one 'leader' or a few (known as an oligopoly situation) companies can emerge, which can force their competitors to leave a market. A dominant firm can increase prices substantially, knowing that its competitors are eliminated and especially if there are high barriers to entry. In this situation it is necessary to restrain the dominating firm's behaviour (Jones and Sufrin, 2004:2).

Although not defined in the Treaty, the objective of 'workable competition' is generally taken to refer to a degree of competition in the EC (Anderman, 1998:17-18). Since workable competition assumes that the pricing mechanism must be in good working order, the EC competition policy is aimed at preventing any firm or group of firms from controlling output and prices by co-ordinating their activities by establishing cartels or other restrictive agreements, also stopping abuses of market power by dominant firms, or by preventing mergers, which will result in a market structure that is too concentrated to allow workable competition to exist. The Commission, through its merger control regime prevents the transactions that would likely deprive consumers of the benefits, such as low prices, high quality products, a wide selection of goods and

[424] See web-site: http://europa.eu.int/abc/12lessons/index3_en.htm

services, and innovation by significantly increasing the market power of the merged firms[425].

Referring to article 3, which ensures that competition in the internal market is not distorted, the treaty makes competition a principle goal. Also, article 4 of the Treaty adopts a co-ordinated economic policy between the Community and the Member States based on an open market economy with free competition. Thus, these articles of the Treaty set out the objective of free and undistorted competition for the Community's internal market. In general, the EC competition policy has an aim to promote and maintain a process of effective competition in order to achieve a more efficient allocation of resources.

5.2.3. Other objectives of the EU's Competition policy

5.2.3.1. Industrial policy, competitiveness and efficiencies

Theoretically, the relationship between competitiveness and competition is controversial. On the one hand, the neo-classical theory of competition as demonstrated by Bork suggests that competition is an essential pre-requisite for competitiveness. On the other hand, competition policy is seldom regarded as a direct instrument for the promotion of competitiveness. Nevertheless, industrial policy-makers have regarded competition policy as a positive instrument to increase the competitiveness of European firms.

There is also a legal basis to this link between the competition and industrial policies as set forth in article 157 (1) of the EU Treaty[426]. This relationship, *inter alia* can be found in the Commission's Annual Report on Competition Policy (XXIII, 1993), where competition policy was referred to as central to the Community's industrial policy (the priority in the White papers was given to the completion of a genuine internal market and an effective industrial policy). The report further reviews the ways in which competition policy may be adapted to meet the new Community priorities, which includes industrial policy and the environment. Also, in the same Competition Report it was stated that far

[425] Guidelines on Horizontal mergers, (2004/C 31/03), at the para 8.
[426] Article 157 paragraph 1 states that 'the Community and the Member States shall ensure that the conditions for the competitiveness of the Community's industry exist'.

from being the direct opposite of industrial policy, competition policy is nevertheless an essential instrument and both policies complement each other. In another insight into the Commission's views, namely in the XXVth Report on Competition Policy in 1995 it was stated that *'[..] competition policy has a key role to play in ensuring that EU industry remains competitive'.* Furthermore, the competition commissioner Monti in his speech of 2000 expressed that competition policy serves an instrument to encourage industrial efficiency, in particular with the optimal allocation of resources, technical progress and the flexibility to adjust to a changing environment[427].

The complementary position between these two policies is illustrated by the fresh emphasis being placed in reforming the merger control regime. There the approach towards the effects of the merger transactions on competition has changed since 2001, when the proposal in the Green papers invited a discussion on whether efficiency issues should be introduced in the merger control rules. Different from the earlier policy, the Commission highlighted the potential for an increased role of efficiency issues. For instance, in the XXXIInd Report on Competition Policy (2002:4) it was stated that *'[..] a further objective of the [..] proposal is to take greater account of the efficiencies that can result from mergers'.*

More recent evolution presents competition policy as a tool to foster structural reform and to promote the Lisbon agenda strategy to make the EU the most competitive and dynamic knowledge-based economy in the world by 2010. The Commission Communication on pro-active competition can be considered a first step to rendering the role of competition policy more visible and as a main instrument to strengthen the competitiveness of European industry (Monti, 28 October 2004).

5.2.3.2. Protection of small and medium-sized firms

Protection of small and medium-sized firms (small and medium sized enterprises – thereafter SMEs) is another goal defined in the EC competition policy. It is because the integration may bring the risk that SMEs, as before

[427] See XXIXth Report on Competition policy, 1999, para 2.

protected from imports by national customs, duties and quotas, may find it difficult to compete with larger firms operating from the other Member States. In order to mitigate that risk the Commission has encouraged collaboration between them (Korah, 2004:12). Also, the Commission's objective to promote the protection of SMEs according to Rodger and MacCulloch (2002:14) is a belief that such enterprises may start to compete across national frontiers and, hence, may support the policy of market integration. Another popular view for the protection of SMEs is that 'small is beautiful'. However, as practice shows small businesses quite often encounter difficulties in entering or expanding into a market due to a lack of capital, lack of human resource and managerial experience. Furthermore, Korah (2004:12) argues that if the concern of competition law is to protect SMEs, then market power will be observed far more pervasively than having the sole concern of efficiency, and this may account for the view of the Commission that any exclusive rights are highly suspect.

Theoretically, the protection of small businesses might be treated as a component of a healthy competitive environment, like a preservation of 'equal opportunities' (Van den Bergh and Camesasca, 2001:3). This is because maintaining a competitive structure conflicts with the practices of dominant firms, which tend to strengthen their power to the detriment of their smaller competitors. However, it does not necessarily mean that the protection of SMEs constitutes an objective of competition rules in itself. According to Waelbroeck and Frignani (1999:18-19), an excessive protection of small business may hinder the adaptations necessary to changes due to the widening of the market and removal of any restrictions for exchange, it is necessary for firms to increase in size as they can take advantage of the possibilities to realise the economies of scale. Referring to small economies, Gal (2003:47-51) emphasised that the main goal of these economies should be to achieve economic efficiency rather than scarifying it for broader policy objectives, such as ensuring that SMEs can operate in the market. Furthermore, the protection of small firms by giving them fair and equal chances to compete with larger rivals are better addressed by other policies, such as tax policy rather than competition policy (Van den Bergh and Camesasca, 2001:6).

5.2.3.3. Promotion of consumer welfare

One of the main objectives of the EC Competition policy is to promote the interests of consumers and to ensure that consumers benefit from the wealth generated by the European economy. The consumers' interest comes first in all aspects of the competition policy, including abuse of a dominant position, anti-competitive agreements and concerted practices and also anti-competitive merger transactions[428]. Consumer protection can find its place in competition law in article 153 (2), which states that *'[..] consumer protection requirements shall be taken into account in defining and implementing other Community policies and activities'*.

Moreover, the former commissioner Monti (2004) mentioned that the Commission shall not only ensure that the market functions in a way that maximises benefits for consumers, but it also gives an opportunity in the fight against violation of the competition rules through the presentation of complaints that give way to an opening of proceedings or by taking part in reforming competition law[429]. For instance, it can be reflected through the Guidelines on horizontal mergers, where consumers demonstrated a legitimate interest by taking part in the examination process and presenting observations on the effects of the operation.

Generally, merger control mechanism assists in improving efficiency and safeguarding consumer interests by preventing the creation of undertakings through merger, acquisition or other structural combination that will have the incentive and ability to exercise market power and will result in a detriment to consumers. It is because market power may give firms the ability to restrict output and consequently charge a higher price to consumers in comparison to its pre-merger situation[430].

Specifically, the wording of EC Merger Regulation and speeches delivered by the competition commissioners does not allow balancing efficiency gains and furthermore, the EC competition law is not designed to check distributional

[428] For further reading, see XXXIInd Report on Competition policy, 2002, pp. 2. Also see M. Monti's speech 'Proactive competition policy and the role of the consumer', Dublin, 29 April 2004.
[429]For further discussion, see M. Monti's speech 'Proactive competition policy and the role of the consumer', Dublin, 29 April 2004.
[430] For further discussion, see ch.4.

effects. For instance, Mario Monti, the commissioner has stressed: *'[..] The goal of competition policy, in all its aspects, is to protect consumer welfare by maintaining a high degree of competition in the common market. Competition should lead to lower prices, a wider choice of goods, and technological innovation, all in the interest of the consumer'.*[431] It means that consumer welfare rather than total welfare plays a leading role in the EC competition law. According to Van den Bergh and Camesasca (2001:3) this view does not perfectly match the definition of allocative efficiency. Gal's theory stresses that total, rather than consumer welfare, should be encompassed in the law of small market economies. However, the speech delivered by the competition commissioner Mario Monti at the Competition Day in Dublin on 29th April 2004 shows that the new Member States, including the Baltic states, ought to follow the competition policy of the EC. Monti stated that *'[..] Competition policy is currently going through important times of change. This is essential to make the competition rules more effective in a European Union of 25 States fully integrated in a globalised economy. [..] Competition authorities will intervene only in cases which affect consumers negatively'. [..] The competitive performance of industry should not deflect from the positive impact of competition policy on consumer welfare'* (Monti, 2004 as quoted in Competition Policy Newsletter, Summer 2004).

The recent reform of the EC merger regime has expressed consolidated consumer interest as a central goal. For instance, according to the Guidelines on Horizontal concentrations, appropriate efficiencies may countervail anti-competitive merger transactions if they ultimately benefit consumers. This shows that the approach towards efficiencies achievable through merger transactions that benefit consumers has changed. As before, the Commission has been criticised for protecting competitors rather consumers. For instance, the *GE / Honeywell* case[432] was blocked by the Commission *inter alia* because it could have led to mixed bundling, as lowering prices by eliminating pricing in-efficiencies can make consumers better off but it in the long run it would have driven out competitors not efficient enough to match such pricing. This EC policy has changed ever

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[431] Mario Monti, The Future for Competition Policy, speech of July 9, 2001, Merchant Taylor's Hall, London, also available at the web-site: www.europa.eu.int/comm/competition/speeches/index_2001.html

[432] Case COMP/M 2220, 2001. For the comments on this case, see Pflanz M. and Caffarra C., The Economics of GE / Honeywell, 23 ECLR 115, 2002.

since. The newly appointed competition commissioner N. Kroes (2005) expressed that she prefers aggressive competition, including by dominant companies as long as it ultimately benefits consumers without having concerns whether it may hurt competitors. Hence, the EC policy protects consumers rather than competitors.

5.2.3.4. Policy towards small market economies

Disputes on national champions in the European Union Institutions were caused by the controversy aroused in the Nordic countries by prohibiting the *Volvo / Scania* merger[433] on the grounds that it would create a dominant position in several national markets. In this case the Commission distinguished five national markets that could be affected by the transaction, these included Denmark, Finland, Norway, Sweden and Ireland, and concluded that the proposed transaction would eliminate Volvo's only significant competitor and as a result would create a dominant position in several countries. Meanwhile, the parties of the transaction claimed a wider market definition, i.e. European rather than national. This *Volvo/Scania* prohibition as well as other merger transactions' prohibitions[434] from Nordic countries has raised fierce debates in Europe, as to what extent the imbalance inherent in the EC merger policy affect large firms from small Member States. According to Prof. Bernitz and Gutu (2003), who delivered a critical analysis of the relevant case-law and the positions of parties to this debate, the disadvantage occurs for the small markets in the Community market, which is not yet fully integrated and the relevant geographic market for certain products/services is still national in scope. This is because, what is substantial dominance in small Member State like Sweden or any Baltic country, might not raise any 'dominance' concerns in Germany or the UK.

There have been different opinions expressed from the EU institutions with regards to specificity of small market economies. For instance, the supportive view towards small market economies was enunciated in the European Parliament. Consideration of taking the efficiencies and competitiveness into

[433] *Volvo / Scania*, case No. COMP/M. 1672, March 15, 2000. For the comments on this case, see, for instance, Wu, Hofer and Williams, The increasing use of empirical methods in European Merger enforcement: lessons from the past and a look ahead, Antitrust insights, NERA, Spring 2004.
[434] For instance, *SCA / Metsa Tissue* case No. IV/M. 2097.

account especially in small markets was discussed during the debates in the European Parliament[435] where the Parliament stated that *'[..] large companies based in small Member States must not be categorically excluded from merging in order to be competitive throughout Europe and globally.'* It was also mentioned that large firms from small Member States seem to decline in their competitiveness in comparison with the other firms in the world due to the unfinished completion of the internal market. However, an opposite view was expressed by the Commission and the Competition commissioners. For instance, Monti is his speech[436] mentioned that in order for the Community to be competitive worldwide, there is a need to have a competitive home market. Furthermore, he mentioned that the emphasis is on market definition in individual cases, without distinguishing large and small market economies. Another competition commissioner Lowe (2003) also stated that the focus is on market definition and factors such as national preferences for national brands, culture, and life style and obviously barriers to entry are all relevant. Referring to the Volvo case, Lowe mentioned that the most important barriers for Irish consumers might be the impact of transport costs and transport restrictions arising from legislation or from the nature of the relevant products. Moreover, if national firms do not face serious competitive constraints from abroad, they can only be national in scope. Merger control is about protecting the competitive process in the market and aims to ensure that consumers can obtain a variety of goods at competitive prices in all countries regardless of a country's size[437]. Hence, the conclusion can be drawn that country's size is not the issue in this case, as the emphasis of the EC policy is on the market definition.

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[435] Minutes of 24 October 2000 (A5-0290/2000), para 18.

[436] As published in XXIXth Report on Competition policy, 1999, para 2.

[437] For further discussion, see the speech 'The interaction between the Commission and Small Member States in Merger Review' delivered by P.Lowe during the Competition Authority Merger Review Day, in Dublin, 10/10/2003. D. Sjoeblom, a Deputy Director-General, also confirmed the EC Commission's position by placing focus on market definition regardless of a country's size (the data obtained from the e-mail addressed to the researcher).

5.2.3.5. Social aspects in the Competition policy of the EU

It has been suggested that the Commission and the Court by elevating the single market principle should take into account other Community's objectives relevant to the application of competition law such as regional or structural imbalances, safeguarding employment and the environment (Steiner and Woods, 2003:398). On several occasions the Commission has recognised social and/or environmental repercussions on the competition rules. In the statement issued in 1993, the Commission pointed out the need *'[..] to ensure that the natural and logical linkages between the Community's competition, research, environmental and social policies are fully taken into account in the Commission's approach to competition policy'* (ISEC B21/93 as quoted in Steiner and Woods). In the XV Report on Competition Policy it was also stated that competition policy is seen as a tool, which can create an environment for the growth of the European industry in an efficient manner and at the same time taking into account social goals[438]. Environmental issues were stressed by the Commission in the XXIIIrd Report on Competition Policy by stating that environmental protection programmes may be used in order to disguise anti-competitive practice.

Despite the fact that social issues, for instance, social effects of a particular concentration can play a role in the consideration of merger approval, the emphasis of competition matters is the dominant criterion[439].

5.2.4. The evolution of priorities over time within the EC jurisdiction

Competition policy priorities in the EC have changed over time. According to Prof. R. Whish, competition policy does not exist in a vacuum, it is merely an expression of the current aims and values of society and '*[..] is as susceptible to change as political thinking generally*' (Whish, 1998:16). The fast changing economic environment entitles the EC Competition policy to follow these changes. The various EC Annual Reports on Competition Policy and the speeches made by the competition commissioners further support the multi-goal

[438] See also the ECMR No. 139/2004, recital 4.
[439]Though the Commission might consider social issues in a failing firm defence scenario.
For further discussion, see Banks, D., Non-Competition Factors and their Future Relevance under European Merger Law, 1997 3 ECLR, pp. 182-184.

task of the Competition policy of the EU and its changes over time. For instance, the XV Annual Report of Competition policy in 1985 expressed the concept of 'effective competition'[440] by stating that effective competition '*[..] preserves the freedom and right initiative of the individual economic operators and it fosters the spirit of enterprise. It creates an environment within which European industry can grow and develop in the most efficient manner and at the same time take account of social goals*'. Meanwhile, the XXIXth Report on Competition Policy in 1999 made the point that '*competition policy serves as an instrument to encourage industrial efficiency, the optimal allocation of resources, technical progress and the flexibility to adjust to a changing environment. In order for the Community to be competitive on worldwide markets, it needs a competitive home market.*'[441]

The competition policy objective of promoting market integration was highly important when the common market was still being established, when industries were traditionally national and the challenge was to get them to transcend those boundaries. However, with progress toward the realisation of the internal market, relative importance of the market integration, as the main goal of competition, has declined (OECD report prepared by Wise, 2005).

The Policy now stresses efficiency, consumer welfare and competitiveness of the European economy. The present competition policy has shifted towards a new approach – a more economic based approach. In one of the recent speeches 'A reformed competition policy: achievements and challenges for the future' Monti expressed that the main achievements over the last five years were characterised by the reforms and the modernisation of European competition policy and concluded that competition policy is now clearly grounded in sound micro-economics (Speech/04/477, 28 October 2004). The major trend has been to ensure that competition policy is fully compatible with economic learning. For instance, the modernisation of the EC merger control regime has started with issuing Green papers in 2001 with an invitation to provide comments in order to reform the merger control rules. As a result of the reforms, the new ECMR issued in 2004 has shifted towards a more economic based approach. The emphasis is not on market structures but rather on the effects of merger transactions in the market

[440] The term 'effective competition' is enshrined in the substantive test of the ECMR, as the ground to prohibit a merger that would '*significantly impede effective competition*'.
[441] XXIXth Report on Competition Policy 1999, para 2.

in question. The introduction of new substantive tests, HHI assessments, efficiencies achievable through mergers and other aspects are the examples of a new EC competition policy approach with reliance on sound economics[442]. These Guidelines also detail the benefits to consumers: of lower prices, higher quality and a wider selection of goods and innovation. Improvement of competitiveness is not explicitly mentioned, but nevertheless, in the 2004's annual report on competition policy while highlighting the notion of improving efficiency, the Lisbon agenda was also mentioned to promote European competitiveness. *'[..] Competition policy is not an end in itself, but one essential tool to achieve efficient market outcomes'*.

5.3. The competition policy of the Baltic countries

5.3.1. Overview

While other European countries, such as Germany, Sweden and the UK had developed competition law traditions, the Soviet 'reorientation' of Eastern Europe, including the Baltic countries, after the Second World War precluded any such influence that the experience of the Baltic countries there might otherwise have had (Gerber, 1998:163). Hence, the competition law legal tradition has not been developed like in other western European countries over time, but was transposed from the EU. The competition law and policy appeared in the legal system of the Baltic states as a part of *acquis*. As a part of the law harmonisation program in line with the EC law, the Baltic countries adopted the EC competition policy, including merger control regime. These rules were adopted without questioning to what extent they can serve the interest of the Baltic countries. Despite some attempts of the European Parliament to favour small Member States, the Commission made it clear that in order for the Community to be competitive worldwide, there is a need to have a competitive home market. The emphasis is on market definition in individual cases, without distinguishing large and small market economies[443]. However, scholars disagree at this point. The

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[442] For further discussion, see chapter 6.
[443] Similar position was expressed by the commentators from both sides of Atlantic during debates of the Trans-Atlantic Antitrust Research Chapter Author's Symposium, 11 May 2005, after the

firms, which do not perform well and which survived only due to national protections, are condemned now to disappear, thereby allowing firms better prepared to face competition to realise economies of scale and increase their production that benefit the entire 'collectivity'. The market integration and increase of competition at the Community level forces firms, which had acquired near monopoly position or even a monopoly in order to achieve economies of scale at a national level to compete with each other. Moreover, the expansion of trade gives go-ahead to the Community's economy to benefit from the advantages of mass production without suffering from the drawbacks of monopoly or near monopoly situation (Albors-Llorens, 2002:7). Professor Gal (2003) also emphasised the necessity of attentiveness of national economic characteristics in designing competition policy, including merger control regime. Sometimes problems may arise when the competition laws of economies in transition are modelled too closely upon off-the-rack variations of statutes or institutions as developed in older market economies (OECD, 2004(30)). While transposition of the EC competition policy in the new Member States, including the Baltic countries, has many benefits, nonetheless, a one-size-fits-all[444] application of such rules is less affordable for small market economies. Professor Geradin and Henry (2005) suggested a differentiated approach (depending on the market structures) should be taken into account in designing competition policy in these countries.

The following sections will discuss the objectives of the competition policy in the Baltic countries and to what extent they are in conformity with the objectives of the EC competition policy and whether they reflect the interest of the Baltic states.

5.3.2. Political objectives

In order to identify the competition policy in the Baltic countries, the researcher has analysed the Annual Reports of each Baltic state, the speeches delivered and publications published by the officials of the Competition Authorities, including the reports submitted to the other governmental institutions

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researcher addressed a question whether the national authorities, especially with small market economies, should have a different competition policy, which is designed to fit their markets.

