MASTER PROJECT

“Changes in American Horizontal merger guidelines: a step forward from an economic point of view?”

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Abstract

Competition Authorities typically issue Merger Guidelines setting out the framework within which merger assessment is conducted. In August 2010 the Horizontal merger guidelines in U.S. were updated. The new Guidelines place less weight on market shares and market definitions than its predecessors. In this paper we summarize the main changes in the Guidelines and argue whether they make sense from an economic point of view. In addition we discuss whether the new features are going to affect merger regulation in Europe. In particular, we ask whether these updates could be implemented in the future European horizontal merger Guidelines.
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1. Introduction

Merger guidelines help to facilitate a smooth, efficient and transparent merger control process. They minimize the transaction costs for parties when dealing with a competition authority ("CA") and reduce the volume of public resources devoted to merger control. More generally, merger guidelines help parties to understand how the CA treat mergers and whether the proposed merger would lead to intervention by the CA. Appropriately structured guidelines should prohibit mergers that would impede competition and consumer welfare and allow mergers that bring benefits and efficiencies to the community. Although the Guidelines are not law, most horizontal merger investigations are resolved at the agency level, rather than challenged in court. Therefore, the Guidelines provide important insight into how best to address agency concerns.

In August 2010 the Department of Justice and Federal Trade Commission issued new Horizontal Merger Guidelines ("2010 Merger Guidelines"). These guidelines bring a few important changes while following a less mechanistic and more integrated approach. Merger regulation in US is often at the forefront of merger regulation in the world and usually CA worldwide are relying on the experience of US when dealing with mergers or drawing up the new guidelines. For example, the competition authority of Ireland relied considerably on the US Guidelines when it drew up the new horizontal merger Guidelines in 2002. For this reason, we believe that it is important to comment on the main new features in "2010 Merger Guidelines" as they might be implemented in practice (depending on their success) worldwide. Thus, the purpose of this paper is to examine these key new aspects and their value from an economic point of view. In addition, a question is raised whether the European Commission should follow the same path as their counterparts in US when the new version of European Horizontal Merger Guidelines will be developed.

The paper is structured as follows. Section 2 summarizes the main changes regarding the unilateral effects. These changes include: downplaying the importance of market definition, describing the concept of "value of diverted sales" and acknowledging the importance of upward pricing pressure ("UPP") index and merger simulations in merger regulation practice. Section 3 discusses price discrimination of targeted customers while the importance of competition on non-price dimensions is stressed in section 4. Section 5 briefly describes
the historic trend between merger regulation in US and Europe. In particular, this section describes how the European Horizontal Merger Guidelines of 2004 were influenced by the American Guidelines. In addition, we are going to argue whether the changes should be implemented in future European Merger Guidelines and what is their likely impact on merger regulation in EU. A concluding section summarizes the main benefits and drawbacks of the key changes in 2010 Merger Guidelines.

2. UNILATERAL EFFECTS

The most important changes in the 2010 Merger Guidelines affected the assessment of unilateral effects of mergers. There were a few important changes and this section is going to discuss their advantages and disadvantages in turn. We begin our analysis with the reduced importance of market definition in merger analysis.

2.1. Downplaying importance of market definition in merger analysis

The Guidelines downplay the importance of market definition in the horizontal merger analysis, stating that “the measurement of market shares and market concentration is not an end in itself, but is useful to the extent it illuminates the merger’s likely competitive effects.” The 2010 Merger Guidelines do not link diversion ratios to market shares explicitly. This change reflects the FTC practice which involves assessing whether the price of any product by the merging firms is likely to increase significantly because of the merger. Hence, the diversion ratio between the merging parties is of crucial importance during the assessment. This is a welcomed change from an economic point of view. A merger combining the firms that are producing close substitutes (the diversion ratio between the products is high) can lead to a significant unilateral price increases even if their combined market share is not very high. For example, a merger between the producers of two luxury brands might lead to a significant price increase of products (especially if non-luxury brands are viewed as poor substitutes) even though the combined share of the two merging firms is small in the context of product market. This conclusion led to the annulment of presumption that the merging firms are significant direct competitors if their combined market share is at least 35% in the 2010