[444] This term applied in Gal's book, 2003.

and international organisations, as well as primary and secondary sources of the Competition Laws. The analysis revealed that the main task of the competition policy in all Baltic states was based not on 'pure' competition but the priority was given to the integration into the EU. Most of the Annual Reports in these countries addressed that the harmonisation of competition law and policy in the light of EC competition policy, which is a pre-condition for the membership, has been the major task of the Competition Authorities[445]. The priority in all Baltic states has been given to the implementation of the requirements of the EC competition policy. According to R. Stanikunas, a chairman of the Competition Council of Lithuania, the main emphasis in the competition policy in 2003 was to ensure sufficient preparedness for the application of the EU competition rules and operation in the EU legal environment upon accession of Lithuania into the European Union (Annual Report of Competition policy in Lithuania, 2003). Particularly, these priorities include the tasks to ensure the further harmonisation of the Lithuanian competition legislation taking due regard of the forthcoming changes in the EU legislation, to establish the procedures for cooperation with the European Commission and the national competition authorities of other Member States, to ensure the efficient application of competition rules and enhance the awareness in issues of competition law and application thereof. The harmonisation with EC law is one of the main goals incorporated into the Law on Competition in Lithuania. Article 1 (3) states that the law *'[..] seeks for the harmonisation of the Lithuanian and the European Union law regulating competition relations'*.

A similar position has been expressed in various Annual Reports of competition policy in the Estonian and the Latvian jurisdictions. In the Estonian Annual Report of 1999 it was stated that *'[..] at present the main goal of the Competition Board [..] is to introduce the necessary amendments which are due to the development of court practice and of the relevant EC rules'*. The main task for the Competition Board of Estonia in 2003 was on preparations to accede to the

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445 See, for instance, the Annual Report of Estonia 1998, where it was referred to the importance of approximation of the Estonian legislation with the Community legislation. See also Annual Report of Estonia from 1999 to 2004, which are available in English from web-site: http://www.konkurentsiamet.ee/eng/index.html?id=765. As regards Latvian jurisdiction, see Annual Report of Latvia 2003, available at web-site: http://www.competition.lv/uploaded_files/ENG/Gads2003-Engl01.pdf. For Lithuanian Annual Reports dated from 1999 to 2004, see web-site: http://www.konkuren.lt/english/index.htm.

EU (Annual Report of Competition policy in Estonia, 2003). Harmonisation of competition law and policy with the EC and preparation for the membership in the EU has also been expressed in the Latvian jurisdiction (see Annual Report of Competition policy in Latvia, 2003[446]).

The insightful look at the Annual Reports of the Baltic countries proves that the priority of the competition policy has been given to the preparation to the membership into the EU. This is because competition policy implemented in the candidate countries[447] played a central role in the evaluation of accession.

5.3.3. Economic objectives of the competition policy in the Baltic countries

Likewise the Commission is a guardian of competition policy within the Community, so is the Competition Council of Lithuania, the Competition Board of Estonia and the Competition Council of Latvia the bodies responsible for enforcing the competition policy in national markets[448]. One of the tasks of the Competition Board of Estonia is to analyse the situation of competition in different markets for goods and services and make recommendations to improve the situation of competition[449]. The main aim of the Competition Council of Latvia is to ensure that it is possible for every market participant to perform his economic activities in a free and fair competitive environment and also promote competition development in all sectors of the national economy for the benefit of all society[450].

As in the EC competition policy, which can be viewed as having a multi-objectives competition policy, the Baltic countries have also set out more than one task in their competition policy. The main objectives of competition policy in the Lithuanian legal system are summarised in the Law on Competition of the Republic of Lithuania (thereafter Competition law of Lithuania) and in the Constitution of the Republic of Lithuania [451] (thereafter the Lithuanian

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[446] Also see the report of Economic Development of Latvia, June 2004, which contains the competition policy.
[447] Referring to the Baltic countries before their accession on 1 May 2004.
[448] See chapter 1 for further discussion about the Competition Authorities in the Baltic states.
[449] Available at web-site: http://www.konkurentsiamet.ee/eng/. See also OECD 04 October 2001.
[450] Available at web-site: http://www.competition.lv
[451] Constitution of the Republic of Lithuania, 1992.

Constitution), which is a supreme law in the Lithuanian Republic. Article 46 of the Lithuanian Constitution provides:

'[..] Lithuania's economy shall be based on the right to private ownership, freedom of individual economic activity and initiative. The State shall support economic efforts and initiative, which are useful to the community. The State shall regulate economic activity so that it serves the general welfare of the people. The law shall prohibit monopolisation of production and the market, and shall protect freedom of fair competition. The State shall defend the interests of the consumers'.

The Constitution's article incorporates a variety of objectives. The first principle of the Lithuanian Constitution encompasses a freedom of individual economic activity. However, such freedom is not without limits as the State can impose restrictions on the economic activity if such activity is harmful to the community and does not serve the general welfare of the whole society. This is because as interpreted by the Competition Council of Lithuania individual behaviour might fail to preserve socially desirable features such as the improvement of welfare for the whole society. It is in the public interest to rely on competition for the efficient allocation of resources and the improvement of welfare. This in turn means that the state has an obligation to ensure that certain economic behaviour, such as anti-competitive agreements, abuse of a dominant position, and creation or strengthening of a dominant position by means of merger transactions is not allowed. Also, no one, including the state, is allowed to introduce a monopoly. In general the Constitution seeks a reasonable balance between the interests of an individual and those of society and such a balance is supposed to be achieved by protecting freedom of fair competition [452]. The constitutional principle of 'protecting freedom of fair competition' was also incorporated into the Law on Competition of Lithuania[453]. However, the law does not provide a definition of 'fair competition'. Nevertheless, the law on Competition does not preclude the Competition Council of Lithuania to refer to the mainstream economic theory, which equates competition with the absence of market power (OECD, 2003[454]).

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[452] Note: the interpretation provided by the Competition Council of Lithuania for the Lithuanian contribution to OECD, 2003. Available at web-site: http://www.konkuren.lt/english/international/oecd.htm

[453] Art. (1) of the Law on Competition of Lithuania, as amended by 15 April 2004 No. IX-2126.

[454] As interpreted by the Competition Council of Lithuania in papers submitted to the OECD, DAFFE/COMP(2003)5.

Unlike Lithuania, both Latvia and Estonia do not have enshrined competition principles in their constitutions. Nevertheless, the competition policy is encompassed in the primary and secondary sources of the Competition Authorities in both countries. For instance, in Estonia the purpose of the Competition Act is the safeguarding of competition in the interests of free enterprise upon the extraction of natural resources, manufacture of goods, provision of services and sale, and purchase of products/services, and the preclusion and elimination of the prevention, limitation or restriction of competition in other economic activities[455]. In particular, merger control in Estonia is required because there is a need *'[..] to maintain and develop competition, taking into account the structure of goods markets and the actual and potential competition in the goods market'*[456].

The purpose of Latvian Competition Law is *'[..] to protect, maintain and develop free, honest and equal competition in the interests of the public in all economic sectors, to restrict market concentration, impose as an obligation the termination of activities which are prohibited by the regulatory enactments regaling competition'*[457]. Instead of explaining the meaning of the term 'honest and equal competition', the Chairman of the Competition Council of Latvia defines a competition policy as an instrument of commercial activity, that ensures the possibility for any individual to offer the products/services in the market and to compete for market share by offering constantly improved products/services on one hand. On the other hand, competition policy also ensures the possibility for consumers to choose products/services, which best meets consumers' requirements. Furthermore, by making daily decisions on buying products/services consumers provide signals for market participants relating to their competitiveness and generating income and profit and providing a basis for the development of new products/services for motivation to invest and create new jobs (Annual Report of Latvia, 2003).

The general consensus of the competition policy in the Baltic countries is very similar. These countries have incorporated the basic objective of competition policy to ensure that competition is not distorted. However, some individual

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[455] See § 1 (1) of the Competition Act of Estonia, RT[1] I 2001, 56, 332, consolidated text July 2004.
[456] 22 (1), Competition Act, 5 June 2001.
[457] Section 2, Competition Law.

features can be distinguished, for instance, Lithuania refers to 'freedom of fair competition' and Estonia to the 'interest of free-enterprise'. Latvia alludes to 'honest and equal competition' that cannot be found in the EC competition policy. With priority given to the political objective – i.e. the integration into the EU, the Baltic states have not explored their 'pure' competition policy. Thus, it is not clear whether, for instance, the Latvian 'honest' competition has meant (or not) the notion of honest trade and ethical conduct similar to the ideas found in the origins of the German Act Against Unfair Competition[458] or in the Paris Convention of 1883, where unfair competition was defined as *'[..] any act of competition contrary to honest practices in industrial or commercial matters'*[459].

5.3.4. Industrial policy, competitiveness and efficiencies

Besides the harmonisation of the competition law and policy with the EC, the Baltic countries had to meet another Copenhagen criterion for the access to the EU. It is the existence of a functioning market economy, developing in such a way that it can sustain the competitive pressure from and in the Single Market and the Economic and Monetary Union. Generally, the creation of the Single Market with no restriction of movements of goods/services and capital increases competition. As a result of the increased competition, firms are forced to search for ways to lower cost and to achieve efficiencies. This is also applicable for the firms in the Baltic countries. Economist Vilpisauskas (2003) projected that the integration into the EU will force Lithuanian firms to increase competitiveness, as they will have to look for new strategies to achieve efficiencies in order to remain in market.

In order to achieve the desire to integrate their economies with the rest of the world, the governments of the Baltic countries started to dismantle the restrictive and inefficient trade regimes inherited from the Soviet Empire. This involved removing quantitative restrictions and phasing out export and import tariffs. All Baltic states apply liberal foreign trade systems in order to attract foreign investors, Estonia being the leader with no import licensing and import tariffs since signing the free Trade agreements with the EU in 1994. The

[458] For the reading as regards the German Act, see Ullrich H., Anti-Unfair Competition Law and Anti-Trust Law: A Continental Conundrum?, EUI Working Paper Law No. 2005/01.
[459] As quoted in A.Jacquemin, Theories of Industrial Organisation and Competition Policy: What are the Links?, Working paper, 2000.

Competition Authorities of the Baltic states have also expressed their role in the formulation and implementation of other policies apart from the competition policy, such as trade and industrial policies. The competition policy in these countries is engaged in competition protection development and promotion spheres. This competition policy includes opening monopoly sectors for competition, the reduction of restrictions and abolishing administrative barriers. It also ensures increasing competitiveness and efficiency growth of the national economy. For instance, the Competition policy of Latvia web-site provides an aim to ensure such legal and economic conditions that would not only attract foreign investments and business activities but also guarantee Latvia's ability to integrate efficiently into the European Union[460]. It has also been mentioned that the goal of Latvia's competition policy is to create legal and economic conditions for free and fair competition, which in the long run promote competitiveness of the whole society and growth of welfare. Long-term goals are related to the promotion of competition in the national economic sectors, which still experience restrictions to entrepreneurial activity and which do not match the interests of society (Economic Development of Latvia Report, December, 2003).

As stated above, firms can increase their competitiveness if they become more efficient. One way of becoming more efficient is through merger transactions. Mergers generally constitute a means of restructuring, allowing a more efficient allocation of resources in any industry. This can enhance the competitiveness of the merging entities and improve competitiveness of the industry as a whole. Due to globalisation process and the integration into the European market, firms, especially in small market economies, require reaching minimum efficient scales in order to compete internationally. Despite the fact that efficiencies in scale and scope achieved through merger transactions[461] can increase competitiveness, the current Competition Laws of the Baltic countries do not contain any provisions on the merger–specific efficiencies. It is worth mentioning that despite not explicitly identifying the objectives of the competition policy, the old Competition Law of Lithuania[462] included enhancement of production efficiency and competitiveness among the goals of merger control. At

[460] Available at web-site: http://www.competition.lv/?1=2
[461] For further discussion, see ch. 4.
[462] The law was in force from 1992 to 1999. See ch.1.

present the Competition Laws in all Baltic countries do not take into account any other goals, for instance, industrial goal in merger cases. The practice proves that efficiencies have been considered even as an 'offence' rather than a 'defence'. In the *UAB Vitoma* case[463] in the jurisdiction of Lithuania the elements, including economies of scale, advantageous price policy were considered as the conditions to restrict competition in the Lithuanian ferrous scrap metal purchase and processing market.

Although efficiency issues are not provided by law, the interviews held in the Baltic countries showed that the considerations of efficiency gains can be taken into account but only up to the level of dominance[464]. This position was stressed by all the professionals in the Baltic states dealing directly with merger cases. However, inadequacy as regards efficiency policy occurred in Latvia, where Jefremova, a board member of the Competition Council, expressed a different opinion from one stated by an official dealing directly with merger cases. Jefremova declared that efficiency consideration can be taken into account in 'borderline' cases, where there are concerns of the emergence of a dominant position, but it is not sufficiently clear how a merger transaction will affect the competition and consumer. Furthermore, *'[..] efficiency defence could mitigate a finding of dominance'*, if the entities involved in the transaction could prove the efficiency gains from the merger and it will be passed on to consumers. These two different opinions show that there is no clear position held with regard to merger-specific efficiencies in the jurisdiction of Latvia.

It can be concluded that there is not a clear approach on the possible efficiency gains achievable through merger transactions in the Baltic countries. These countries have set out an objective to increase competitiveness; however, they have not explored all the means to achieve it.

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[463] See Annual Report of Lithuania, 2000-2001, available at web-site http://www.oecd.org
[464] Interviews held at the Competition Authorities in the Baltic countries during September-October, 2004.

5.3.5. Protection of consumers or competitors?

The scholars agree that the focus in the Soviet regime was on producer welfare rather than on consumer welfare[465] The Baltic countries being a part of the Soviet empire had a strong centralised system, where the State had control over prices, quality and variety of products/services and consumers did not play a role. This is why after re-gaining their independence the Baltic states have encountered difficulties in introducing consumer protection. For instance, the registered consumer complaints vis-à-vis Major Commodity Groups and Services in 1998-1999 period in Lithuania revealed that in many cases consumers lack knowledge about their rights. The Competition Council of Lithuania has often requested to protect the rights of consumers even in areas of activities that fall under the competence of other institutions. In contrast to the EC policy where consumers are more active and have their say, for instance, by giving comments on reforming the ECMR, consumers in the Baltic countries are passive[466]. At present they hardly play any role in forming competition policy. Anti-competitive concerns of proposed merger transactions are usually expressed by the competitors rather than consumers. Also, in the opinion of Klimas[467], a former board member of the Competition Council of Lithuania, consumers in Lithuania are not 'matured' and lack knowledge of competition policy. According to Klimas, the opinion of consumers is too emotional in the context that they might use their right to claim that a firm has been involved in anti-competitive behaviour in order to retaliate for some personal things[468]. The researcher agrees that the consumers in the Baltic countries still lack knowledge of their rights. However, it is not a reason to exclude them from the activity of competition policy.

Protection of consumers is not explicitly mentioned in the Competition Laws of the Baltic countries as a goal of competition policy. The Competition Laws in the Baltic countries provide either definition of undertaking (in the cases of Estonia and Lithuania) or definition of market participant (in the case of

[465] See for instance, Eörsi G., Harmathy A., Law and Economic Reform in Socialist Countries, Akademiai Kiado, Budapest, 1971, pp. 103.
[466] The information was obtained from the questionnaires to the Competition Authorities of the Baltic states.
[467] The information was obtained during the interview on 5 September 2004.
[468] Note: Some cultural aspects of the Baltic countries are that they sometimes are called as 'country of relatives' in the sense that everybody knows each other.

Latvia) but do not determine the definition of consumer. It is not clear whether the Baltic states have the Chicagoan notion of consumer as society at large encompassing even every market player, or the EC's notion of consumer in competition law as any intermediate or final consumer, as a 'customer' or 'user' who might be another market operator purchasing the product/service, or finally referring to consumers as the final user otherwise the 'man from street', as acting outside his/her business or profession. § 22 of the Estonian Competition Act states that in appraisal of a concentration other factors will be taken into account, including *'[..] the interests of the buyers, sellers and ultimate consumers'*. This provision shows that Estonia has a different approach from the EC policy as it has a broader approach and protects total welfare rather than consumer welfare. Also, is not clear whether priority is given to the interest of producers or consumers in the existence of conflict. The ambiguity of the objectives of the Competition Act in Estonia as regards protection of consumers' rights can be illustrated by the following case, where the courts of different instances provided a different interpretation. AS Elion Ettevotted[469] (former AS Eesti Telefon) was charged for unfair pricing conditions by the Competition Board of Estonia. On appeal, the administrative court and the circuit court supported AS Elion Ettevotted's position that without establishment of the fact of prejudice to other undertakings or excluding other undertakings from the market, § 14 (1) (undertaking with special or exclusive rights) does not apply. However, the Supreme Court, which is the highest court in Estonia, supported the position of the Competition Board by stating that application of unfair pricing conditions by abusing the dominant position is prohibited irrespective whether other undertakings are prejudice or not. Furthermore, AS Elion Ettevotted argued that the aim of the Competition Act was only to protect other undertakings from distortions of competition rather than consumers. However, the Supreme Court disagreed with this approach and stated that the aim of the Competition Act is also to protect persons not involved in business and public interests[470]. This case illustrates that the Competition Board of Estonia, with support of the Supreme Court, is willing to protect the interest of consumers.

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[469] Case AS Elion Ettevotted v Competition Board, case no. 3-3-1-66-02, judgement of the Supreme Court of 18 December 2002.
[470] As commented in the Annual Report of Estonia, 2004. Available at web-site: http://www.konkurentsiamet.ee/eng/index.html?id=765

As regards the Latvian jurisdiction, the Latvian Competition Law has declared that undistorted competition in all sectors is the main objective of the competition policy. However, according to Jefremova, a board member of the Competition Council of Latvia, the Competition Council often stresses the benefit of society as a main goal of competition policy. Furthermore, the Latvian competition policy is not about *'[..] the pursuit of competition for its own sake – the interests of economic efficiency which are closely related to the consumer welfare are taken into account as well'* (Jefremova, 2003[471]). However, she did not explore further. Thus, it is not clear whether consumer welfare needs to be looked at in a broader context like that expressed by the Chicagoan notion or narrower.

As aforementioned, the safeguarding of consumers is not incorporated in the Competition Law of Lithuania. Despite that, consumer protection can be found in several Annual Reports. For instance, in the Annual Report of 2001, chairman Stanikunas stated that while developing competition culture in the country, the activity of the Council has been to improve the economy and promotion of investment by protecting legitimate interests of undertakings and consumers. The report does not explain further what position will be supported if the interests of undertakings and consumers are in conflict, which is usually the case. In the Annual Report of 2003 it was also stated that the main purpose of the Competition Council is to enforce the provision of the Competition Law in a way that best serves the progress of the society[472]. The definition of society is not provided, which gives a presumption that like in Estonia, the jurisdiction of Lithuania also is willing to take a boarder approach and protect total welfare rather than consumer welfare.

The examples illustrated above suggest that the protection of consumers in competition policy is ambiguous in the Baltic countries. In order to avoid ambiguity, the Competition Authorities in the Baltic states should consider

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[471] Speech delivered during the 'International Workshop on Competition Policy' in Seoul, 29/04/2003-03/05/2003.
[472] All Annual Reports are available at web-site: http://www.konkuren.lt/english/index.htm

explicitly expressing their position as regards their support either of total welfare or consumer welfare[473].

5.3.6. The evolution of priorities in competition policy within the jurisdiction of the Baltic countries

One of the main objectives of the competition policy in the Baltic countries, especially before membership into the EU has been a political one – as to harmonise their legislation in the field of competition with the EC law and prepare for the EU accession. In contrast to the EC, where the competition law has been developed gradually, the Baltic countries had legal transposition. It in turn means that the Baltic countries have had an educational task: to inform and teach society of the competition principles by providing knowledge about the competition rules and raising the competition culture. This has taken place in the form of seminars, issuing special publications and explanatory materials publicly accessible on the homepages of the Competition Authorities of the Baltic countries. Quite often a breach of the competition rules has occurred in the Baltic states due to the unfamiliarity of these rules. Thus, the Baltic states have had a unique objective to teach staff completely new law and inform society of the principles of competition and its importance.

Bearing in mind that these countries were a part of the Soviet system and as a result inherited giant companies, which as a rule were too big for the small Baltic markets and were surviving on State subsidizes, the Baltic countries came with the idea that 'big is bad'. For instance, the Competition Board of Estonia in its Annual Report (2000) stated that it has spent the first years tearing down the old thinking of 'the bigger the better'. Ineffective massive former Soviet companies, which had images of 'the bigger – the more powerful', can fall to the category of 'big is bad'. However, it does not necessary mean that all big companies are 'bad' and should be stopped from growing, especially for small market economies. According to Gal's theory, in small market economies only a limited number of players can be supported by the market.

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[473] During the interviews held at the Competition Authorities of the Baltic countries, the interviewees stated in all three countries that they safeguard the interest of consumers. However, the law does not express such a position.

Later, the policy has changed realising that small players can no longer operate alone in the market due to the fact that the Baltic countries have become a part of the world economy and as a result the firms there have faced international competition. This in turn means that small players are forced to make decisions on whether to merge, find new niches in the market or leave the market. However, this position is not clearly incorporated in the Competition Laws in the Baltic countries. As aforementioned after the modernisation of the EC competition law, the EC competition policy has shifted toward a new approach – a more economic based approach. The emphasis is not on market structures anymore but rather on the effects of merger transactions for instance, in the market in question. Meanwhile, the Baltic countries put emphasis on market structures rather than on the effects. Despite, some reforms in the competition policy area, these countries are still required to modernise their competition rules[474].

Since the explicit aim of the Baltic countries has been to bring their competition law and policy in line with the EC competition policy, it is no surprise that these countries have implemented competition law and policy virtually identical to the EC competition policy. Likewise incorporated in the Treaty, all Baltic countries refer to undistorted competition as a main objective of competition policy. However, with the priority given to the political objective – i.e. the integration into the EU, the Baltic states have not explored their 'pure' competition policy.
The Baltic countries are still required to improve their competition policy in order to keep in line with the modernised EC competition policy. Since the EC competition policy has moved towards a more economic based approach, the Baltic states have been left behind. There is a need to introduce more economic reasoning in their competition policy. Also, a clear position of the efficiency gains achievable through merger transactions in order to increase competitiveness and the safeguarding of the consumer interest should be explicitly expressed.

[474] Further discussion will be provided in chapter 6.

Chapter 6. LEGAL APPROACH TOWARDS MERGERS

Unlike an abuse of a dominant position or prohibition of cartels, which are enforced only when allegation occurs (otherwise *ex-post* procedure is applied), a merger control is based on an *ex–ante* system, which is designed to prevent undesirable effects on competition in the future[475]. Hence, the merger control for the competition authorities is as a predictive exercise. Since, as discussed in chapter 4, horizontal, vertical and conglomerate merger transactions have both positive and negative consequences for society welfare, the question raised in this chapter will be how the merger control rules of the EC and in parallel the Baltic countries assess these effects. As regards detrimental effects, mergers may create or strengthen substantial market power, enabling the merging parties to raise prices unilaterally by restricting output and/or otherwise have a significant impact on market conditions. Also, by increasing market concentration, merger transactions may enable the firms participating in the market to collude the pricing and output decisions. As regards advantageous effects, merger transactions may enable the merging firms to achieve efficiency gains in terms of the process of innovation or production, or other forms, which will lead to lower costs and a decrease in prices; as a result consumers will be better off compared with a pre-merger situation. Moreover, the specific implications in chapter 4 were made on small market economies. Merger transactions in small market economies must be looked at from a different angle: highly concentrated small market economies' markets may require further concentration in order to achieve efficiencies.

Chapter 5 analysed the objectives of competition law of the EC and the Baltic countries and what goals the ECMR and the merger control regimes in the Baltic states are trying to achieve. Since the policy goals determine which mergers are counted as beneficial or harmful, chapter 5 provided data, which will be further analysed in this chapter. Chapter 4 discussed two countervailing merger effects on competition, namely market power and efficiency gains from the economic perspective, meanwhile, this chapter will focus on these two effects from a legal perspective. Bearing in mind that a merger control regime is an important tool to prevent anti-competitive effects and keep markets competitive,

[475] This policy is applied because it can be difficult and costly to disentangle a merger, which has already taken place.

the questions raised in chapter 6 will be to what extent do the motives[476] affect and influence the regulatory authorities of the Baltic states and to what extent the approach taken by the Baltic countries is different from the EC vis-à-vis merger control rules. The EC merger control mechanism encounters both positive and negative approaches[477]. In contrast to the EC approach, the Baltic countries adopt a negative approach towards the appraisal of merger transactions. This negative approach may mean that the Baltic countries are reluctant to admit pro-competitive effects of merger transactions on competition.

As chapter 4, this chapter also contains two main focus areas. These are the efficiencies achievable through mergers and the market power that merger transactions can lead to, at both – the EC and national levels - the Baltic countries.

6.1. Efficiency gains from a legal perspective

6.1.1. The historical background of efficiency considerations in merger cases

The efficiencies achievable through mergers have been highly discussed by lawyers and economists in the US jurisdiction since the *Brown Shoe / United States* case[478]. The position of the court in this case was that a merger resulted in efficiencies should be prohibited as small rivals could be disadvantaged thereby. Hence, efficiencies were considered as an 'offence' in the *Brown Shoe* case. This case and the merits of the Supreme Court's position on mergers were highly criticised by Bork in his book 'The Antitrust paradox a policy at war with itself'[479] for the lack of economic reasoning.

The position towards efficiency-specific mergers has changed since the assessment of the economies has been progressively refined. In the case *Federal Trade Commission / Procter & Gamble Co.*[480], judge Harlan suggested that the efficiencies defence should be available for conglomerate mergers. Furthermore, the efficiencies defence has been extended towards horizontal and vertical

[476] which were analysed in chapter 3 and further developed in chapter 4.
[477] Referring to articles 2 (2) and 2 (3) as compatibility and incompatibility to a relevant market.
[478] 370 US 294 (1962).
[479] For further reading see Bork, R., The Antitrust Paradox, a policy at war with itself, The Free Press: a division of Macmillan, Inc., New York, 1993.
[480] 386 U.S. 568 (1967).

mergers. Ever since, there is an explicit indication of the efficiency consideration in the Anti-trust law of the US as regards merger cases.

The merger-specific efficiency issues have also been analysed on the other side of the Atlantic. For instance, in response to the merger wave earlier in the decade and the European Commission's plan in 1972 to introduce a merger control regime (where the leading French officials stressed the idea to have domestic rather the Community level merger control[481]) France in its competition law legislation of 1977 included for the first time the provisions on merger control. According to the French Competition law of 1977, all potential anti-competitive mergers, which had more than a specified market share, were checked to determine whether such a transaction *'[..] contributes to economic and social progress to a degree that compensates for its harm to competition'* (Burst and Kovar, 1982:309-325, as quoted in Gerber, 1998:192). The German competition law of 1973 also contained some exceptions, when merger transactions could avoid prohibition. The Federal Cartel office (thereafter FCO), which is the Competition Authority of Germany, could approve a merger transaction, despite the creation or strengthening of a dominant position, if the merging parties were able to prove that the transaction would lead to improvements in the competitive situation and that these improvements would outweigh the likely harms caused by the merger (Gerber, 1998:318). Furthermore, the merger control rules contained the provision, where the minister of economics could prevent any prohibition decided by the FCO in a case, where a merger transaction may benefit the whole economy and thereby outweigh the harms of any competitive restraints caused by the merger. A similar policy was applied in the jurisdiction of Lithuania by way of the 1992 Law on Competition, where the Government could override the merger prohibition decision made by the Competition Authority in cases, where such a transaction would lead to an increase of efficiency.

When the merger control rules were introduced on the Community level, it did not contain any explicit provisions as regards efficiency gains. On several occasions the Commission expressed that there is no real legal possibility of justifying an efficiency defence under the wording of the Merger Regulation.

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[481] Despite such early announcement, the Commission succeeded only in 1989 when the EC Merger Regulation was issued for the first time. It is mainly because of objections from some Member States, as France or Germany.

Efficiencies were assumed for all mergers up to the limit of dominance. This was known as the 'concentration privilege'. Any efficiency issues were considered in the overall assessment to determine, whether dominance has been created or strengthened and not to justify or mitigate dominance in order to clear a concentration, which would otherwise be prohibited[482].

The consideration of efficiency was not a formal part for the appraisal of merger transactions under the EC merger regime. Nevertheless, article 2 (1)(b) of old ECMR[483] stated that the Commission in the appraisal of merger transactions takes into consideration other factors including *'[..] the development of technical and economic progress provided that it is to consumers' advantage and does not form an obstacle to competition'*. In this case, the Commission could consider efficiency claims in assessing the notion of the development of technical and economic progress, bearing in mind that two conditions set up in the provision had to be met. They are: i) the benefits should be passed on to consumers, and ii) the competition will not be impeded. This 2 (1)(b) provision of the 1989 ECMR was applied in several EC cases, where efficiency issues were analysed even before the 2004 Merger reform, when the efficiency 'defence' was explicitly introduced.

6.1.2. Efficiencies in the EC case law

First of all, from the economists' standpoint the position of efficiencies in merger cases is clear: economists point to what the benefits the merged entities and thereafter consumers might gain as a result of merger synergies. This is a clear position of the efficiency 'defence'. However, unlike the economists' view, the Commission did not have a clear position until 2001, as to whether efficiencies achievable through merger transaction should be treated as the 'defence' or 'offence'. This controversial Commission's position can be illustrated by the following cases of mergers (involving all types of mergers), where the efficiency issues were considered either positively or negatively.

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[482] For full discussion, see OECD, 1996, pp.53.
[483] Note: the old ECMR refers to the Regulation of 4064/89 with further the amendments of 1310/97. Meanwhile, new ECMR refers to 139/2004 Regulation.

According to Camesasca (1999:25), the landmark case on the role of efficiencies remains the case of *Aerospatiale-Alenia / de Havilland*[484] with horizontal overlaps. The parties in this case claimed that cost savings of the combined entity would arise from rationalising part procurement, marketing and product support as well as through better management of certain aspects of de Havilland's internal operations. The Commission considered that the claimed efficiencies of 0.5% of the total turnover of the proposed concentration would contribute to the development of technical and economic progress within the meaning of article 2 (1)(b) of the Merger Regulation[485], but concluded that consumers would not benefit sufficiently from these gains and such progress would not be to the consumers' advantage, as this combination would reduce airline customers' choice. From de Havilland it can be stated that the Commission requires efficiencies to be substantial and thereby merger specific with the burden of proof resting on the merging parties (Camesasca, 1999:25; Jones and Gonzales-Diaz, 1992:158).

In the *MSG Media Service* case[486] vertical issues were analysed. The operation involved the creation of a joint venture between three German companies to handle the technical, business and administrative handling of digital pay TV services. In this case un-quantified efficiency gains from the merger were found to be irrelevant because even if the operation were to contribute to technical and economic progress, article 2 (1)(b) of the ECMR provides that technical and economic progress is relevant only if no obstacle is formed to competition. In conclusion, the Commission stated that the joint venture would be enable to dominate in the upstream market for supply of administrative and technical operators, which would enable the parents to create or strengthen a dominant position in the downstream market for digital pay TV services, which would hinder competition as new entrants would be dependent on the vertically integrated competitor for the supply of essential administrative and technical services. Because of the deterrent effect of the operation to future entrants into the market, the Commission concluded that the hindering of competition made the

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[484] Case IV/M053, October 2, 1991.
[485] According to the Merger Regulation 4064/89, OJ No. L395, 30.12.1989 at the time.
[486] *MSG Media Service* IV/M 469.

achievement of technical and economic progress questionable. Thus, efficiency gains are not counted if the transaction would have anti-competitive effects.

A similar conclusion by the Commission was made in the *Nordic Satellite Distribution* case[487], where the operation would have created a highly vertically integrated structure ranging from programme provision via satellite capacity to cable TV networks. The Commission recognised that the joint-venture could have long-term economic benefits and benefit consumers. Nevertheless, the Commission prohibited the operation since the transaction would have anti-competitive effects as NSD's joint Nordic encryption system would become dominant and third parties cannot get access to such a system. In conclusion, the Commission stated that the operation would lead to a reduction in the variety of television services in the Nordic countries and therefore the requirement of article 2 (1) (b) of the Merger Regulation was not met.

Despite the promotion of technical and economic progress by the parties in *Bertelsmann / Kirch / Premiere*[488] the acquisition of joint control was prohibited by the Commission. It stated that a contribution from technical and economic progress is irrelevant under the Merger Regulation, because it might not be positive as the parties would ward off and control the future market in digital pay-TV and multimedia services and other digital pay-TV providers would be unable to develop freely and without restriction. Once again the efficiencies by the Commission were considered as an offence rather than a defence.

The operation in *Saint-Gobain / Wacker-Chemie / NOM*[489] involved the creation of a joint venture for the manufacture, processing, marketing and sale of silicon carbide. In this case the Commission did not dispute that some synergies are achievable from streamlining the production. However, the Commission concluded that the operation would be more harmful than beneficial. It is because the benefits of synergies from the operation are likely not to be passed on to the consumers. In this case, the Commission took 'a price' as the main indicator, concluding that there is the possibility of a price increase of silicon carbide as a result of the operation and this will outweigh the potential synergies.

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[487] *Nordic Satellite Distribution* IV/M 490(July 19, 1995), OJL 53/20 (March 2, 1996).
[488] *Bertelsmann/Kirch/Premiere* IV/M. 993 (1999/153/EC), para 119-122.
[489] *Saint-Gobain/Wacker-Chemie/*NOM IV/M.774, (97/610/EC), para 246.

In *Gencor / Lonrho*[490], as in the previous cases described above, the Commission found that even the synergies would occur as a result of the operation, but it would not lead to the advantage of the consumers since it *'[..] will create a jointly dominant position in the platinum and rhodium markets and form an obstacle to competition in those markets'*. The factor of 'time' was taken into consideration. The Commission found that only substantial synergies can be in the processing and refining facilities and these can only be realised in several years time and the realisation of other synergies claimed by the parties is vague. This is because the Commission looked at the fact that overall synergies of the merger might be negative due to *'[..] very different organisational cultures of the two companies, which will make integration difficult and probably costly'*.

Despite the 'offensive' view vis-à-vis efficiencies in the merger cases as discussed above, the cases such as *Alcatel / Telettra*[491], *Mannesmann / Valourec / Ilva*[492], *ABB / Daimler-Benz*[493], *Mercedes-Benz / Kassbohrer*[494] and to a lesser extent *Agfa-Gevaert / DuPont*[495] showed that the Commission may rely on efficiencies in order to clear a transaction.

In summarising the EC case studies, the Commission whilst analysing efficiencies delivered from mergers took into consideration various factors. From *de Havilland* as discussed above, it can be concluded that the Commission requires efficiencies to be substantial and merger-specific, with the burden of proof resting on the parties. In this case the question whether these cost savings should be passed on to consumers was left open. Subsequently, in the following case *Saint-*

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490 *Gencor/Lonrho* IV/M. 619, para 212-214.
491 Case IV/M. 042, [1991], OJ L122/48.
492 Case IV/M. 315, [1994] OJ L102/15 (the consideration of that the transaction would reduce overcapacity and would help to achieve plant capacity was taken into account by the Commission).
493 Case IV/M 580, [1997] OJ L 11/1.
494 Case IV/M 477 [1995] OJ L211/1 (the Commission in this case supported that the merger will achieve synergies in relation to production, research and development, and administration).
495 IV/M. 986. The parties claimed that post-transaction would solve the problem of unused capacity of both business entities in the market of negative printing plates and they will have a scale advantage both for production and sales, and the transaction will also be to offer a wider range of products. Despite those efficiencies, the Commission considered other negative aspects of the proposed transaction (an insufficient countervailing power on the demand side, the difficulty to switch suppliers due to package deals and exclusivity arrangements etc) and took the preliminary decision that the notified operation will lead to the creation of a dominant position on the common market in one relevant product market, in particular a market for negative offset printing plates, as a result of which effective competition would be significantly impeded. This transaction was approved after submitting the commitments by the parties and removing the competition concern.

Globain the Commission explicitly mentioned that the requirement of the efficiencies resulting from the merger should be passed on to the consumers.

In addition, from the case studies, it can be concluded that the Commission will take into consideration efficiencies under certain conditions. First, if efficiency can be gained only from a merger and not otherwise. Second, the efficiencies must be passed on to consumers. Third, the 'time' factor can play a role, as efficiencies must be time consuming and therefore substantial. And finally, even if through a merger efficiencies may be gained, the merger may not justify the creation or strengthening of a dominant position as a result of which effective competition would be significantly impeded[496].

These controversial aspects as regards merger-specific efficiency issues have put the Commission under attack. Pressure has mounted for the Commission to consider efficiencies more positively, especially after concerns arose in a number of cases that merger-specific efficiencies were insufficiently appreciated. For instance, the Commission's rejection of the *GE-Honeywell* merger[497] was highly discussed on both sides of the Atlantic. The Commission was criticised for not taking positively efficiency issues into account in this case. Due to the pressure placed on the Commission, it decided to begin a major review of the ECMR by issuing a Green Paper in December 2001 outlining possible reforms. The Green Paper invited views to consider, how efficiencies achievable through merger transactions could be incorporated without suggesting an approach itself. Hence, the beginning of the reforms ended one episode of the relatively short history of the EC merger control regime.

6.1.3. Substantive tests

The illegality test plays a big role in the merger analysis as it defines criteria that must be followed while deciding what merger transactions should be prevented and what mergers can be approved. Two major tests or the combination of them are in a domain of merger control regimes worldwide. They are widely

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[496] Article 2 (3), The EC Merger Regulation 4064/89.
[497] *GE /Honeywell,* M. 2220, 05 February 2001.

known as the dominance test and the substantial lessening of competition (thereafter SLC) test. There is also the Public Interest test, which was applied in the UK before being replaced by the SLC, following the enforcement of the new Enterprise Act 2002. This test is the broadest in range in comparison with the dominance or the SLC test, which will be further discussed. It is because the Public Interest test apart from competition issues includes non-competition issues such as industrial policy or employment considerations. In contrast to the Public Interest test, a dominance test prohibits merger transactions, which create or strengthen a dominant position in the market as a result of it competition will be impeded significantly. Meanwhile, the SLC test prevents mergers, which are likely to lessen competition in the market substantially. Here, the competition authority is concerned whether or not a merger transaction might substantially lessen competition in the market irrespective of whether a dominant position will be created or strengthened. Some jurisdictions, such as Germany or Estonia apply a dominance test. Other jurisdictions such as the US, Canada, and Australia apply the SLC test; the UK and Ireland have also lately adopted the SLC test. Latvia and Lithuania apply a modified test as a combination of the dominance and SLC tests.

The opinions have been expressed in the Green Paper (2001) that the SLC test is more favourable in comparison to a dominance test for achieving efficiency gains through merger transactions. Moreover, according to Gal (2003) the SLC test is more suitable for small market economies. This is because in small market economies there are a larger number of merger transactions that would tend to create or strengthen a dominant position, which do not necessarily lessen competition. For instance, if a market is already highly concentrated and is characterised as an oligopoly that co-ordinates its conduct by reducing output and increasing prices. In this case, a merger transaction would not lessen competition due to the fact that competition does not exist. The merger instead may help to remedy such a situation, where firms are unable to realise the efficiency gains, and may also augment productive efficiency significantly. Furthermore, Gal (2003) also suggests that a merger transaction should be approved, it may even create a dominant position for the newly merged entity (especially where the dominance definition involves firms with market shares equal to or lower than 50%), if such a merger enables the merging parties to compete effectively with an incumbent monopoly or with foreign importers (Gal, 2003:206-208).

6.1.3.1. Consistency of efficiency gains with the 1989 ECMR substantive test

In the merger review, the Commission has established a presumption of compatibility or incompatibility with the common market. Article 2 (2) of the ECMR of 1989 provided that a concentration, *'[..] which does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it shall be declared compatible with the common market.'* Meanwhile, article 2 (3) stated that a concentration, which *'creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it shall be declared incompatible with the common market'*[498]. Furthermore, article 2 (2) and recital 15 of the old ECMR stated that *'[..] concentrations which, by reason of the limited market share of the undertakings concerned, are not liable to impede effective competition may be presumed to be compatible with the common market; [..] an indication to this effect exists, in particular, where the market share of the undertakings concerned does not exceed 25 %'*, was regarded as a safe harbour of efficiency enhancing merger transactions. However, despite a safe harbour for efficiency claims, Mano (2002) mentioned that lack of efficiency claims can be logically interpreted as a sign that the merger transactions is market power orientated rather than efficiency enhancing. As a result of this logic it might predispose the EC merger regulators to be cautions if not suspicious as regards merger's effects on competition (in Enterprise Papers, No. 11, 2002). It has been expressed by some scholars and by the competition commissioners that the wording of the substantive test of the old ECMR implied up to some level of dominance. This logic, that merger transactions are more market orientated rather than efficiency enhancing, has been overtaken from the EU into the jurisdictions of the Baltic countries[499], where the mergers are more likely to be seen as an easy way to create or strengthen a

[498] Article 2 (3), 4064/89 ECMR.

[499] The interviews held in September – October, 2004 at the Competition Board of Estonia, the Competition Council of Latvia and the Competition Council of Lithuania showed that the one of main tasks of these Competition Authorities is to keep hand in hand with the EC rules on competition, including merger control rules. All Baltic countries adopted a dominance test as a substantive for merger control, which will be further discussed in the following sections.

dominant position and as a threat to a market structure rather than a means to achieve efficiencies.

Despite the fact that the substantive test delineates a two-tier test, where two conditions are implied, those are the creation or strengthening of a dominant position and a subsequent finding of significant impediment of competition. The decisive criterion was the creation or strengthening of a dominant position with little independent significance accorded to the second condition. Moreover, article 2 (1)(b) was interpreted by the Commission and most commentators as allowing no practical scope for an efficiency defence, once the creation or strengthening of a dominant position was determined (Ilzkovitz and Meiklejohn, 2001:13). For instance, in the *Danish Crown / Vestjyske Slagterier* case[500] the Commission stated that '*[..] the creation of a dominant position in the relevant markets [..], therefore, means that the efficiencies argument put forward by the parties cannot be taken into account in the assessment of the present merger'*. This emphasis from the case proves that the Commission was reluctant to take any efficiency considerations into account once dominance was found.