Merger Guidelines. The potential downside of this change is that practitioners may be uncertain about the role of the HHI while assessing mergers between firms producing differentiated products, thus, increasing ambiguity. Another potential drawback is that the courts may not welcome the claim that the evidence of anticompetitive effects diminishes the need to define the markets in merger cases given that this claim is inconsistent with the case law. If the courts do not take the view of the FTC on this issue, then this change will have no impact on merger regulation.

2.2. The value of diverted sales and upward pricing pressure test
As mentioned above, the importance of market definition is diminished. Instead, the 2010 Merger Guidelines place more emphasis on other empirical and theoretical ways to estimate and predict anti-competitive effects. The value of diverted sales was introduced to assess the unilateral price effects of differentiated products. The concept is explained as follows: there are Firm 1 and Firm 2, producing product 1 and 2 respectively. The key question is whether a merger between the two aforementioned firms raises competitive concerns? In other words, the question is whether proposed merger is going to lead to a profitable price increase of one or both products. The problem is that before the 2010 Guidelines the index was not considering possible entry or repositioning of products taking as given possible competing products offered by non-merging firms. Indeed, the amended version of the guidelines addresses a different question: taking into consideration all the products which exert a competitive constraint and their prices, will the optimal price of product 1 for the merged entity is higher when compared to the case in which Firm 1 does not merge? To answer this question it is worth considering how the pricing incentive of the merged entity changes, holding fixed the price of products 2, from a non-merged situation. At this point the notion of diversion ratio becomes relevant. This notion quantifies how much of the displaced demand for product 2 switches to product 1, after having decreased the price of product 1. Hence, the higher the diversion ratio is, the higher the disincentive to offer product 1 by the merged entity. Thus, owning product 2 affects the profits of the merged entity due to the lost unit sales of product 2 until the latter price exceeds its marginal cost. There is an opportunity cost of selling product 1 that is internalized by the merged firm and it is equal to the diversion ratio (D) multiplied by the margin of product 2:

\[ \text{Diverted value sales} = D \times (P - C) \]

Finally, keeping the formula above and dividing it by the price of product 1 (P) it results in:
\[ \text{GUPPI} = D_{ij} \times (P_{ij} - C_{ij}) / P_i \]

The formula above represents the General Upward Pricing Pressure Index (‘‘GUPPI’’) for product 1. This tool helps to focus our attention on the incentive to sell an additional unit of the product 1, considering the cost opportunity of not selling a unit of product 2. Hence, this new approach ensures a solid process to assess the alleged unilateral effects that a merger could raise. In fact, it is considered a quasi-safe-harbor, particularly when the opportunity cost term is as small as a fraction of that product’s price. In addition, the GUPPI allows internalizing the effects of increasing efficiency as well. Indeed, if the efficiencies, created by the merger do not offset the opportunity cost, the merger is likely to lead to an increase of product 1 price.

Many commentators\(^2\) expressed concerns about this innovative instrument. Critics argue that the CA must be careful in setting a bar for non-merging firms’ ability to reposition their products and offer close substitutes. Otherwise, the assessment of horizontal merger will end up being more challenging and in some cases it could lead to an increase in type 1 errors i.e. some pro-competitive merger will be wrongly blocked. In the second place, the GUPPI was criticized because the Guidelines do not determine at which level an increased price raises concern. A bar of 10% efficiencies was proposed, but in the Guidelines there are no indications about a minimum bound and due to this reason they consider this instrument being difficult to implement in practice.

All in all, the value of diverted sales, scaled as GUPPI, is a useful quantitative tool to assess whether a merger could raise unilateral effects or not. On the other hand, Guidelines do not explain in a clear manner how GUPPI is going to be implemented in practice and which are the thresholds for a merger to be considered anticompetitive.