Although the former substantive test failed to specify the welfare standard, as to whether the consumer or producer should be applied, the EC practice showed that the central focus is on the consumer welfare standard rather than the producer welfare test. In this case the problem is likely to occur with a dominance test dealing with a situation, where a merger transaction leads to lower prices and as a result increases in consumer welfare but simultaneously leads to the creation or strengthening of a dominant position (Mano, 2002:para 2.2; Gal, 2003). According to Gal (2003), this problem is common in small market economies, where markets are highly concentrated and quite often mergers lead to the creation or strengthening of a dominant position, though this does not necessarily mean that a decrease in consumer welfare will occur.

Theoretically, there are two legal options (not necessarily exclusive from each other), which could be taken into account for the treatment of efficiency issues. The first option is the so called 'integrated approach', where efficiencies are to be taken into consideration in assessing whether or not the concentration would lead the creation or strengthening of a dominant position. However, this

[500] Decision No. 2000/42/EC, 9 March, 1999, OJ No. L20 25/01/2000.

approach had limited scope under the old substantive test, as it was conceptually difficult for merging entities to challenge that efficiency would stop them from having the ability to act on the market without being effectively constrained by others, or otherwise influence price, production or innovation, which was the main concern of the old substantive test (Lowe, October, 2002). The second option is known as the 'efficiency defence', meaning that the finding of dominance can be 'rebutted' by the efficiencies achievable through a merger transaction. In this case, there is a possibility for merger-specific efficiencies to outweigh or render any negative effect of a dominant position, which is to significantly impede competition. Thus, theoretically, efficiency issues could have been covered under the second part of the former substantive test, which refers to significant impediment of competition. This means, that despite having the ability to act as a dominant firm, the merging parties could prove that because of the efficiencies they have an incentive to act pro-competitively and as a result of it the competition would not be significantly impeded. In general, the first option leads to the conclusion that by taking efficiency claims into consideration, a dominant position would not be created or strengthened, as efficiency gains help to mitigate finding dominance. Another option concludes that efficiencies would outweigh any anti-competitive effects of a dominant position, which had to significantly impede competition.

6.1.3.2. New Merger Regime of the EC

Bearing in mind that through merger transactions efficiencies can be achieved, the question arises here, why there was no explicit analysis of efficiency issues in the past, i.e. before the 2004 EC merger reform (when the efficiency 'defence' was finally introduced explicitly in the EC merger control regime). Lowe (2002), a competition commissioner, explained that the prospect of the Commission considering efficiencies more explicitly in the future than it has done in the past is 'a natural development'. This is because the Commission is still considered a relative newcomer to merger control, counting from 1990. Also, in its early days the main concern of the Commission was on applying the competition test without further consideration of some broader industrial policy or

in general the public interest test. This policy explains why the Commission was so cautious or even reluctant to take into account explicitly efficiency claims.
Now, according to Lowe, the Commission has sufficient experience and knowledge to make its merger review process more sophisticated and fine-tuned to merger specific efficiency cases[501]. The development of the EC merger review process is in line with the Commission's endeavour to base its merger control analysis with economics. Central to the new merger control regime is the 'more economic based approach'. This means that the stronger focus is on industrial models and quantitative methods of analysis in two different means: firstly, in case investigations and, secondly, in formulating legislation and defining the criteria that are set. This new approach reflects in the amended ECMR of 2004 and the new Guidelines on horizontal mergers as well as on recent decision-making (Christiansen, 2005). So far there has been no prohibition on the basis of the new substantive test, nor has a merger been approved on the grounds of efficiency gains. Nonetheless, the evidence can be found of greater recourse to statistical and economic methods of analysis (Hofer et al., 2005b; Christiansen, 2005). For instance, in the current *Blackstone / Acetex* case[502] econometric studies were undertaken by the economists engaged by the firms as well as by the CET (Durand and Rabassa, 2005; Christiansen, 2005).

6.1.3.2.1. Consistency of efficiency gains with the new ECMR substantive test

The debates launched in Green Papers raised the question, whether there was a need to change a substantive test for the purpose of analysing efficiency gains. Some scholars argued that the efficiencies were incorporated into article 2 (1)(b) of the ECMR of 1989, where the Commission shall take into account *'[..] development of technical and economic progress provided that it is to the consumers' advantage and does not form an obstacle to competition'*. Others stated, that efficiencies were only applicable up to the limit of dominance. Nonetheless, the new wording of the present substantive test better expresses efficiency issues (Verouden, 2004). The focus is not any more on dominance. The creation or strengthening of a dominant position is no longer the main scenario to

[501] For further discussion, see P. Lowe speech delivered in New York, on the 30-31 October, 2002.
[502] Case No. COMP/M. 3625. OJ L 312, 29/11/2005.

assess the compatibility of a merger transaction with the common market. Despite the fact that the legal framework can facilitate, but cannot guarantee high quality analysis of merger appraisal, nonetheless, the wording of the substantive test can influence the way analysis is conducted (Baker, 2003). The wording of the new substantive test shifts attention on the effects on competition in the post-merger market, which according to Colley leads naturally to an examination the extent to which efficiency gains can mitigate or disprove the incentives to raise prices (Colley, June 2004:343). Furthermore, recital 29 of the ECMR highlights the importance of efficiency gains in assessing merger effects on competition, which can serve as a defence in otherwise problematic transactions.

6.1.3.2.2. The EC Guidelines on the assessment of horizontal mergers as regards efficiencies

The Commission's guidelines on the assessment of horizontal mergers[503] (thereafter – guidelines) issued in 2004 have increased the transparency in the Commission's competition policy. The guidelines set out principles how the Commission assess horizontal concentrations evolving the experience with the appraisal of horizontal mergers under 4064/89 Regulation and the case law of the Commission, the ECJ and the CFI. One of the major contributions of the guidelines is the Commission's acknowledgement of the importance of efficiency issues in merger analysis. Although efficiencies were introduced, certain conditions were set out. The efficiencies achieved through a merger should be substantial and timely, and should in principle benefit consumers; they must also be merger specific and verifiable. The guidelines state that effective competition brings benefits to consumers and the Commission lists the benefits to consumers, such as low prices, high quality products, a wide selection of goods and services and innovation[504]. Hence, benefits to consumers do not necessarily mean a decrease in prices, as other benefits may be counted, such as an increase in quality or improved or newly formed products/services, resulted from efficiency gains in

[503] Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, (2004/C 31/03).
[504] Guidelines, para 8.

the sphere of R & D and innovation, or otherwise[505]. As regards merger specificity, the Commission states that *'[..] efficiencies are relevant to the competitive assessment when they are a direct consequence of the notified merger and cannot be achieved to a similar extent by less anticompetitive alternatives'*[506]. This condition is in line with the principle of proportionality, which was discussed in chapter 1, as it encompasses a safeguard approach to any unnecessary anti-competitive effects, where the benefits in question can be achieved through means posing less risk to competition than the merger (Lowe, October 2002). However, it is a burden on the parties to prove the efficiency gains resulting from the merger and that there are no less anti-competitive, realistic and attainable alternatives of a non-concentrative nature. The final condition is that efficiencies have to be verifiable. This means that they are likely to materialise and be substantial; as the benefits to consumers should be quantified and where the data for a precise quantitative analysis is impossible, a clearly identifiable positive impact on consumers must be proved.

The EC horizontal merger guidelines, which is a positive step towards the transparency of the Commission's policy in merger cases, introduces a more structured and transparent approach as regards efficiency gains from merger transactions, by considering efficiencies as a counterbalance to anti-competitive effects. This step shows that the Commission admits positive effects of merger transactions and is ready to take efficiencies into account, while analysing merger transactions. The guidelines are a useful tool for new Member states[507], including the Baltic states, where the competition law and policy are still considered a new phenomenon. The guidelines can play an educational role for the Competition Authorities of the Baltic states by guiding them on how to deal with merger cases. The researcher considers that the EC Commission's explicit view towards taking the efficiencies into account is a welcome development since efficiency gains play an important role in merger transactions according to sound economics. Furthermore, as an example of the EC merger policy showed that the Competition Authorities of the Baltic states should not underestimate the importance of efficiency consideration in merger reviews and introduce it in to their Competition

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[505] Guidelines, para 79-81.
[506] Guidelines, para 85.
[507] In this research the new Member States refer for the States, which joined the EU on 1 May 2004.

laws. The following sections will review any efficiency considerations in the Baltic countries.

6.2. Approach towards efficiency issues in the Baltic countries

6.2.1. Overview

In the OECD (1999) report of the development of competition policy in the Baltic countries[508], it was stated that these countries have made significant progress towards achieving fully functioning market economies since re-gaining their independence in 1991 and the development of competition policy. This report also stressed that the Competition Authorities of these three countries should evaluate the merger transactions presented to them according to current market conditions, especially by taking into account actual and potential competition. This is because the majority of merger transactions are not competitively harmful. As regards efficiency gains, it was mentioned that bearing in mind the inheritance from the Soviet Union, i.e. inefficient companies remained from the period of central planning, the efficiency considerations in merger transactions are of paramount important in the Baltic states. As was suggested by the OECD in 1999, in the absence of significant restraints on imports, mergers of domestic firms in the Baltic countries may be unlikely anti-competitive (Clark, 1999). The following paragraph will examine to what extent this advice has been taken into consideration in the jurisdictions of the Baltic countries.

Although the Baltic countries joined the EU simultaneously, a different approach towards the introduction of merger control was taken in each country. Estonia, for instance, as was stated above applied an 'invisible hand' policy until 2001. The Competition Law of 2001 empowered the Competition Board to prevent anti-competitive merger transactions. Thus, any efficiency issues were not applicable until 2001. In the Latvian jurisdiction, the Latvian Competition Authority applied very high thresholds for the challenging of merger transactions, where one of the pre-merger firms had to be in a domain of a dominant position. Thus, the Competition Council of Latvia had a jurisdiction over dominant firms

[508] This report was presented during the conference held in Paris and later published in the book OECD, Competition Law and Policy in the Baltic countries, 1999.

involved in a transaction. As a result of these high thresholds only about 4-5 cases per year were evaluated by the Council. Efficiency issues were not considered, but it can be asserted that there was a wide 'safety zone' in Latvia, as only the mergers between very large firms were challenged.

In contrast to Estonia and Latvia, the efficiency gains achievable through a merger transaction were recognised in the jurisdiction of Lithuania until 1999, however, not by the Competition Council of Lithuania but rather by the Lithuanian Government. *Lietuvos cukrus*[509], known as the sugar case illustrates one of the first examples of efficiency considerations in the Lithuanian jurisdiction. The owner of a sugar factory located in Lithuania proposed to acquire another three local sugar factories. The sugar market was highly concentrated in Lithuania at the time and there were only a few importers due to the high tariffs. The Competition Council of Lithuania completely rejected this transaction, which would lead to the creation of a dominant position and therefore would further increase concentration in an already concentrated market. However, the decision was overturned by the Government on the ground that this transaction would provide modernisation and would otherwise increase efficiencies. The legal ground was based on article 11 of the 1992 Law on Competition, which allowed the Government to annul the decision of the Competition Council, if a merger transaction would realise the efficiency gains and that these benefits would not be achieved in other ways except through the proposed transaction. As a result of this transaction, the consumers were left worse-off in comparison with a pre-merger situation. The consumers were forced to pay a higher price for sugar, because of the policy of the Government, which placed tariffs on import. As was mentioned in the 1999 OECD report, a merger of domestic firms is nearly almost pro-competitive, if there are no barriers to entry. Consideration of efficiencies in merger cases was a welcome factor; however, the interference of the Government, which might have other aims apart from the competition issues, was a negative aspect[510]. This provision was annulled by the Law on Competition of 1999.

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[509] 1998. For the comments on this case, see Annual Report, 1998.

[510] In the White Paper it was expressed that a strong emphasis should be placed on the requirement that competition authorities are independent and enjoy sufficient levels of resources and expertise to deal with competition issues. This is because the links with government may have a detrimental impact on the business community's acceptance of decisions. Also, there is a need for independence from undue political influence to prevent corruption.

6.2.2. Reasons of the lack of efficiency considerations in the Baltic countries

To date there is no statutory provision in the Competition Law in the Baltic countries, which would provide any consideration of efficiency gains in the appraisal of merger transactions. The question that might arise here is, why the Competition Authorities of the Baltic countries insofar have not introduced explicitly efficiency claims in their merger control regime. The researcher considers that the internal and external factors could have caused such a policy towards merger specific efficiency gains in the assessment of merger transactions in the Baltic countries.

As regards internal factors, one reason might be a very similar situation to the earlier EC policy towards efficiency claims. All three Competition Authorities in the Baltic states are 'young' institutions without sufficient experience and knowledge of how to deal with difficult future predictive analysis of a merger's effects on competition. This is because Estonia, Latvia and Lithuania as being a part of the Soviet Empire were centralised economies with a policy to set and control prices. This policy to control prices had to change almost overnight into the protection of competitive processes. For instance, the Competition Board of Estonia was re-organised from the Price Control office (otherwise the Price Board). The regulators, who worked at the old system, had to change and adopt a new system. Proos, a Deputy Director General, described the situation in Estonia in 1991, when the legal acts relating to prices and competition issues were drawn up by officials exercising the supervision of the Price Act together with ministerial officials. All of the officials did not have knowledge of basic principles of market economy, as they possessed a degree in law or economics that was obtained at so called Soviet time (Proos, 2002). Nakrosis, who studied the governmental capabilities to manage the EU matters, mainly in the case of Lithuania[511], also mentioned that the integration to the EU required huge reform efforts in the Baltic countries, including the establishment of new regulatory institutions and the development of new regulatory skills. The communist tradition as *'[..] everything that is not explicitly allowed is forbidden'* had to be changed.

[511] Lithuania (and Latvia) failed to be invited in 1997 to the first round of the EU accession negotiations.

Other problems that the Competition Authorities in the Baltic states faced, especially in their early days, was a lack of resources. The implementation and enforcement of the European legislation, including the competition law and policy, frequently required significant human and budgetary resources; it was often more than applicant countries[512] could afford (Nakrosis, 2003:111). The public sector was quite often incapable of recruiting and retaining qualified personnel. The best university graduates and officials from the civil service have had a preference of choosing better paid jobs in the private sector than lower paid jobs in public bodies[513]. For instance, the lawyers' offices charged for 3 hours the same amount of money that a medium employee of a public body could have received as one month salary. Hence, top lawyers were not interested to work in a government agency with low money (Proos, 2002).

Considering that examining efficiency gains is a rather difficult task and requires professional expertise, the Baltic countries presumably decided to exclude this provision due to the fact that they do not have sufficient knowledge and expertise in this area.

Furthermore, it can be stated that external factors have also had an influence on the competition law and policy in the Baltic states. One external factor is the EU harmonisation process and the implementation of the *acquis* in the jurisdictions of the Baltic countries. The Baltic states were eager to harmonise their competition law and policy as close as possible with the competition law and policy held by the Commission for the successful membership into the EU. The policy applied by the EC Commission towards efficiency defence was controversial before introducing the guidelines on the assessment of horizontal mergers and changes made to the ECMR in 2004. There was no explicit efficiency defence in merger cases and furthermore, on several occasions the Commission pointed out that efficiency considerations can be taken into account up to the level of dominance, as once the creation or strengthening of dominance was found, any efficiency issues were out of the question. The Competition Authorities of the Baltic states have been influenced by the EC competition policy and introduced policy similar to the previous Commission's position to focus on dominance. By the focus on dominance the researcher means that the first limb, i.e. the creation or

[512] Now new Member States, which joined the EU in 2004.
[513] Referring also to Competition Authorities of the Baltic countries, which are public bodies.

strengthening of a dominant position, was in a domain of a former EC substantive test leaving little attention to a second limb – the significant impediment of competition.

Apart from following the EC merger control policy, another reason for the focus on dominance might be the inheritance from the Soviet Empire of big ineffective dominant firms, which were controlled and subsidised by the State. The researcher presumes that this inheritance left the Baltic countries with the concern that 'big is bad'. However, this statement can be applied only for inefficient former Soviet companies, but in general cannot be true about all big firms. Referring to sound economic theories, especially with the emphasis on small market economies, the researcher argues that such a position is detrimental for Estonia, Latvia and Lithuania. These countries cannot afford to focus on dominance, because in some markets only one firm can support the market efficiently. Furthermore, the market of the Baltic countries can be considered as growing markets, thus, any local dominant firm today might not be dominant tomorrow due to foreign or local competitors, if there are no restraints to enter the market (Pukeliene, 2006).

The interviews held in the Competition Board of Estonia, the Competition Council of Latvia and the Competition Council of Lithuania showed that the regulators are familiar with the concept of 'efficiency', however, so far it has not been applied in practice[514]. In a few cases, the regulators of the Competition Authorities of the Baltic countries have defined the relevant market broader, instead of evaluating efficiency gains[515]. Also, the researcher discovered that some regulators are sceptical towards merger transactions referring to them as 'legalised cartels'[516]. This is because a merger implies the formal and complete integration of one firm into another, meanwhile, due to internal pressures cartels tend to disintegrate after a while. It could lead to the conclusion that since merger

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[514] To some extent efficiencies were considered in one case in Estonia. It will be further discussed in the section 6.2.4.

[515] See, for instance, Vesiga case, where the parties claimed the realisation of efficiencies through the transaction. However, instead taking efficiencies into account, the Competition Council of Lithuania defined a broad product market definition and as a result approved the transaction. This case will be further discussed in the section 6.4.1. Also see Malinauskaite, 2006.

[516] This position was expressed by the former board member of the Competition Council of Lithuania T.Klimas during the interview held on 5 October 2004 at the leading law firm in competition issues of Lithuania, Lydeika, Valiunas ir partneriai.

transactions are far more reaching, they should be prohibited *per se*[517]. Nonetheless, economists Lindsay (2003), Van den Bergh and Camesasca (2001) and many others expressively stated that in contrast to cartels, merger transactions may carry advantageous results for social welfare, for instance, through the realisation of efficiency gains. The following section will analyse substantive tests in the Baltic states and to what extent the efficiency gains are consistent with the current substantive tests in these countries.

6.2.3. Consistency of efficiency gains with the former substantive tests in the Baltic countries

6.2.3.1. Estonia

In order to reach a harmonisation with the EC policy, the Competition Authorities of the Baltic countries designed their substantive tests for the appraisal of concentration transactions on the EC substantive test. The wording of the substantive test introduced to these countries has been almost identical to the former EC substantive test. For instance, § 22 (2) of the Estonian Competition Act provides that a concentration shall be prohibited *'[..] if it may create or strengthen a dominant position as a result of which competition would be significantly restricted in the goods market'*. The wording of the substantive test for the appraisal of merger transactions places focus on dominance rather than on a merger's effects on competition. Likewise, the former substantive test of the ECMR was criticised by scholars for not allowing a practical scope for an efficiency defence, once the creation or strengthening of a dominant position is determined, the same applies to the Estonian substantive test for the appraisal of merger transactions.

Before the efficiencies were explicitly recognised in the EC jurisdiction, any efficiency considerations were examined under article 2 (1)(b), which stated that while examining concentrations other factors such as 'the development of technical and economic progress' should be taken into account. In consistency with the EC, § 22 (1) of the Estonian Competition Act states that appraisal of a

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[517] See Van den Bergh and Camesasca, 2001, pp. 307-308.

concentration shall be based on the need to maintain and develop competition, by taking into account the structure of goods markets and the actual and potential competition in the goods market[518]. The examples referred in this provision place emphasis mainly on static aspects rather than dynamic factors. This in turn may mean that unlike article 2 (1)(b) of the former ECMR, where efficiency issues could have be covered[519], § 22 (1) conceptually does not leave that room.

6.2.3.2. Latvia

The former substantive test in the Latvian jurisdiction provided that a merger transaction shall be prohibited if it *'[..] creates or strengthens a dominant position, which will significantly hinder, restrict, or distort competition in any relevant market'*[520]. The wording of this substantive test emphasised a dominant position, which would automatically hinder, restrict or distort competition. However, the creation of a dominant position was hardly possible, as only firms in a domain of a dominant position could get through the first filter and be challenged by the Competition Council of Latvia[521]. Thus, it can be asserted that despite not having an explicit efficiency defence, the Competition Council of Latvia incorporated a wide safety zone, as only very large merger transactions fell under the jurisdiction of Latvia.

6.2.3.3. Lithuania

Merger control policy by its nature proposes only a limited choice of decisions to influence competition, which are either the acceptance of the merger, or the rejection, or a comprise – the acceptance but on certain conditions, as, for instance, divestment. Similar to the EC policy, the jurisdictions of the Baltic countries also may issue three types of decisions as regards merger transactions.

[518] The examples of it include: (i) the market position of the parties to the concentration and their economic and financial power, and opportunities for competitors to access the goods market; (ii) legal or other barriers to entry into the goods market; (iii) supply and demand trends for the relevant goods; (iv) the interests of the buyers, sellers and ultimate consumers.
[519] Though not always successfully as discussed above.
[520] Section 16 para 3 of the Competition Law of 1998.
[521] One of the requirements for the notification was that one of the firms involved in a transaction had to be in a domain of a dominant position. See ch. 1.

The Competition Authorities of the Baltic states can approve a merger, they can also approve a so called conditional merger, which means that a merger is approved only if certain conditions set up the Competition Authority are met, and they can completely reject a merger transaction.

In contrast to the EC merger regime and the other Baltic countries, the substantive test in the Lithuanian jurisdiction is related to the three decisions of the Competition Council of Lithuania. Article 14 (1) provides that concentration may be approved without any conditions. The Competition Council of Lithuania may approve conditional concentration by imposing to its decision conditions and obligations for the parties involved *'[..] in order to prevent the creation or strengthening of a dominant position'*[522]. Finally, article 14 (3) provided that the Council may refuse to grant a permission, *'[..] where concentration will establish or strengthen a dominant position and result in a substantial restriction of competition in a relevant market'*. As it can be seen all provisions referred to the creation or strengthening of a dominant position. Hence, similar to Estonia and Latvia, the wording of the substantive test was not in favour of efficiency considerations and placed the focus on dominance.

The emphasis on dominance of the substantive tests for a merger appraisal in the Baltic countries contradicts Gal's theory, which states that solely focusing on dominance is mistaken especially, for the small market economies, where there are a limited number of market players and quite often the market can support only a limited number of firms. According to Gal (2003), merger transactions with efficiency impetuses even leading to monopoly might make markets more efficient, if the market can support only one player.

However, neither wording of the former substantive tests in the Baltic countries, nor the practice of applying them, by placing a focus on dominance left any room for the efficiency issues.

[522] See article 14 (2), Law on Competition of 1999.

6.2.4. Consistency of efficiency gains with the new substantive tests in the Baltic countries

As discussed in chapters 1 and 5, the Baltic countries showed an eagerness to join the EU and have attempted to go step-in-step with the EC policy, including the Competition policy. Changes made to the ECMR in 2004 spurred the Competition Authorities of the Baltic countries to review their merger control regimes. To ensure further harmonisation with the EU, the Competition Laws, particularly the substantive tests for merger appraisal, in the Latvian and Lithuanian jurisdictions have been changed. There have been no amendments in a substantive test for merger appraisal in the Estonian jurisdiction, and a dominance test is still applicable. However, the groups are currently working on amending the legislation on concentration provisions (Annual Report, 2004). Despite the absence of the efficiency defence in the jurisdiction of Estonia, to small extent efficiency issues were considered in the *Tallinna Piimatööstuse AS/ Meieri Tootmise AS* case[523]. In this case the Competition Board referring to the stricter EU requirements on dairy products, in its decision noted that investment was necessary to meet these requirements. Since, the compatibility of the merger transaction did not raise any serious doubts, the Competition Authority of Estonia did not analyse further the efficiency claims in more detail (Paas, 2005). This case expresses a positive approach towards efficiencies by the Board. However, it is not clear whether the same position would have been held if the case had anti-competitive effects as well as pro-competitive effects. Future practice and therefore the law will show, which policy will be chosen by the Competition Board of Estonia.

It can be contended that the current Latvian substantive test for the appraisal of concentrations is the most favourable to efficiency gains in comparison to the substantive tests of the other Baltic states. This is because the Latvian jurisdiction applies a combination of both dominance and SLC tests (Jefremova, 2004). Section 16 paragraph 3 of the Competition Law of Latvia states that the Competition Council of Latvia by its decision shall prohibit a

[523] Nr. 55-KO: koondumine Nr 12-ko/2002. Available in Estonian at web-site: http://www.konkurentsiamet.ee/dokumendid/ko2000255.htm (In Estonian).

merger transaction *'[..] as a result of which a dominant position is created or strengthened, or which may significantly reduce competition in any concrete market'*. According to the new substantive test of Latvia, a merger transaction can be prevented in the presence of either of the conditions: i) when a merger leads to the creation or strengthening of a dominant position, or ii) when a merger may reduce competition significantly. The notion of dominance was left, but nonetheless, the limb of SIEC has been lifted and gained an equal weight as a limb of dominance. Bearing in mind that there have been no further guidelines issued by the Competition Council to define the criteria in applying the new substantive test and no explicit efficiency defence exists, it is not clear how the test will be interpreted. Its efficiency will be tested in the years to come, when the Competition Council of Latvia will develop its approach in the application of the substantive test.

The past practice in Latvia proves that the focus was on dominance rather than on efficiency gains[524]. According to Lasmane (the official who deals directly with merger cases in the Competition Council of Latvia), once the creation or strengthening of dominance is found, any efficiency considerations are irrelevant (Lasmane, September, 2004). However, a different opinion was given by Jefremova, a board member of the Competition Council in Latvia. During the International Workshop on Competition Policy in Seoul in 2003 she mentioned that despite the absence of efficiency defence in Latvian law, the efficiency issues, nevertheless, can be considered in 'borderline' cases. The borderline cases have been defined as the situation, when there are concerns about the emergence of a dominant position by the merging parties, but it is not clear how the merger transaction will affect the competition and consumers. In this case the efficiency gains can be used to mitigate a finding of dominance if the merging entities fulfil two conditions. They have to prove that efficiency gains will be achieved through the merger and the benefits from the efficiency gains will be passed on to consumers[525]. However, there is no written provision in the Competition Law of Latvia as regards these rules for the assessment of efficiency gains. Furthermore, there have been no cases in so far in the jurisdiction of Latvia, where the merger–

[524] The statement relied on the information obtained during the interviews held in September-October, 2004 at the Competition Council of Latvia.
[525] See the speech delivered by T.Jefremova, during the International Workshop on Competition Policy in Seoul, 29 April – 3 May, 2003.

specific efficiency gain would be considered. Nonetheless, theoretically, this policy towards the interpretation of efficiencies in the Latvian jurisdiction can be referred to 'integrated approach' as discussed above, where a dominant position would not be created or strengthened, as efficiency gains help to mitigate a finding of dominance. This approach was criticised by Lowe for its limited scope, as it is conceptually difficult for merging entity to challenge that efficiency would stop them from having the ability to act on the market without being effectively constrained by others, or otherwise influence price, production or innovation (Lowe, October, 2002).

Furthermore, the researcher considers that such an approach vis-à-vis efficiency claims is inappropriate for the Latvian jurisdiction because of the following reasons. First of all, this approach places an unnecessary burden on the merging parties and on the Competition Council of Latvia, which do not have sufficient practice in applying merger control rules. Secondly, this approach does not provide enough transparency, for instance, what are the criteria of the evaluation of efficiency issues in the merger cases. Transparency is very important for the Baltic countries, which have additional informative and educative competition goal to teach society about the principles of fair competition. Also, lack of transparency may lead towards corruption. An example here might be the situation in the jurisdiction of Lithuania as discussed in chapter 3.

In response to the modernisation of the EC substantive test for the appraisal of merger transactions, the Competition Council of Lithuania has also modified the substantive test. The substantive test in the Lithuanian jurisdiction as aforementioned is related to three decisions of the Competition Council of Lithuania: approval, conditional approval and prohibition of a proposed transaction. The legal text of article 14 (3) has been amended and now provides that the Competition Council of Lithuania may refuse to approve concentration, *'[..] where concentration will establish or strengthen a dominant position or substantially restrict competition in a relevant market'.* The wording of this test (which is similar to the modified Latvian substantive test) enables to check transaction on either of two conditions: (i) whether it creates or strengthens a dominant position; or (ii) whether it substantially restricts competition in a relevant market. It can be contended that the efficiency issues may be considered under the second part of the test. This change is welcome, however, it does not give enough clarity, as article 14 (2) was left unchanged, which states that the Competition Council may impose the conditions and obligations for the parties involved in order to prevent the creation or strengthening of a dominant position[526]. This provision clearly emphasises the focus on dominance. After the last modification in 2005, the Competition Council of Lithuania has amended the explanations concerning the establishment of a dominant position[527]. While assessing the creation of a dominant position through merger transactions, the Competition Council may take into consideration the *'[..] well-grounded explanations of the undertakings concerning the efficiencies that are beneficial to consumers, are an integral part of the merger and are verifiable'*[528]. The influence of the EC guidelines can be seen here; however, the Competition Council does not explain these conditions further. Nevertheless, it shows that the Competition Authority of Lithuania like Latvia may consider efficiency issues in order to mitigate a finding of dominance, which, as discussed above, is not the most 'appropriate' approach for the Baltic countries. Furthermore, if the interpretation of the modified substantive tests in Latvia and Lithuania is used as defined by Riesenkampft[529], the emphasis will still be on dominance, despite the changes in the substantive tests. Following the Riesenkampft reasoning, any efficiency gains will not be evaluated under the SIEC limb once dominance is found. Any efficiency issues can be considered only by a means of mitigating finding of dominance. To conclude, the Baltic countries (namely Latvia and Lithuania) should follow the Fountoukakos and Ryan's (2005) interpretation and place the emphasis on the SIEC limb[530] (referring to the second part of the substantive tests in Latvia and Lithuania).

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[526] See article 14 (2), Law on Competition of 1999.

[527] Resolution No.17 on the Explanations of the Competition Council concerning the establishment of a dominant position, 17 May 2000.

[528] *Ibid*, Fn. 525, para 38.

[529] As discussed in chapter 1, section 1.2.7.3., where Riesenkampft referred that the same standard for the assessment of merger transactions can be used in the future. If it is the case that a merger creates or strengthens a dominant position, a significant impediment to competition can be assumed without further examination.

[530] For further discussion, see chapter 1, section 1.2.7.3.

From written provisions on the substantive issues as discussed above, the conclusion that can be made is that in contrast to the EC approach, which employs both positive and negative approach of merger's effects on competition[531], the Baltic countries adopt a negative approach towards merger transactions. This negative approach may mean that the Baltic countries are reluctant to admit pro-competitive effects of merger transactions on competition.

In consensus with Mano (2002), the researcher considers that the lack of efficiency considerations can be logically interpreted as a sign that the merger control regimes in the Baltic countries are orientated towards dominance or market power rather than efficiency enhancing. As result of this logic it might be predisposed that the regulators of the Competition Authorities mistreat the possibilities of the pro-competitive effects that merger transactions can provide and look suspiciously at the effects of the mergers on competition.

6.2.5. Efficiency defence in other jurisdictions

The efficiency defence is explicitly recognised in other jurisdictions. In the UK together with the Enterprises Act of 2002 the Guidelines of merger assessment was introduced, which has explicit rules on merger specific efficiency gains. Efficiency defence is also recognised in other jurisdictions such as Spain, France and others. Apart from old Member States, some new Member States also have efficiency defence. The most suitable example to compare with the Baltic countries might be Malta, which like the Baltic countries joined the EU on 1 May 2004. Also, as with Estonia, Latvia and Lithuania, Malta refers to a small market economy. The difference is that the smallness of Malta is defined by the geographic conditions (as well as the population), meanwhile, the Baltic states were land 'islands' because of political reasons.

In contrast to the Baltic countries, which have a compact Competition Law or Competition Act in the case of Estonia, that contain all competition rules including merger control regime, the Maltese jurisdiction has a Merger Control

[531] See art. 2 (2) and 2 (3) of the ECMR No. 139/2004.

Regulation[532], which came into force on 1 January 2003. The Maltese Merger Regulation allows two types of merger defence: (i) efficiency defence; and (ii) a failing firm defence. They were both introduced into the jurisdiction of Malta even before the EC guidelines on horizontal merger assessment came into force.

In the Maltese jurisdiction the merging firms may claim that efficiencies achieved through a merger would ultimately offset any anti-competitive effects, if the efficiency gains would ensure that the price is maintained at or below the pre-merger level. Three criteria must be satisfied for such a defence to succeed and get approval from the Office for Fair Competition, which is the Competition Authority of Malta. The first criterion is that the efficiencies must be verifiable, as the more verifiable efficiencies are, the more likely the Office for Fair Competition would uphold the defence. It means that not all types of efficiencies will be approved. For instance, productive efficiencies, such as the reduction of production costs would be more effective than efficiency claims by the merging parties based on improved management, since the latter is considered less verifiable (Buttigieg, Spring, 2003:45-46). The second criterion similar to the EC or other jurisdictions is that efficiency must be merger specific by meaning that efficiency gains cannot be achieved by other means. The third criterion is so called 'pass-on requirement' that is designed to take into account only those efficiencies, which are passed on to consumers in Malta in the form of lower price, or in the form of innovation, choice or quality of products/services, if the price remains the same or even if slightly increased in the short term[533]. The last criterion shows that like in the EC or even US jurisdictions (on which the Maltese efficiency defence was modelled), the Maltese jurisdiction also addresses the consumer welfare standard rather than total welfare standard in assessing merger transactions. The Guidelines accompany the Regulation on control of concentrations, which further explain the various types of efficiencies that the Office for Fair competition would consider in merger cases.

Hence, the Maltese jurisdiction introduced explicit efficiency consideration in the assessment of merger transactions. Taking as an example the

[532] Regulation on Control of Concentrations 2002, LN 294 of 2002. Before the regulation came into force, Malta did not have a proper merger control regime. Any merger transactions were, albeit often unsuccessfully covered by the provision of the abuse of a dominant position.

[533] See comments of Buttigieg on the regulation, The Substantive Standard for Merger Evaluation in Malta, Bank of Valletta Review, No. 27, Spring 2003.

other jurisdictions, the Baltic states should also consider introducing explicit efficiency gains in their jurisdictions, which will give more certainty and transparency.

6.3. Market power and the theory of harm from a legal perspective

As was mentioned in chapter 4, a market power for anti-competitive purpose matters, because if a firm obtains a market power, it has an ability to maintain prices significantly above the competitive level for a sustained period of time. In order to measure market power created through merger transactions for competition policy, the Commission has developed a methodology. It involves defining the relevant market, which consists of geographical and product markets, then assessing possible anti-competitive effects and finally any counter-balance effects, such as buyer power and new entry barriers etc.[534] The market definition plays an essential role in the merger control regime: the wider product and geographical market definitions are used, the less likely that the merger transactions will be considered as problematic. The substantive test is a cornerstone of the merger control regime, as it sets up criteria, which merger transactions should be prohibited and which can go ahead. The following sections will analyse all these issues specifically.

6.3.1. Market definition within the EC

Market definition is described by the Commission as a tool to identify and define the boundaries of competition between the firms; otherwise, market definition determines the framework in which the analysis of a merger transaction's effects on competition will be carried out[535]. According to the Commission's notice on relevant market, the main purpose of market definition is to identify in a systematic way the competitive constraints that the firms involved in the merger face by determining the actual competitors that are capable of

[534] The following sections do not distinguish different types of mergers, as the same market definition and substantive test are applied to all mergers regardless of form. Although different theory of harm is applied for each merger type, the Commission has issued insofar only Guidelines on horizontal mergers.

[535] See the Commission Notice on the definition of relevant market for the purposes of Community competition law (97/C 372/03) at the para 2.

constraining the behaviour of undertakings in question and to prevent them from behaving independently of effective competition pressure. It is because the exercise of market power depends on the extent to which firms are able to raise prices above the competitive level, which may be directly measured by using the own-price elasticity of demand facing the firm[536]. There is an interest of undertakings to understand how the Commission or the national competition authorities define the markets, as they can predict whether there is a risk for their transaction being prohibited.

While assessing a merger case, a relevant market has to be defined as a combination of geographic market and product market. The benchmark criterion to define relevant product market was formulated before the Commission issued the Notice on market definition by the ECJ in the *Continental Can* case[537], by stating that *'[..] the possibilities of competition can only be judged in relation to those characteristics of the products in question by virtue of which those products are particularly apt to satisfy an inelastic need, and are only to a limited extent interchangeable with other products'*. In 1979 the Commission issued the Notice on Market definition, which defines a relevant product market as a market including all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the characteristics of the products/services, their prices and their intended use[538]. In the *United Brands* case[539], the ECJ stated that geographic market definition is the *'[..] geographic area in which it is marketed and where the conditions of competition are sufficiently homogeneous for the effect of the economic power of the undertaking concerned to be able to be evaluated'*. According to Lindsay (2003), a geographic market definition is very similar to a product market definition due to the products/services' characteristics, which include the location. This means that physically identical products/services can be seen in different locations as different economic products. Thus, a relevant geographic market combines the area, in which the parties concerned are involved in the supplying and demanding of products and/or services, in which the competition's conditions are sufficiently

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[536] OJ C 372, 97/C 372/03, I, 4.2.1. See also comments on the market definition by Camesasca, 1999, pp. 89-95.
[537] *Continental Can / Commission*, case 27/76, E.C.R. 1978, pp. 207.
[538] OJ C 372, 97/C 372/03, at the para 7. See also *United Brands / Commission* case 27/76 E.C.R. 1978, *Hoffman-La Roche / Commission* (Vitamins) case 85/76, E.C.R. 1979 etc.
[539] *United Brands / Commission*, case 27/76, E.C.R. 1978, the para 11.

homogeneous, and which can be distinguished from neighbourhood areas because the competition's conditions are appreciably different in those areas[540]. These market definitions provide general legal principles and are open to interpretation. According to Navarro et al. (2004:para 5.12-5.13), these definitions on their own provide very little guidelines, to the meaning of relevant market, and the criteria, and evidence on which the Commission places its decisions when defining markets in practice. Hence, the Commission has a room to develop these definitions through the cases and give them a working meaning. For instance, the Notice does not provide: what does constitute a barrier to entry, the manner in which international comparisons of prices should be assessed in order to measure differences, and at what point these differences are significant. All these questions are significant for defining the relevant market definition in a given case (Navarro et al., 2004:para 5.13).

For the Commission's Notice on the market definition there are three main aspects, demand-side substitutability, supply-side substitutability and potential competition to define market. In the demand-side substitutability the Commission uses a test known among economists as the SSNIP test otherwise 'hypothetical monopolist test'. The SSNIP stands for **s**mall but **s**ignificant **n**on-transitory **i**ncrease in **p**rice, as it examines how consumers would react to a hypothetically small but not insignificant permanent price rise, which is defined as a range from 5 to 10%. The emphasis of the demand-side substitutability is on the ability of the customers to switch to alternatives in response to a significant price increase. For instance, in the *Du Point / ICI* case[541], the Commission stated that for two products to be regarded as substitutes the direct consumer *'[..] must consider it a realistic and rational possibility to react to, for example, a significant increase in the price of one product by switching in a relatively short period of time'*. As it can be seen there is no precise measurement, as for instance, a time period[542].

The Commission in its Notice on Market Definition systemised the criteria to be followed in defining the product market definition. These include functional

540 OJ C 372, 97/C 372/03, at the para 8.
541 Case IV/M 214, 1992 OJ L 7/13, at the para 23.
542 Compare with the US Guidelines, the Authorities defined the consumers' reaction within one year. This approach has been criticised by some scholars, as different implications occur in different economic sectors. For instance, the shoes and aircraft markets are different where the orders of the latter are planned for several years ahead. For further comments, see Navarro et al., 2005, at paras 5.33-5.39.

substitutability, evidence of substitution in the recent past, use and characteristics of products, consumer preferences, barriers and costs that limit or impede effective substitution, quantitative criteria, and different categories of clients and captive clients, and price discrimination. While defining the relevant product market, the Commission may rely on the physical characteristics and functionality of the products involved (Cook and Kerse, 2000:135). Physical characteristics may embrace speed of operation, level of performance, diversity of application and many other factors. However, if the products perform the same functions it does not necessarily mean that they belong to one and the same product market. The sole focus on functional substitutability may lead to the wrong result. For example, the Commission in *Nestle / Perrier* case[543] rejected the arguments of the merging parties that mineral water and all remaining non-alcoholic drinks can be defined as one market, i.e. to quench thirst. The Commission stated that partial functional substitutability alone is not sufficient to establish substitutability in competition terms. This position was expressed in a number of the cases[544], the most recent being the *Newscorp / Telepiu* case[545], where the pay TV and free-to-air TV were defined as two separate markets.

As regards geographic market definition, depending upon the product/service in question, a wide range of factors may be relevant in order to determine a geographic market. The Commission commonly refers to the following factors: comparative prices, trade patterns, location and identity of suppliers and purchasers, consumer preference and national demand characteristics, the nature of products/services concerned, entry barriers, supply conditions, transport costs, and other regulatory factors. Despite the EC Commission's single market programme, the scholars admit that the Community market is not yet fully integrated and as a result the relevant geographic market for certain products are still national in scope. Also, there are trends established in the EC of a geographic market depending on sector. For instance, Cook and Kerse (2000:140) argue that the Commission tends to regard the food and retailing

[543] Case IV/M 190, [1992] OJ L 356/1.
[544] See also cases *Coca – Cola Enterprises / Amalgamated Beverages Great Britain*, case IV/M 794, [1997]; *Solvay / Wienerberger*, case IV/M 565, [1995]; *Dalgety / The Quaker Oats Company*, case IV/M 554, [1995]; *Nordic Satellite Distribution* case IV/M 490, [1995]; *Cable and Wireless / Veba* case IV/M 618, [1995] and others, where the Commission has defined the markets narrower than based only on functionality.
[545] Case COMP/M 2876, [2004], OJ L 110/73.

sectors as regional or even local markets. It may be illustrated by the *Tesco / Catteau* case, where it was stated that *'[..] supermarkets draw customers from a local catchments area'*[546].