2.3 Merger simulation

Although, GUPPI is a good instrument to evaluate the unilateral effects in a simple way, it

cannot internalize the full scale of competition in real world industries. Due to this fact, the 2010 Guidelines recognize the merger simulation as a tool that the Competition Authorities should apply. Merger simulation allows predicting the alleged post-merger price increase, internalizing the effects of possible entry, efficiencies and repositioning in the model. This is a powerful instrument, particularly when applied jointly with the GUPPI, but at the same time it is not easy to implement in practice. Indeed, being an econometric model, merger simulation model relies on several assumptions in order to simplify the reality. Due to this reason, the CA should be carefully when they apply merger simulation models. For instance, in the case which involved the merger between Oracle and PeopleSoft, the Commission constructed merger simulation model to prove the detrimental effects that the proposed merger would raise. However, the Commission constructed a model that was incorrectly specified. Claas Bengtsson, the economist from the Office of the Chief Economist who acted in this case, explained that the integration of additional players into the model no longer resulted in consistent – across the board price increases. “If it is true that an extended simulation model inevitably produced inconclusive results (i.e. price increases are still forecasted for the majority of scenarios but not throughout all scenarios) due to the increased complexity, then the simulation method did not suffice in providing unambiguous evidence, and, thus, did not contribute to overcome the shortcomings of qualitative assessments”.

Consequently, the merger was cleared because the CA failed to demonstrate the negative effects of the merger on the consumer welfare. This case stressed the difficulty of creating a solid and robust merger simulation model. It can be a powerful instrument if based on correct assumptions, but it can also be the best opportunity for the parties to close the case if model is not correctly specified.

3. Competition on non-price dimensions

2010 Merger Guidelines include a new section discussing the impact of horizontal mergers on innovation and product variety. Every year there are more and more new technology industries. In these industries competition through innovation is as important as competition via prices. The best example is the industry of over-the-air radio where the radio content is

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entirely free to consumers and therefore competition takes place entirely on content quality dimension. The importance of innovation competition over the long run is of crucial importance too, because it brings many benefits to consumers by greatly improving existing products and/or introducing completely new goods.

The Guidelines looks at both short-term and long-term impacts of the merger on the introduction of new products and the effects regarding the product variety. The analysis is similar to the analysis on pricing effects. In particular, agencies will look whether the new product being developed by one of the merging parties will cannibalize the profits from products of the other party that are already in the market. If the answer is positive, the proposed may lead to the delay of introduction or, in the extreme case, cancellation of the new product. Similarly, horizontal merger may lead to withdrawal of some products of merging parties, thus reducing variety of these products. In the longer-run merger might reduce the incentives to innovate. Agencies will try to estimate firms’ capabilities of innovation and examine whether the proposed merger will diminish innovation competition in the future. 2010 Merger Guidelines also takes into consideration the fact that merger might enable competition that would not take place otherwise, by bringing together complementary capabilities.

The introduction of this section is a significant improvement over the 1992 Guidelines. As mentioned above, the competition on non-price elements is becoming more important in many industries. In the past agencies tended to ignore mergers’ impact on non-price competition. One of the best illustrations of this behavior is the case of Sony/BMG merger which was assessed by the European Commission. While the Commission acknowledged that lack of innovative products and artists is one of the reasons for the declining demand in the record music industry, it ignored the proposed merger’s impact on the pace and extend of innovations in the music industry as well as the reduction in the diversity of music which the merger entailed. The release of new records bears the risk of existing product cannibalization. For this reason, the merger between two of the major record companies raised significant concerns regarding innovation competition. However, the Commission did not take this theory of harm into consideration. 2010 Merger Guidelines stress the importance of innovation competition and we believe that this is an important advancement in merger
regulation.