Both market definitions are considered by the ECJ as a necessary pre-condition for any assessment of the effect of a merger transaction[547]. However, despite the fact that a market definition is a very important starting point for a competitive assessment, it is not an end in itself. Monti, the competition commissioner by pointing out the importance of the definition mentioned that *'[..] market definition is not an end in itself but a tool to identify situations where there might be competition concerns [..].We use market definition and market shares as an easily available proxy for the measurement of the market power enjoyed by firms. [..] What is ultimately important is to understand the nature of the competitive situation facing the firms involved in a [..] proposed merger. The market definition is a first - and very important – step in the analysis'*[548]. Hence, the market definition is an important step in the analysis of a merger transaction, and incorrect market definition will lead to misleading analysis of the impact of a merger transaction on competition. For instance, if markets are defined too narrowly, the mergers which do not harm or even may benefit consumers may be prohibited; or on the contrary if markets are defined too widely, the merger transactions which harm consumers may be cleared.

The Commission is not bound to follow its previous decisions as regards market definition and it may differ depending on the activities of the merging parties or the effects of the merger transaction (Lindsay, 2003). For instance, in the *Industri Kapital (Nordkem) / Dyno* case[549] the Commission defined the geographic market for the analysis based on the area of the activities of the parties involved, which was regional[550]. Quite often the Commission leaves the question

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546 C.M.L.R. 402 [1993].

547 See, for instance, case T-2/93 *Air France / Commission* [1994] E.C.R. II-323 (at the para 80); joined cases C-68/94 and C-30/95 *France / Commission* [1998] E.C.R. I-1375 (at the para 143); or case T-342/99 *Airtours plc / Commission* [2002] (at the para 19).

548 The speech by Monti, Market Definition as a cornerstone of EU Competition Policy, delivered on the 5th of October, 2001, available at the web-site: http:/europa.eu.int/comm/competition/speeches/index_2001.html

549 Case COMP/M. 1813, [2001] O.J. L154/41. See also comments on this case by Lindsay (2003), pp. 70.

550 For the examples of how the market definition may differ depending on the activities of the merging entities or the effects of the merger transactions, see Lindsay, The EC Merger Regulation: Substantive Issues, Sweet & Maxwell, 2003, pp. 68-70.

of the market definition open. In his speech the competition commissioner Monti (2001) expressed that the market definition is defined only when it is strictly necessary due to limited resources and *'[..] if none of the conceivable alternative market definitions for the operation in question give rise to competition concerns, the question of market definition will normally be left open'*[551]. A few cases provide a good example of this approach, where the Commission concluded that there was no need to define a market definition, as a transaction nevertheless would be compatible without having to adopt a definitive conclusion about the extent and the limits of the market. For instance, in the *Compaq / Tandem* case[552] the Commission left open the product market definition, since it did not create any competition problems, as the joint market share of both companies was minimal[553]. In the *Sara Lee / BP Food* case[554] it was stated that bearing in mind small market shares of CFBG (i.e. the food division of BP which was acquired by Sara Lee) even under the narrowest possible market definition, the transaction would not create or reinforce a dominant position. There have been several cases[555] where the market definition question was left open due to the opposite reason, as under any alternatives being considered, a transaction would lead to the creation of a dominant position (as a dominance test was applied at that time) (Navarro et al., 2004: para 5.17).

The Commission has often been criticised for defining the markets too narrowly. It may be recalled that in the Nordic cases, discussed in chapter 5, the parties had argued that the geographic market was the whole EEC. However, the Commission took a view that the market is national rather the EEC.

6.3.2. The substantive test of the EC and market power

The former substantive test for the appraisal of merger cases applied in the EC as aforementioned was a dominance test. The dominance test was a two-tier

551 *Ibid*, Fn. 43.
552 Case IV/M963, 1997.
553 The market definition was left open in the following cases, see for instance, *Georg Fisher / Disa* case IV/M 1009, 1998; *Nestle / San Pelligrino* case IV/M 1065, 1998; *Basf / Shell* case IV/M 1041, 1997; *BP / Hoels* case IV/M 1078, 1998; *Dow Jones / NBC-CNBC Europe* case IV/M 1081, 1998 etc. For the comments on the cases, see Navarro et al., 2005, at paras 5.08-5.18.
554 Case 4 C.M.L.R. 23, 1993. for the comments, see Cook and Kerse, 2000, pp.133.
555 See for instance, *Exxon / Mobil* case IV/M 1383, 1999; and *Astra Zeneca / Novartis* case IV/M 1806, 2000.

test with two limbs implied, namely the creation or strengthening of a dominant position and a subsequent finding of significant impediment of competition. In practice, according to the old article 2 (3), a merger transaction would be challenged if it was likely that the merged entity would have a 'dominant position' in the market, where a firm in a domain of a dominant position has been generally defined as the firm with the largest market share. Hence, according to the former substantive test, the creation or strengthening of a dominant position was a dominant criterion for challenging merger transactions otherwise it was a 'legal straight-jacket' that all competitive scenarios must wear.

During the review of the ECMR in the 2001 Green Paper the discussion was launched on the merits of the dominance test, whether there should be a move from the dominance test to the SLC. The major concern was the 'gaps' left in the former dominance test. As was mentioned above, the first condition, the creation or strengthening of a dominant position played a major role giving the second condition (a significant impediment of competition) less importance, otherwise, without the first condition being met, the second condition could hardly be used to challenge a merger transaction. The new substantive test of the 2004 ECMR lifted the second condition to the major importance. Hence, the focus now is not on dominance, but rather on a 'significant impediment of competition'. The creation or strengthening of a dominant position is now referred as an example of a significant impediment of competition[556].

6.3.3. Theory of harm

6.3.3.1. Overview

Chapter 4 analysed possible anti-competitive effects of a merger transaction acknowledged in the economic literature. These are unilateral effects and co-ordinated effects. Unilateral effects result in the situation, where a merger allows the merged entity by eliminating the competitive restraints to increase its prices regardless of the response of the remaining firms. Meanwhile, co-ordinated

[556] The further discussion of the new substantive test was provided in the section 6.1.3.2.1. and chapter 1.

effects occur where a merger transaction creates a more favourable environment for tacit collusion.

The EC Guidelines on the assessment of horizontal merger has departed from this traditional categorisation and presented three types of potential effects instead of the traditional two. The Commission has introduced a new definition of a paramount market position, where a merger is said to create or strengthen a paramount market position, if as a result of the transaction the merged entity enjoys a very large market share and a considerable market share advantage over rival firms. The second category is defined by the Commission as 'non-collusive oligopolies', which applies in a situation where the merged entity will have market power notwithstanding that it will not hold a paramount market position. For instance, when the merging entities do not hold the largest market share, but the merger nevertheless is between suppliers of differentiated products, which are regarded by consumers as close substitutes or between suppliers whose competitors are capacity-constrained. Since both categories may cause unilateral effects and for economists[557] is considered identical (as whether the merged entity will have the power profitably to reduce value for money, choice or innovation through its own acts without the need for a co-operative response from rivals), the researcher considers that further analysis by distinguishing into two groups rather than one is unnecessary and might only lead to the confusion for the Competition Authorities of the Baltic countries. The final category refers to collective dominance, as a merger having co-ordinated effects.

As there are differences in the assessment of unilateral effects and co-ordinated effects due to different factors being taken into account, these effects will be further discussed separately.

6.3.3.2. Single dominance. The EC case

The former substantive test for merger appraisal was strongly linked to the concept of dominance as set out in article 82 of the Treaty. The definition of dominance in application to article 82 was defined by the ECJ in *Hoffman / La*

[557] See for instance, comments on unilateral effects by Lindsay (2003), pp.146.

Roche case[558], which was also referred with regards to the ECMR in further cases, by stating that a dominant position relates to *'[..] a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained in the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of the consumers'*. Hence, the essential element of dominance is an ability to act independently of the competitors and consumers, otherwise, be free from the pressure imposed by competition as regards price, quality and conditions of business. However, while article 82 focuses on structure leading to abuse, the Merger Regulation concentrates on the future structure of a market alone, and the potential for competition following the concentration. Bearing in mind that a more dynamic analysis is more appropriate in the ECMR context, a dominance concept should be associated with more obviously effects-related criteria contained in the SIEC limb (the second limb referring to the former substantive test) (Fountoukakos and Ryan, 2005:280). The language of the dominance test and the involvement of article 82 thereof resulted occasionally in a perception of the Commission's approach by which its merger decisions were too concerned with static, legalistic factors and less with dynamic otherwise economic factors (Fountoukakos and Ryan, 2005). By placing the emphasis on SIEC limbs the new substantive test solved these inadequacies. The Explanatory Memorandum explained further that the modernisation of the ECMR *'[..] has the additional advantage of not linking the definition of dominance under the Merger Regulation to any further interpretations given by the ECJ to the concept of dominance under Article 82 of the Treaty'*.

With regard to the assessment of dominance Goyder (2003:361-362) defines several factors in order to assess a degree of dominance in any particular market. The first factor is the aggregate of the market shares that the merged entity would have after the transaction provided they are durable in nature rather than temporary. While assessing the market, the concept of dominance has to seek the balance between the existing facts and likely future developments. Although the EC does not provide the particular market shares, from the recitals it seems

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558 Case 85/76 [1979] E.C.R. 461 para 38. See also case 27/76 *United Brands / Commission* [1978] E.C.R. 207 at the para 65; Case T-30/89 *Hilti / Commission* [1991] E.C.R. II-1439 (at the para 90); or Case T-102/96 *Gencor / Commission* [1999] E.C.R II-753 (at the para 200).

that a combined share of less than 25% does not raise a presumption of dominance. However, if the share reaches 40% and increases up to 65% or even 70%, then it may be difficult to refute unless in extremely unusual circumstances like, for instance, in the *Alcatel* case[559], where the Commission authorised the creation of a firms with a post merger market share of 83%[560]. In *AKZO* case[561] an undertaking holding a market share of 50% was held to have a dominant position by the ECJ. Although, as the EC practice shows, undertakings with a market share of 40% or 50% are as a rough rule of thumb presumed to be dominant, the competition commissioner Kroes emphasises that high market shares are not on their own significant to conclude that a dominant position exists and therefore risks failing to take proper account of the degree to which competitors can constrain the behaviour of the allegedly dominant undertakings (Kroes, 2005). Hence, in assessing dominance the Commission will conduct a detailed analysis consisting of the market position of the allegedly dominant firm, the market position of competitors, barriers to expansion and entry and the market position of buyers (Kroes, 2005). Thus, the second criterion in Goyder's classification the relationship of the market share of the merging entity and its competitors is also another important factor. Apart from that, other factors would have to be examined as in relation to the respective strengths of the firms, such as an individual product range, the quality of their R & D in a technical industry, the strength of the customer base and the way in which market shares had developed in the past.

The third factor is based on industries, as more traditional industries may show a marked degree of stability. Namely, in industries that are subject to innovation and/or R & D, market shares are likely to vary and are a less certain indicator of a market power. On the contrary, in the market, such as in *Tetra Pak/Alfa-Laval* [562] case a market share exceeding 90% was maintained consistently for a considerable number of years supported by a wide range of technological advantages over all its competitors.

[559] Case IV/M0422, [1991] 4 CMLR 778.
[560] It is primarily because of the existence of countervailing buyer power as well as the ability of competitors to increase supply to the merged entity.
[561] *AKZO / Commission* [1991] ECR 1-3359.
[562] Case IV/M68 [1992] 4 CMLR M81.

Fourthly, other commercial strengths can also play a role, such as intellectual property rights, over-capacities in neighbouring markets, the forecast of likely product demand and changing patterns of raw material supply and the changes in technical standards and so on[563].

6.3.3.3. Collective dominance. The EC case

The concept of the term 'collective dominance' was not explicitly covered by the wording of the old EC Merger Regulation. Article 2(3) of the former substantive test prohibits the creation or strengthening of a dominant position, which from its use of the words prima facie appears to suggest that the Regulation applies to single dominance rather than collective dominance (Motta, 2000). Nevertheless, the Commission's recognition to apply 'dominance' flexibly was evident in the case law, where the concept was attempted to extend to the notion of joint or collective dominance. The concept of collective dominance was developing throughout the 1990s in parallel with the evolution of the same concept under article 82, which allowed the Commission to intervene against the mergers leading to oligopolistic market structures (Fountoukakos and Ryan, 2005:281). The first to bring the applicability of the Regulation to the creation or strengthening of a dominant position by collectively two or more firms was the *Nestle / Perrier* case[564]. The application of the concept of collective dominance to the Regulation was also acknowledged by the ECJ in the *France* v *Commissioner* case[565], where the court stated *'[..] the applicants' submission to the effect that the choice of legal bases in itself mitigates in favour of the arguments that the Regulation does not apply to the collective dominant positions cannot be accepted'*. Hence, the collective dominance in the EC law has been developed through the case study.

Collective dominance may arise in the situation, where considering the actual characteristics of the relevant market and the changes in its structure that the merger transaction would entail, the alteration of market structure would make each member of the dominant oligopoly; as it becomes aware of common

[563] For further reading, see Goyder, 2003, pp. 361-363.
[564] M. 190 [1992] OJ C 53.
[565] Cases C68/94 and 30/95 [1995] 4CMLR 829.

interests, consider it possible, economically rational, and preferable, to adopt on a lasting basis a common policy on the market with the aim to sell at above competitive prices, without entering in agreement [566]. Furthermore, the commissioner, Monti (2000)[567], also gave a definition that can be considered as collective dominance. He stated that *'[..] the presence of such factors increases the likelihood that major market players monitor each other's behaviour, detect deviation from tacitly agreed price and retaliate against the one who deviates'.*

As regards the criteria for finding a collective dominance, in the *Gencor / Lonrho* case[568] the Commission mentioned that structural links between the market parties were not essential for finding collective dominance and it was sufficient if links of an economic nature, as to whether the economic conditions of the market lead the firms to co-ordinate their behaviour, was established. Also, in this case the Commission identified the characteristics of an oligopolistic market, such as high concentration, homogeneous products and maturity level of products, transparency of prices and capacity, high barriers to enter and growth, stable demand and modest growth, absence of buyer power, symmetry of market shares and costs structures. However, a high level of concentration is not in itself a sufficient factor to determine the existence of collective dominance[569]. As a general rule of thumb, the Commission is reluctant to pursue a theory of collective dominance if the relevant market is characterised by the existence of more than six market players in a pre-merger situation. For instance, in the *Price Waterhouse / Coopers & Lybrand* case[570] the Commission stated *'[..] from a general viewpoint, collective dominance involving more than three or four suppliers is unlikely simply because of the complexity of the interrelationships involved, and the consequent temptation to deviate'.* Hence, a safe harbour situation can be assumed when more than six market players have a combined market share of less than 60 to 70% (Dethmers, 2005). Despite having all these factors as presented in *Gencor / Lonrho* case, the oligopolistic conduct can barely occur pursuant to economists in the absence of some mechanism for co-ordination. In the appeal of

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566 See *Airtours / Commission*, case T-342/99 at the para 61; also see *Gencor / Lonrho* case T-102/96 at the paras 276 and 277.
567 Speech delivered at the EC Merger Control 10th Anniversary Conference, Brussels, 14-15 September, 2000.
568 Case IV/M 619.
569 See Court's position expressed in Kali and Salz case.
570 Case COMP/M. 1016, at the para 72.

the *Airtour* judgement, the Court pointed out the need for the Commission to establish the existence of a credible monitoring and retaliation mechanism. Three conditions were set out in this case as a requirement to prove the finding of collective dominance. The first condition is a market transparency, as each party of the dominant oligopoly must have the ability to know the other party's behaviour. The second condition is that the tacit co-ordination must be sustainable over time. The third condition is that the foreseeable reaction of current and future competitors and consumers should not be able to jeopardise the common policy.

However, as discussed in chapter 4, unlike with unilateral effects, the economists have not been able to provide econometric techniques for the assessment of collective dominance. No economic or analytical techniques are available that can predict with certainty the propensity of firms to collude in a market (Kuhn, Kai-Uwe, 2002). According to Dethmers (2005:644), lack of detailed economic analysis on collective dominance is evident from the fact that the Commission has never applied any detailed econometric techniques to assess collective dominance in so far with the exception of the *Sony / BMG* case[571].

The lack of a systematic and consistent approach of the EC towards a collective dominance was the target of many critical comments. The question was raised whether the dominance test can be applied to mergers producing non-co-ordinated (or unilateral) effects in situations of oligopoly. A stretch of the plain meaning of the concept of dominance was widely objected due to its legal uncertainty associated with a definition of dominance that could be stretched without the limit. The lack of clarity in the application of unilateral effects in oligopoly situations raised concern that the Commission could use such analysis in an opportunistic manner (Horner, 2006:29). The Commission was criticised for leaving the 'gap' in the identification of collective dominance. Nonetheless,

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[571] Case COMP/M. 3333, 2004, at the paras 69-74. In this case the combined market shares of oligopolists exceed 70 to 90% of the relevant market and were considered as a five-to-four merger (four-to-three in Greece). Here, the Commission scrutinised whether any price co-ordination, on the basis of a parallelism in average price, could have been reached in using list prices as a focus. Further examination involved the different majors' discounts, whether they were aligned and sufficiently transparent as to allow monitoring of any price co-ordination on the level of net price. After that, the Commission looked at a list-price/net-price correlation analysis. Finally, the Commission examined the potential variations in discounts on price and came to the conclusion that the indications to identify the co-ordinated behaviour were insufficient to establish the existence of a collective dominance.

Dethmers (2005, 640-641) and other scholars stated that the new ECMR and the Guidelines now close the 'gap'; as the two theories of harm are defined in the Guidelines, namely unilateral and co-ordinated effects, enabling the Commission to assess individual dominance, collusive collective dominance and non-collusive oligopolies (referring to unilateral effects). According to paragraph 41 of the Guidelines *'[..] coordination is more likely to emerge in markets where it is relatively simple to reach a common understanding on the terms of coordination'*. In addition, like in the *Airtours* judgement, the Guidelines set out three conditions for co-ordination to be sustainable. However, in contrast to *Airtours*, the Guidelines provided a non-exhaustive list of factors which could be indicative of unilateral effects. The examples include large market shares, the degree of substitutability of competitors' products, limited switching possibilities, limited possibilities of increased supply, barriers to entry and the elimination of a competitive constraint (Guidelines, paras 27-37)[572].

Co-ordinated and unilateral effects encompass the totality of possible anti-competitive effects flowing from a merger, hence, the new substantive test closes any perceived 'gap' and therefore should be able to cover all anti-competitive merger scenarios.

6.4. Market power and the theory of harm in the Baltic countries

6.4.1. Market definition within the Baltic countries

As discussed above the Commission's Notice on the market definition establishes very general principles. Also, the practice proves that the Commission quite often does not define a market and leaves it open. It means there is a wide scope left for the national competition authorities to define market definitions. This section will show how the Competition Authorities of the Baltic countries are dealing with the task of defining the markets. In consistency with the policy of the EC, the Competition Authorities in the Baltic countries except Estonia also have a market definition consisting of two parts. It is a product market and geographic market.

[572] For further comments, see Horner, 2006.

In contrast to the EC policy and other Baltic countries, the Estonian Competition Act has one definition of the goods market to combine both product and geographic markets. § 3 of the Estonian Competition Act provides a definition of the goods market as *'[..] an area covering, inter alia, the whole of the territory of Estonia or a part thereof where goods which are regarded as interchangeable or substitutable (hereinafter substitutable) by the buyer by reason of price, quality, technical characteristics, conditions of sale or use, consumption or other characteristics are circulated*'. However, the law does not provide further explanation and there are no specific criteria set out how the Competition Board defines a relevant market.

The Competition Law of Latvia defines a relevant market and a relevant market of a good. Paragraph 4 article 1 of the Competition Law states that a relevant market is '*[..] a market of a concrete good which is evaluated in connection with a relevant geographical market'*. Meanwhile, a relevant market of a good is defined as a market of a particular good, which includes all those goods that may be substituted for this specific good in a relevant geographical market, taking into account the factor of substitution of demand and supply, the specific features of the good and its utilisation characteristics[573]. As with the situation in Estonia, the Latvian Competition Law does not provide more detailed information on a relevant market definition. The question of a geographic market definition in the Latvian jurisdiction was raised in the *Stevedoring Services* case[574]. The product market was determined as stevedoring services performed on 'general cargo' including containerised cargoes, where most of these cargoes shipped through Latvian ports were trans-shipped to and from inland points outside the territory of Latvia. Geographic market was defined as a market of Latvia, Lithuania, Estonia, Kaliningrad, St. Petersburg and Helsinki. For delivering a wide market definition in this case, the Competition Council relied on the information that the shippers of all these ports were generally indifferent as to which of these Baltic sea's ports to use and their decision was based on the factors of price, speed and safety. The merger transaction did not pose a high degree of market power in such a broad geographic market definition and the transaction

573 See paragraph 5, article 1, Competition Law of Latvia of 2001.
574 For further comments, see OECD, 1999.

was approved[575]. However, such broad geographic market definition is not always determined in the jurisdiction of Latvia. The *SIA Latvia Statoil / SIA Shell Latvia* was the case[576] where the Competition Council of Latvia paid special attention to the definition of the relevant geographic market and applied more specific restrictions than those notified by the parties. Four separate relevant markets in the towns of Latvia, namely Riga, Liepaja, Ventspils and Daugavpils were defined. The following factors were taken into consideration: (i) consumers were not economically motivated to buy petrol and diesel outside the town territories; (ii) the major part of citizens in Latvia reside and work in the same administrative territory or its vicinity and the fuel is purchased where the major part of consumer activities (work and social life) take place; (iii) petrol station penetration indicators in some town territories were compared with indicators of the territory of the entire country. Both types of indicators were substantially different.

According to article 3 paragraph 5 of the Law on Competition of Lithuania, a relevant market is defined as a market of certain goods in a relevant geographic market. Geographic market means the territory, in which the conditions of competition in a relevant product market are in essence similar to all undertakings and which may be distinguished from adjacent areas[577]. Meanwhile, a product market is defined as the aggregate of goods, which from the consumers' view are appropriate substitutes according to their characteristics, application and prices [578]. Apart from these provisions in the Law on Competition, the Competition Council of Lithuania also issued Explanations of the Competition Council concerning the Definition of the Relevant Market[579]. The purpose of this document is to increase the clearness and transparency of decisions of the Competition Council of Lithuania, as it provides the key principles and criteria for the definition of a relevant market. It in turn facilitates the firms involved in a transaction to understand what information is necessary for the defining market definition and on what criteria the decision is based. These explanations have

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[575] For further comments on this case, see OECD, Competition Law and Policy in the Baltic countries, 1999, pp. 70.
[576] The comments on this case were presented by the regulators of the Competition Council of Latvia during the interview held in Latvia, September 2004.
[577] Paragraph 7, article 3, the Law on Competition of Lithuania.
[578] Paragraph 6, article 3, the Law on Competition of Lithuania.
[579] No. 17, 24/02/2000, Vilnius, Official Gazette, 2000, No. 19-487. Available at web-site: www.konkuren.lt

been drafted on the basis of the Commission Notice on relevant market definition[580], as discussed above. Similar to the Commission's Notice, the criteria defining of the relevant market involve the demand substitution, being the most important factor, then the supply substitution. The potential competition is not normally taken into account for defining the market. Nonetheless, this factor can be carried out at a subsequent stage, once the position of the firm in the relevant market has been ascertained, and where such position gives rise to concerns from a competition point of view[581].

Moreover, like the EC the Explanations provide the criteria for the assessment of geographic market definition, these include: (i) evidence of purchases performed in the other area in the recent past; (ii) principal characteristics of demand; (iii) views of customers and competitors; (iv) current geographic pattern of purchases; (v) trade flows (patterns of shipment); and (vi) barriers and switching costs associated to divert orders to companies located in other areas. For the defining product market definition, or substitutability of two products in particular, the Competition Council examines the following factors: (i) evidence of substitution in the recent past; (ii) quantity tests; (iii) views of customers and competitors; (iv) consumer preferences; (v) barriers and costs associated with switching demand to potential substitutes; and (vi) different categories of customers and price discrimination. Similar to the policy of the EC, the Competition Council of Lithuania provides imprecise criteria for defining the relevant market definition, which can be further developed in the merger cases.

In the *UAB ZIP3 / UAB Vesiga* case[582] and the *UAB Vesiga / UAB VMGH* case[583] scenario the approval was given by the Competition Council on 15 July 2004 by letting *UAB ZIP3* acquire 100% of *UAB Vesiga* shares. However, the transaction was not completed as the parties involved in the group of this transaction[584] decided that it was more economically useful for the other parties to merge. As a result, the notification for the new transaction, namely for the *UAB*

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580 97/C 372/03.

581 See chapter 3, paragraph 13, Explanations of the Competition Council concerning the definition of the relevant market.

582 *UAB ZIP3/UAB Vesiga*, No 1S – 112, 15/07/2004.

583 *UAB Vesiga /UAB VMGH*, No. 1S – 86, 14/07/2005.

584 For the explanation, see the following chain: UAB 'Zabolis and partneriai' holds 100 % market shares of UAB 'ZIP3', there UAB 'ZIP3' holds 100 % market shares of UAB 'VMGH' and UAB 'VMGH' holds 100% of UAB 'Vilniaus majonezo gamyba'.

Vesiga / UAB VMGH acquisition, took place in July 2005. These cases could be looked at collectively, given the same analysis in defining a product market had been applied in both cases and the parties involved were the same (i.e. *UAB ZIP3* holds 100% share of *UAB VMGH*). By basing its decision on consumer's survey presented by the merging parties as the main evidence, the Competition Council of Lithuania determined that the product market in this case was 'sauces and seasonings'. To this one group the Council assigned all of the following products, such as mayonnaise, ketchup, tomatoes sauce, mustard, ground horse-radish, salad cream and soured cream. The Competition Council in its decision noted that as a result of this transaction, the concentration in the mayonnaise market will be high. Nevertheless, the merger transaction was approved, because the decision was based on a wider 'sauces and seasonings' product market rather than on the mayonnaise market (Malinauskaite, 2006). However, the EC practice has criticised a simple functionality test to define a product market definition (Cook and Kerse, 2000:137-136). If the products perform the same functions it does not necessarily mean that they belong to one and the same product market. The focus solely on functional substitutability may lead to an inappropriate result. As already mentioned above, in the *Nestle / Perrier* case, the Commission rejected a product market definition based on simple functionality by stating that *'[..] a limited substitutability in terms of functionality alone is not sufficient to establish substitutability in competition terms'*[585]. The Commission rejected the merging parties' product market definition as non-alcoholic drinks, and determined that mineral water constitutes a separate product market. According to Cook and Kerse[586], a test based on pure functionality would often give the wrong results. The question here is not as simple as what alternatives could be found to serve the same purpose if one product was not available. This is because those alternatives might not be suitable equally for all groups of customers. Bearing in mind that the product market definition in *Vesiga* case heavily relied on a consumers' survey, the scholars argue that these surveys should be treated with caution, as they are unscientific and do not substitute for proper price correlation analysis. Any

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[585] See para 9, [1992], OJ L 356/1.
[586] Cook and Kerse, E.C. Merger Control, Sweet & Maxwell, 2000, p.136.

decisions based on surveys must be carried out with caution and awareness, as the surveys is the art and science to ask the right people the right questions[587].

It has been suggested that a careful analysis of a product use, functionality and physical characteristics is more reliable than customer surveys[588]. However, it cannot be asserted that surveys should be excluded at all, but nevertheless, any market researches must be checked. For instance, in the *Procter & Gamble / VP Schickedanz* case[589], the Commission carried out a detailed examination of several market research studies. The Commission in this case was checking whether tampons and sanitary towels belonged to the same feminine hygiene product market definition as submitted by the merging parties, since both products had identical use and functionality as relied on their general market research. However, the Commission instructed independent experts to provide their opinion on the submitted consumer studies and their quality. Although both products performed the same function, the increase in price was insufficient for most customers to switch; as a result the Commission concluded that tampons and sanitary towels belonged to two separate markets. This case proves that the Commission will check the quality of consumer's surveys and sometimes will even invite an independent expert to make a conclusion. As far as the Baltic countries are concerned, the lack of resources could very well mean that reliance on independent experts is limited. However, as the case in Lithuania showed, such surveys should really be examined.

The interviews held at the Competition Authorities of the Baltic countries confirmed that the major problem for the Competition Authorities is to define the relevant markets. The general principles established in the Commission's Notice on the market definition and the Commission's policy quite often leave the question of market definition open and give a wide scope for the national competition authorities to define market definitions. It can be illustrated by the *Vesiga* case in Lithuania, that reliance mainly on the market research provided by

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587 For further reading about the customer surveys, see for instance, the article written by Hughes M., and Beale N., Customer Surveys in UK Merger Cases – the Art and Science of Asking the Right People the Right Questions, E.C.L.R., 2005, pp. 297-303.

588 For further reading, see Cook and Kerse, 2000, pp. 136-137. Also see Hughes and Beale, 2005, pp. 297-303.

589 Case IV/M 430 [1994] OJ L354/32.

the merging parties gave a broad definition of product market[590]. The market definition is an important step in the analysis of a merger transaction. It is not only because incorrect relevant market definition will lead to misleading results on the impact of a merger transaction on competition in a single case, but also future cases can be based on a similar basis forming deluded precedents[591]. Furthermore, disparity in approaches taken by the EC and the Baltic countries in delineating the relevant market definitions can be problematic where the commitments of the Baltic countries are to employ and apply concepts in competition law in a manner consistent to the EC approach.

6.4.2. The substantive tests of the Baltic countries and market power

All Baltic states adopted the dominance test, which was almost identical to the former substantive test for merger approval in the EC jurisdiction. Even the wording of the substantive test was similar to one applied in the EC. For instance, § 22 (2) of the Estonian Competition Act provides that a concentration shall be prohibited *'[..] if it may create or strengthen a dominant position as a result of which competition would be significantly restricted in the goods market'*. Hence, like in the EC case, the priority was given to the creation or strengthening of a dominant position (otherwise the first limb), leaving the significant restriction of competition as a supportive condition.

The old substantive test of Latvia for the appraisal of merger transactions had a clear emphasis on a single dominance, which as was presumed automatically hinders or otherwise restricts competition. To follow the EC amendments and to close gaps of the former substantive test, the new test was introduced in the Latvian jurisdiction for the appraisal of merger transactions. The new substantive test states that the Competition Council of Latvia by its decision shall prohibit merger transactions as a result of which a dominant position is created or strengthened, or which may significantly reduce competition in any concrete market[592]. Hence, the substantive test expanded the power of the

[590] A wide product market definition, based on the consumers' survey as the main evidence, was also defined in *Alita* case. For the comments on this case, see Malinauskaite, 2006.
[591] Despite the fact that a market definition ought to be defined in every individual merger cases on case-by-case basis.
[592] See section 16, paragraph 3 of the Competition Law of Latvia.

Competition Council of Latvia to prevent not only the potential harm of a single dominance but also the harm from a collective dominance (Jefremova, 2004)[593].

The Competition Council of Lithuania also applied a dominance test for the appraisal of merger transactions, which was changed into a modified dominance test following the EC modernisation. Despite the modification of the Lithuanian substantive test, the focus on dominance can be found in the following articles. Article 14 (2) of the Law on Competition of Lithuania provides that concentration transactions may be permitted but only with conditions, where the conditions involve the prevention of the *'creation or strengthening of a dominant position'* (this provision was left unchanged). Paragraph 3 of article 14 provides that the Competition Council of Lithuania may refuse to approve concentration, *'[..] where concentration will establish or strengthen a dominant position or substantially restrict competition in a relevant market'*. The similar wording of the substantive test of article 14 (3) is applied also in post-merger control. Article 14^1 of the Law on Competition of Lithuania states that the Competition Council within twelve months from the implementation of concentration in question has a right to obligate the merged undertakings to submit notifications on concentration and *mutatis mutandis* apply the concentration control procedure, if it becomes probable that concentration will result in the creation or strengthening of the dominant position, or a significant restriction of competition in the relevant market. The wording of the substantive test for an appraisal of merger transactions in the jurisdiction of Lithuania is ambiguous. A transaction is first of all checked according to either part of the test: whether it will establish creation or strengthening a dominant position; or whether a notified transaction will restrict competition substantially. If neither of these conditions is met, then the transaction is approved[594]. If, for instance, there is a threat that a transaction will create or strengthen a dominant position, then in this case the transaction still can be approved by imposing conditions to prevent the creation or strengthening of a dominant position[595]. However, if there are concerns that a transaction will restrict competition substantially, then again it is checked, whether the transaction can be

[593] Comments on the new substantive test was presented by a board member of the Competition Council Jefremova during the interview held in Latvia in September 2004. However, there has been no practice insofar of collective issues in merger cases.
[594] See article 14 (1) of the Law on Competition.
[595] See article 14 (2) of the Law on Competition.

approved on conditions. It means article 14 (2) will apply, which states that the conditions imposed by the Competition Council of Lithuania involve the prevention of the creation or strengthening of a dominant position. As a result, despite the changes in the substantive test, the focus is still on dominance.

So far the Competition Authorities of the Baltic countries have cleared all merger transactions[596]. The question one might ask is why do the Baltic states have such a situation: whether it is linked to a slack attitude on the Competition Authorities' part in the enforcement of merger control; or whether the policy held in all Competition Authorities of the Baltic countries is to blame. The Estonian Competition Authority is 'the youngest' in comparison with the other two Competition Authorities of the Baltic states in the context that only since the end of 2001 the Competition Board has gained power to challenge anti-competitive merger transactions. Until 2004 the Competition Council of Latvia had high thresholds for the notification of mergers, and as a result used to have about 4-5 merger notification cases per year, which were all approved. After the enquiries to the Competition Authorities, the researcher came to the conclusion that this situation can be explained by the policy held in all Authorities. There is a practice held in the Competition Authorities to discuss the proposed merger transaction in advance. Upon learning of a possibility in a particular case that a dominant position may be created and the restriction of competition may arise, and consequently such a transaction would not be approved, the firms (owners or legal representatives), quite infrequently, abandon their intentions to effect concentration or withdraw their concentration notifications. For instance, the notification of the intended concentration in Lithuania in the *AB Panevėžio Pienas / AB Rokiškio Sūris*[597] case was submitted four times; in three cases it was withdrawn, as the Council would not approve such a transaction. Each time the applicant would indicate a different reduced size of targeted shareholding, and emphasise that the main purpose of the concentration effected by *AB Rokiškio Sūris* is to acquire an interest in *AB Panevėžio Pienas* of the size ensuring a significant influence in the process of decision making while preventing any

[596] With one exception in the Lithuanian jurisdiction in Sugar case, where the Competition Authority blocked the decision. However it was overturned by the Government.
[597] Decision No. 1S – 29, 03/04/2003, available at web-site: http://www.konkuren.lt

devaluation of shares. A similar situation was in the *Aibe* case, where three mandatory notifications of concentration were submitted by the network *Aibė*[598].

6.4.3. Single dominance. The study of the Baltic countries

The main focus of the Competition Laws of the Baltic countries is on single dominance rather than on collective dominance. All Baltic countries apply a dominance test or modified dominance test like in the case of Latvia or Lithuania for the appraisal of concentration transactions with the main focus being on single dominance. All Baltic countries place emphasis on market share rather than concentration index to define a dominant position. For instance, the first paragraph of § 13 of the Competition Act of Estonia provides that an undertaking is in a domain of a dominant position if it *'[..] accounts for at least 40 per cent of the turnover in the goods market or whose position enables the undertaking to operate in the market to an appreciable extent independently of competitors, suppliers and buyers'*. The second part of the definition of dominance is in line with the EC policy. However, a strict bind to a market share of at least 40% is troublesome. According to the theory of markets, even very high market shares do not grant a position of dominance if entry into the relevant market is easy (OECD, 1999:31). For instance, the Commission approved the merger with 83% of the market share[599]. The potential competition from outside the market should also be analysed instead of automatic bind to the 40% of market shares for defining a dominance held by an undertaking[600]. For Schinkel and Thielert, although the explicit definition of dominance could be seen as a measure to increase the transparency of the Estonian Competition Act, the definition in terms of rigid market share can easily lead to erroneous results[601].

According to the Latvian Competition Law, section 1, paragraph 1, a dominant position is *'[..] an economic (commercial) position in a relevant market of a market participant or several market participants if the market share of such participant or the participants in this relevant market is at least 40 per cent and if*

[598] See Annual Report of 2003, available at web-site: http://www.konkuren.lt
[599] In *Alcatel* case as discussed above.
[600] See Fishwick, 1989, pp. 455. Also see Schinkel and Thielert.
[601] For further reading, see Schinkel, M.P. and Thielert, J., Estonia's Competition Policy: A Critical Evaluation towards EU Accession.

such participant or such participants have the capacity to significantly hinder, restrict or distort competition in any relevant market for a sufficient length of time by acting with full or partial independence from competitors, clients or consumers'[602]. For instance, in the *SIA Latvia Statoil / SIA Shell Latvia* case[603] the Competition Council of Latvia in assessing unilateral effects of the proposed transaction concluded that the petrol and diesel retail market share in separate geographic markets, namely in Liepaja, Daugavpils and Riga will not reach 40%, while in Ventspils it will be approximately 40%. As regards more recent developments, the Latvian government has considered draft amendments to the Competition Law in order to strengthen the effectiveness of competition policy by extending the definition of a dominant position. One of the criteria for submitting the notification report has been strengthened: the parties involved in the transaction have an obligation to notify if their total market share exceeds 35%. Thus, the definition of a dominant position in Latvia will be extended by replacing, considerably low by the EC standard[604], a 40% market share test to 35%.

Similar to the case of Estonia, the Law on Competition in Lithuania also binds to 40% of market shares in order to define a dominant position. For instance, paragraph 11 of article 3 states that *'[..] unless proved otherwise, the undertaking with the market share of not less than 40% shall be considered to have a dominant position in the relevant market'*[605]. The definition, in terms of rigid market shares of 40% as suggested by scholars can lead to erroneous results and should be re-considered by the Competition Authorities of the Baltic countries.

In contrast to the EC, all Baltic states imposed rigid policies for defining dominance referring to 40% of market shares (or 35% like the case of Latvia).

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602 See Competition Law of Latvia, 22 April 2004, section 1, paragraph 1.

603 *SIA Latvia Statoil / SIA Shell Latria,* 2003.

604 As was mentioned above, in *Alcatel* case, the parties had 83% of the market shares (though they were not considered as having a dominant position), in *AKZO* case the merged entity with 50% of the market shares was determined as having a dominant position. Also, Gal in her theory suggested that mergers, especially where the dominance definition involves firms with market shares equal to or lower than 50%, should be approved.

605 Different from the other Baltic countries, the Competition Council of Lithuania has issued the explanatory document concerning the establishment of a dominant position, which was modified in 2005 after the modernisation of the EC merger control policy.

Such strict bind to a market share of 40% is troublesome, as it can lead to erroneous results. It can be noted that even very high market share does not grant a position of dominance if entry into the relevant market is easy.

6.4.4. Collective dominance. The study of the Baltic countries

The focus in the jurisdictions of the Baltic states is on a single dominance. For instance, neither the Competition Act of Estonia, nor the current practice of the Estonian Competition Board (Konkurentsiamet) gives direct answers whether a merger transaction could be challenged on oligopoly grounds (Simovart and Paas, 2006:77). As aforementioned there are working groups assigned to work on the provisions of merger control regime, thus, it can only be expected that the legal text in future will define the notion of collective dominance.

Similarly to the Estonian case is a situation in the Latvian jurisdiction, where the Competition Law does not provide any provision on collective dominance and only a single dominance is defined. However, the wording of the new substantive test shows that the issues on collective dominance can be covered by the second part of the substantive test for the appraisal of concentration transactions. It was also confirmed by the board member Jefromava that the issues of collective dominance fall to the second part of the substantive test. However, there is no practice so far in the jurisdiction of Latvia of the assessment of merger cases involving a collective dominance.

In contrast to the other Baltic countries, the Law on Competition of Lithuania refers to jointly held market shares by a number of firms in order to define what can be called a collective dominance. The second part of paragraph 11 article 3 states that *'[..] each of a group of three or a smaller number of undertakings with the largest shares of the relevant market, jointly holding 70% or more of the relevant market shall be considered to enjoy a dominant position'*. However, in practice, the Competition Council of Lithuania is reluctant to refer to a collective dominance as the ground of challenging a merger transaction. For instance, the issues of a collective dominance was analysed in the *AB Rokiskio* *suris / AB Panevezio Pienas* case[606] in the jurisdiction of Lithuania, where horizontal overlaps occurred due to both companies being active in producing dairy products, which is considered as a concentrated market in Lithuania. This case was highly criticised by the former board member of the Competition Council Pajarskas for the lack of evidence to prove collective dominance. It was not clear whether firms would have economic links that would enable them to co-ordinate their behaviour and that consequently would lead to co-ordinated effects. Thus, collective dominance was dismissed and the decision was based on a single dominance and it was approved upon the conditions set out by the Council.

Chapter 4 analysed two countervailing merger motives with two contrasting effects on competition, as efficiency gains achievable through merger transactions and the ability to create or strengthen market power as a result of mergers from an economic perspective. Meanwhile, the emphasis of this chapter was on legal analysis. The question was raised to what extent commercial motives analysed in chapters 3 and 4 affect and influence the regulatory authorities of the EC and in parallel of the Baltic countries.

The analysis of the past merger cases revealed the controversial EC policy towards efficiency gains achievable through merger transactions, as efficiencies were treated as an offence rather than defence in some cases, as discussed in this chapter. According to the former EC policy, any efficiency considerations could have been taken into account only up to the limit of dominance; once a fear that a dominant position might be created or strengthened was established, any efficiency issues were out of the scope of the analysis. The former substantive test of the EC placed the emphasis on the creation or strengthening of a dominant position leaving significant impediment of competition at a second place.

As the Baltic countries by signing the European Agreements committed to ensure their harmonised interpretation and application of the EC competition law and policy, the position held at the time in the EC vis-à-vis efficiency gains achievable through mergers have been transposed to the Baltic states. All three countries introduced dominance tests for merger appraisal with the wording being almost identical to the former EC substantive test. Hence, the creation or strengthening of

[606] Case No. 1S-29, 03/04/2003. The notification was submitted 3 times each time providing lower market shares in order to get approval from the Competition Council.

dominance though merger transactions has become a deep-rooted element in merger analysis of the regulatory authorities in the Baltic countries. The concept of dominance as defined in the *Hoffman* case has been also transposed. However, different from the EC, all Baltic states imposed rigid policies for defining dominance referring to 40% of market shares. Such strict bind to a market share of 40% is troublesome, as it can lead to erroneous results. It can be noted that even very high market share does not grant a position of dominance if entry into the relevant market is easy.

In contrast to single dominance, which can be considered as the main focus in the Baltic countries, merger transactions leading to collective dominance or oligopoly situations has not been developed yet and is given little importance. For instance, in Estonia neither the Competition Act nor the current practice of the Competition Board give guidance to whether a merger could be challenged on oligopoly grounds. In Latvia, a similar policy applies, as there are no guidelines or other provisions issued, or case law as regards collective dominance. However, the new substantive test was imposed in Latvia to follow the EC modernisation, where the situation of collective dominance can be challenged under the second part of the test, which provides that provisions on merger control are to prevent the reduction of competition in any relevant market. Different from the other Baltic states, Lithuania defines a concept of collective dominance referring to 70% jointly held market shares by a number of firms. However, the practice shows, as discussed in this chapter, that the Competition Council lacks knowledge and experience in proving collective dominance. Thus, the Baltic countries need to develop their laws in order to cover the oligopolistic cases, as these types of situation together with a single dominance are in a domain in small market economies.

The Commission has started a new era in developing merger control mechanism after the major reforms of the ECMR. The new substantive test was introduced, which is more in favour to efficiency issues than its predecessor. Also, the Commission explicitly has acknowledged the importance of efficiency issues in merger cases by issuing the Guidelines on horizontal mergers, which have the provisions on merger-specific efficiencies. Generally speaking the EC approach towards merger control regime has shifted towards a more economic based approach. However, the Baltic countries are left behind and there is insufficient economic analysis provided in the assessment of merger cases, what is especially important for the countries of small market economies, like ones of the Baltic countries. The focus on a single dominance is mistaken. As N. Koers (2005), a new competition commissioner, indicates even dominant companies can compete.

As stated above, the current Latvian substantive test for the appraisal of concentrations is the most favourable to efficiency gains in comparison to the substantive tests of the other Baltic states. Any efficiency issues now can be covered under the second part of the test, the limb of SIEC. Bearing in mind that there have been no further guidelines issued by the Competition Council to define the criteria in applying the new substantive test and no explicit efficiency defence exists, it is not clear how the test will be interpreted. Its efficiency will be tested in the years to come, when the Competition Council of Latvia will develop its approach in the application of the substantive test.

Chapter 7. CONCLUDING REMARKS

This comparative study examined the merger control mechanisms at the EC and at the national levels, namely Estonia, Latvia and Lithuania. Globalisation process has caused a surge of cross-border as well as domestic merger transactions within the jurisdiction of the EC. The Baltic countries were not an exception; after the opening of borders to international trade, merger transactions have become an important fact in the Baltic countries. Thus, with the emergence of merger transactions, there was a necessity to introduce merger control regimes in the Baltic countries in order to prevent the anti-competitive merger transactions. After re-gaining their independence, the Baltic countries had a choice to turn to the West or remain with the East. The Baltic states decided to turn to the West after the 50 years of occupation from the East. Joining the EU was considered the best choice for these countries. The merger control mechanism in the Baltic countries was transposed as a part of the *acquis communautaire* as a *quid pro quo* for being admitted in the EU. Hence, the EU has been remarkably effective in stimulating the development of competition policy and laws, including merger control regime, in the Baltic states. However, for the inexperienced Competition Authorities of the Baltic states the introduction and enforcement of merger control mechanisms has not been an easy task.

This research has attempted to ascertain to what extent the approach towards merger control regime taken in the Baltic countries is different from its counter-part – the EC. The thesis has built the methodology to assess the approaches vis-à-vis merger control rules taken at two different levels: at the supra-national – the EC and at the national – the Baltic states. As far as the methodology is concerned, the research employed a comparative law analysis with an inter-disciplinary approach. Explicit recourse to economic theories was essential for understanding the rationale behind the competition law, which is widely accepted as a 'no-man's land' between law and economics. Considering that the comparative law method has been adapted to suit the needs of the EU both in harmonising and approximating the commercial and competition laws of its members and in facilitating the CEECs including the Baltic countries in their modernisation programmes, often with the goal of membership of the EU, the comparative method and comparison itself has been an essential tool for generating knowledge in this thesis. Bearing in mind that the Baltic countries committed themselves to employ and apply concepts in competition law in a manner consistent with the EC approach, the more rewarding emphasis of the thesis was on finding the differences rather than similarities [607] in approaches adopted by the Baltic countries towards merger control regime from the EC.

The first chapter, which is an introductory chapter, analysed the emergence and further development of competition law and policy, including merger control regime in the EC and in parallel in the Baltic countries from the historical point of view. The question in this chapter was raised as to what extent the Baltic countries share a similar historical development experience with the EC as far as merger control is concerned. It has been ascertained that different from the EC, where the merger control regime has developed over time, the merger control mechanism in each Baltic country was transposed as a part of the *acquis*. The implementation of the merger control mechanisms in the Baltic countries has not been a single act *per se*. It has constituted as a new revolution for these countries, as their whole legal, economic and political environments have been changed. The merger regime was introduced into the legal systems of the Baltic countries, while they have been still going through economic, legal and political reforms.

Considering that merger control regimes in each Baltic state were transposed from the EC, there are no doubts about the high influence of the ECMR on these countries. In general terms, the competition law and policy in the Baltic countries is a compact version of the competition law and policy of the EC. However, in contrast to the EC law, the merger control rules and other aspects of competition law as an abuse of a dominant position, prohibited agreements and other restrictions of fair competition are governed by a single document - Competition Law in each Baltic country (or Competition Act as in the Estonian case).

Despite quite often being portrayed as one unit, the research attempted to discuss the distinguished features of each Baltic state. A different approach towards the

[607] Though it was not a rigid rule.

introduction of merger control mechanism had been taken in each of them. Latvia had set up high thresholds for merger notification. Thus, only very large merger transactions fell under the jurisdiction of the Latvian Competition Council. The prevention of mergers leading to the creation of a dominant position was hardly possible, as only firms already in a domain of a dominant position could have been challenged. The Competition Board of Estonia was empowered to prevent anti-competitive mergers only in 2001; before that the Board acted as a Register body in order to learn the features of the Estonian markets and prepare to deal with merger cases in the near future. Such information gained was a good practice before imposing full control over anti-competitive mergers.

Lithuania had the 'strictest' merger control regime from its introduction in 1992 in comparison with the other Baltic states. The merger transactions leading towards the creation or strengthening of a dominant position could have been blocked by the Competition Council of Lithuania. That said, until 1999 the Competition Council's power to block mergers was subject to intervention by the Lithuanian Government who had the power to overturn such decision taken by the Competition Council[608]. Both institutions, i.e. the State Competition and Consumer Protection Office and the Competition Council, responsible for the enforcement of competition law in Lithuania until 1999 lacked formal independence from the government. The links with government may have a detrimental impact on the business community's acceptance of decisions. Hence, the situation has changed since Lithuania adopted the 'integrated agency model' – a single independent enforcement agency named the Competition Council, which discharges investigative, enforcement and adjudicative functions of competition law and policy in Lithuania. The Latvian Competition Council acts under the supervision of the Ministry of Economics. However, the Ministry of Economics does not have the power to influence the investigations and the decisions of the cases taken by the Competition Council of Latvia. The Estonian Competition Board is a governmental agency within the administrative jurisdiction of the Ministry of Economic Affairs and Communications. However, it could be considered that the Board acts as an independent body with regards to its role in the decision-making process. In contrast to Latvia and Lithuania, the Estonian

[608] It happened once, when the Council's decision was overturned by the Government (see Sugar case).

institutional model is based on the 'bifurcated judicial model', where the Board's officials investigate the alleged competition law violation and the court adjudicates upon and enforces the competition law. Hence, despite being portrayed as one unit, the Baltic countries share distinctive features: each Baltic state employed different approaches to the introduction of merger control rules in their jurisdictions, differences can also be distinguished in the institutional models chosen by these countries for the enforcement of competition law and policy.

Furthermore, the study examined the motives behind firms' decisions to merge, in particular firms operating in and from the Baltic countries. Questions were raised as to what are the impetuses for firms to merge in the jurisdictions of the Baltic countries and whether these motives have specific implications within the Baltic states in comparison with theory. The motives were examined in order to determine the rationale behind the mergers as that in turn might help to understand their effects on competition. In the study, it was clear that the actual reasons for mergers in the Baltic countries are no different to the ones described in theoretical discourses. That said, three main trends were distinguished. First of all, the motives for the majority of merger cases notified to the Competition Authorities of the Baltic countries were to achieve and/or increase efficiencies and as a result of this be able to compete internationally. Secondly, foreign companies acquire or merge the national Baltic firms for an easy and quick way to enter in to the unknown market. Another international element was the spill-over effects on the Baltic countries' markets from the merger transactions between parents companies through subsidiaries based in the Baltic states.

Apart from commercial motives, the study also revealed socio-political aspects of merger effects in the context of the Baltic states. However, despite establishing the possibility of merger transactions having socio-political effects, especially in conglomerate merger cases, the research did not aim to prove whether these aspects should be (or not) taken into account by the competition authorities in merger analysis. This issue requires further analysis.

Despite exploring various motives for merger further, the study made focus on two main motives with two countervailing effects on competition. These are pro-competitive and anti-competitive effects, as there is a trade-off between them. As regards the pro-competitive effects, through merger transactions efficiencies can be achieved resulting in gaining benefits such as products produced, services provided at lower costs and/or higher quality and/or the creation of new products/services. Thus, mergers can deliver a wide variety of benefits to consumers or to competition in general. On the contrary, mergers can pose certain risks as well. Mergers may contribute to the creation of market power and as a result lead to higher prices for consumers, or take advantage of their market strength to disadvantage smaller competitors through various means, or generally facilitate co-ordination among the firms. Hence, merger transactions can impose anti-competitive effects. These two countervailing effects on competition were a recurring element throughout the thesis and has been analysed from both economic and legal perspectives.

Chapter 4 critically evaluated both positive and negative effects on competition that a merger transaction may impose. The analysis of these two effects was highly important as there is a trade-off between them. The comparison of the length to which mergers extend market power with gaining efficiencies has been recognised as a highly complex and controversial subject. Referring to economic theories, it was noted that any efficiency gains achieved through all types of mergers play an important role in merger analysis and cannot be ignored. The economic theories discussed showed that under certain circumstances efficiencies may offset any anti-competitive effects. Horizontal, vertical and conglomerate mergers were distinguished and analysed separately due to the differences in anti-competitive effects (as unilateral or co-ordinated effects) on competition. As different types of mergers may have anti-competitive effects with horizontal mergers causing the most concerns, so all these types of mergers may enhance efficiencies. The conclusion was made that regardless of merger transaction type, mergers can impose pro-competitive and/or anti-competitive effects on competition upon the existence of certain conditions. This is why both effects should be analysed and balanced.

Moreover, the specific implications were placed on small market economies. Merger control is an important mechanism for small market economies because of two main reasons. First of all, merger transactions increase concentration in a market structure. For small market economies, which are usually defined as having concentrated markets, mergers may lead to a further concentration, simply because these transactions reduce the number of market players and increase market shares of merging entities[609]. Secondly, merger transactions may enhance efficiencies, which were not attainable in the pre-merger situation. Hence, mergers may allow firms to overcome insufficient size to achieve the efficiencies, which may arise in oligopolistic structures of small market economies. This is because in small markets there are a limited number of market players and market can serve only to a limited number of players as a result only a limited number of firms can act effectively in the market. The limited measures in small market economies augment the need for the optimal merger control. In this case, concentrated market structure might need to become further concentrated in order to achieve minimum efficient scales, even a merger to monopoly can lead to a reduction in prices. Bearing in mind that competition policy is intended to prevent the creation of anti-competitive market structures, which in turn result in higher prices and inefficient output; it is particularly challenging to find the balance between productive efficiency gains and competitive conditions in small market economies. Rigid policy toward mergers may prevent desirable efficiency–enhancing merger transactions in small market economies to take place and instead entrench inefficient market structures. Moreover, this rigid merger control policy is especially undesirable when economies become increasingly exposed to international competition, as is the case in the Baltic countries, where after opening up their borders the local companies have faced international competition. Merger policy in this case should not prevent local firms in small market economies from trying to achieve efficiencies in order to overcome competitive disadvantage, which results from limited domestic demand. For large economies in most instances the efficiencies may still be created as most of their industries include a large number of companies which have already realised their economies in scope and scale. Meanwhile, for small market economies the adoption of such a policy would result in the prevention of many beneficial mergers. Hence, efficiency considerations in small market economies must play

609 Also, merger transactions may facilitate tacit collusion or co-operative behaviour.

an important role, considering the fact that merger transactions may help the realisation of potential efficiency gains, for instance, in oligopolistic markets, which would otherwise remain unexploited due to lack of their optimal size.

In the course of evaluating the different economic models applicable to mergers, the conclusion is made that the balancing approach is the most suitable for small market economies, because it recognises efficiency defence as any merger transactions should be permitted, if the efficiency gains achieved through the merger are great enough to offset any anti-competitive effects. The efficiency considerations should be left to the last stage as to avoid unnecessary burden placed on parties as well as the Competition Authorities of the Baltic states, which have insufficient knowledge and experience to deal with the complicated analysis of efficiency gains, especially with dynamic efficiencies, which are difficult to evaluate. As regards the technique, it brings to a conclusion that a sequential model, particularly a modified version of a sequential model, is the most suitable for the Baltic countries. This model contains two main stages. The first stage works as a filter: larger merger transactions, which meet the thresholds set by the Competition Authorities of the Baltic countries, are examined by the regulators by using structural indicators, which does not require high information costs and does not consider any efficiency issues, which are presumed neutral or sufficient enough to outset any anti-competitive effects. Only those merger transactions, which crossed the upper threshold set up in the first stage, go for a further examination into the second stage. Here, the efficiency gains are examined, even in merger cases leading to a monopoly or close to monopoly situation. Hence, this approach will limit a number of cases, which require in-depth analysis and as a result will save high information costs. Also, the modified sequential approach allows an in-depth analysis for some 'problematic' merger transactions, which might have high concern of sufficient realisation of efficiency gains to offset the anti-competitive effects.

Since the competition policy determines which mergers might be considered harmful and which ones beneficial, the study analysed the competition policy and its goals vis-à-vis merger control. Since the explicit aim of the Baltic countries has been to bring their competition law and policy in line with the EC competition policy, it is no surprise that these countries have transposed competition law and policy virtually identical to the EC competition policy. Likewise incorporated in the Treaty, all Baltic countries refer to undistorted competition as a main objective of competition policy. However, with the priority given to the political objective – as the integration into the EU, the Baltic states have not explored their 'pure' competition policy. In contrast to the EC, there after modernisation the Commission explicitly admitted possible positive effects of mergers on competition, as the importance of efficiencies in merger analysis, the position vis-à-vis efficiencies achievable through mergers in the Baltic countries is controversial and vague. The Baltic countries are required to improve their competition policy in order to keep in line with the modernised EC competition policy. Also, a clear position of the efficiency gains achievable through merger transactions in order to increase competitiveness and the safeguarding of the consumer interest should be explicitly expressed.

Apart from economic theories, the thesis provided a legal analysis. Questions were raised as to what extent the commercial motives affect and influence the Regulatory Authorities of the Baltic states and to what extent is the approach vis-à-vis merger control rules taken by the Baltic countries different from its counter-part - the EC. The merger control mechanisms in the Baltic states were introduced as a part of the *acquis* and has been highly influenced by the ECMR. The first competition law of each Baltic country was already to a large extent inspired by the Community competition rules, but nevertheless, the Baltic countries made further amendments to follow the changes under the Community law. The wording of the substantive tests for merger appraisal in each Baltic state has been almost identical to the former dominance test of the ECMR. However, it has been discovered that the wording of the substantive tests and the practice of applying them demonstrate that the decisive criterion of the Competition Authorities of the Baltic states is on 'finding a dominance'. The EC merger control policy has shifted towards a more economic based approach with the emphasis being placed on the effects on competition. Meanwhile, the Competition Authorities of the Baltic states place their focus mainly on market structures rather than analysing the effects of merger transactions. The focus on market structure rather than on the effects on competition is irrational policy for the countries of small market economies. This is because one of the features of small market economies is that most of their markets are concentrative. It in turn means that mergers would lead to concentrating markets even more. Hence, if taken literally almost all mergers would have to be prevented, if the focus is on market structures. Whereas, an emphasis of the merger's effects on competition allows wider evaluation, as merger transactions may lead to markets becoming more concentrative which might be a necessary evil considering limited measures in small market economies to exploit efficiencies. Thus, merger transactions with the impetuses to achieve efficiency gains, even if they lead to more concentrated markets should be treated in favour by the Competition Authorities in the Baltic countries, as these transactions may make market more efficient and more competitive.

From written provisions on the substantive issues in the Baltic countries, the conclusion can be made that in contrast to the EC approach, which employs both a positive and a negative approach of the effects of merger on competition, the Baltic countries adopt a negative approach towards merger transactions. This negative approach may mean that the Baltic countries are reluctant to admit pro-competitive effects of merger transactions on competition. The lack of efficiency considerations can be logically interpreted as a sign that the merger control regimes in the Baltic countries are orientated towards dominance or market power rather than efficiency enhancing. As result of this logic it might be predisposed that the regulators of the Competition Authorities mistreat the possibilities of the pro-competitive effects that merger transactions can provide and look suspiciously at the effects of the mergers on competition.

Considering the Competition Authorities of the Baltic countries do not have an explicit efficiency defence, it might have twofold consequences. By not taking efficiencies explicitly into consideration as a possible positive impact of merger transactions on economic welfare, this on one hand involves a risk of blocking the occasional merger with possible pro-competitive effects. On the other hand, there is a risk that some efficiency-enhancing mergers might not be pursued in the first place.

In conclusion, the study revealed that the approach towards merger control mechanism taken in the Baltic states is different from the EC. After the EC moved towards a more economic based approach, the Baltic countries are left behind. Insufficient economic analysis is provided in these countries in merger cases. The Baltic countries should consider moving towards a more economic based approach by focusing on specific implications of their markets' features and placing emphasis on the effects of merger transactions on competition (dynamic aspects) rather than on market structure (static aspects).

The current tendency can be seen that after the modernisation of the ECMR, the Baltic countries are willing to make improvements in their Competition Laws. For instance, the Competition Authorities of Latvia and Lithuania have modified their substantive tests for the appraisal of merger transactions to correspond to the modernisation of the ECMR. There have been no changes so far in the jurisdiction of Estonia as regards the modification of the merger control provisions. Nonetheless, there is a group working on the modernisation of the provisions on concentration. Thus, these provisions are due to be improved in the near future.
In response to the ECMR modernisation, the substantive tests were modified in Latvia and Lithuania. The conclusion is made that the current Latvian substantive test for the appraisal of concentrations is the most favourable to efficiency gains in comparison to the substantive tests of the other Baltic states. Any efficiency issues now can be covered under the second part of the test, the limb of SIEC. Bearing in mind that there have been no further guidelines issued by the Competition Council of Latvia to define the criteria in applying the new substantive test and no explicit efficiency defence exists, it is not clear how the test will be interpreted.

The study revealed that the Baltic countries are familiar with the notion of merger-specific efficiencies. The possibility of consideration of efficiency issues in merger cases was expressed in Latvia, where efficiencies could be analysed in borderline cases as to mitigate finding of dominance. However, this position is not explicitly expressed. Different from the other Baltic states, Lithuania issued the guidelines on explanations of the concept of dominance, where the notion of efficiencies were also introduced. Thus, likewise in Latvia a finding of dominance can be mitigated. This policy expressed in Latvia and Lithuania, where a dominant position would not be created or strengthened, as efficiency gains help to mitigate a finding of dominance, was criticised by Lowe (2002) for its limited scope, as it is conceptually difficult for merging entities to challenge that efficiency would stop them from having the ability to act on the market without being effectively constrained by others, or otherwise influence price, production or innovation. Also, this approach is not suitable for the Baltic countries, because of the following reasons. First of all, this approach places an unnecessary burden on the merging parties and on the Competition Authorities, which do not have sufficient practice in applying merger control rules. Second, this approach does not provide enough transparency, for instance, what are the criteria of the evaluation of efficiency issues in the merger cases. Transparency is very important to the Baltic countries because governmental agencies require transparency to enable them to properly discharge their obligation to inform and educate their citizens on the principles of fair competition. Without transparency, the general citizenry will lose confidence in the authorities as enforcers and decision makers in competition matters. Also, in the context of merger control rules, transparency means that the merging parties should be able to predict the reaction of competition authorities with sufficient reliability. Hence, the introduction of explicit merger–specific efficiency gains is an important tool for the Baltic states, which will also increase the transparency and accuracy of the merger review process in these countries.

This research is an introductory study of merger control regimes in the Baltic countries. This is because there is insufficient practice of enforcing merger rules in these countries at present, as they are still in the process of adapting and modernising their merger control regimes. Future research can evaluate whether the Baltic countries will follow the EC approach of introducing a more economic based approach, which will allow taking into account their different market structures and how the rules adapted will be enforceable in practice. Hence, the efficiency test (if introduced) in the merger control regimes of the Baltic countries will be tested in the years to come when the Competition Authorities of these countries will develop their approaches in the application of their modernised merger control rules.

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