Nevertheless, 2010 Merger Guidelines provide no definitive framework for analyzing non-price competition. For example, Guidelines does not explain how will agencies behave if the price effects of merger will point to prohibition while innovation effects suggest different action. The crucial question of which effects (price or non-price) prevail when the merger is reviewed is not answered. Critics of the Guidelines show further deficiencies. The role of entry and repositioning in the analysis is not explained. In addition, it is not clear how diversion ratio will be calculated for the products which are not in the market yet. In addition, Guidelines fail to explain whether the reduction in innovation might result from coordinated effects as well. Finally, long-term effects on innovation are hard to assess, because of the uncertainty associated with R&D. As a result, both type 1 and type 2 errors might increase.

To sum up, the inclusion of the section which discusses the impact of horizontal mergers on innovation and product variety is a welcomed change from 1992 Guidelines. However, more detailed description of the assessment of competition on non-price dimensions is needed in order to reduce ambiguity and resolve some important issues. At the moment the 2010 Merger Guidelines leaves impression that non-price factors are less important than the price factors to the FTC which should not be the case. Innovation competition is gaining importance in many industries (especially technology industries) and will be crucial when assessing mergers for years to come.

4. Price discrimination of targeted customers and other changes

4.1 Price discrimination of targeted customers
2010 Merger Guidelines added a separate section on targeted customers and price discrimination (‘‘PD’’). The prime concern here involves intermediate goods and services. PD might occur when producers of these intermediate products set different prices for different customers. The FTC is concerned whether the merger may enhance merged parties’ market power over some of its customers. Agencies may also ask whether a group of coordinating firms can engage in PD. The main reason for examining PD is that some customers are more vulnerable than others to anti-competitive effects. This might lead to a reduction of competition between buyers of intermediate goods. For example, small buyers
might pay the higher price (which is not reflected by lower costs of supplying the larger customer) than bigger buyers and thus their ability to compete with them on level terms is hindered. As a result, retail prices are higher and final consumers are harmed. Therefore, market definition might include only the subset of those vulnerable customers.

The potential issue with this approach is that market definitions might become too narrow leading to more type 1 errors. On the other hand, economic theory states that PD might be used by the merged entity to exclude its rivals especially when there are economies of scale and buyers are not coordinated. Nevertheless, it is also true that PD increases firms’ profits allowing dedicating more funds for investments and innovations. Taking everything into account, we believe that the addition of this section is more intended for the protection of firms than the protection of consumers. Narrow market definitions may lead to more false merger prohibitions which will have negative welfare results.

4.2 Strong buyers’ power
The FTC followed the lead of the European Commission and introduced a section on countervailing buyer power. The main argument is that in some cases powerful buyers may constrain the ability of the merging firms to raise prices if they have the ability and incentive to integrate upstream and stop buying the input. Nevertheless, the existence of these strong buyers does not imply automatically that the merger will be cleared as agencies will look at other factors as well. Discussion on buyer power was included in the 2004 European Horizontal Merger Guidelines and the argument was used successfully to clear few high profile merger cases. For example, in Enso/Stora case the merged entity would have 50 and 70% market share in the market of Liquid Packaging Board. Yet, the merger was approved on the base that the main buyer Tetrapak (who buys 60-80% of total sales) was so strong that the merging firms would have been unlikely to exercise market power. There is some empirical evidence that buyer concentration does negatively affect the market power of the sellers⁴. We believe that the inclusion of this section is a welcomed changed that would lead to more pro-competitive mergers being cleared.

⁴ See Scherer and Ross (1990: ch. 14) for a review of this literature.
4.3 Changes in the HHI thresholds

Another noticeable change is the new thresholds of the Herfindal-Hirschman Index. The FTC decided to raise the thresholds and now they are as follows:

- if the HHI is lower than 1500 (an increase from 1000), the merger should be cleared
- if the 1500<HHI<2500 and ΔHHI<100, the merger should be cleared
- if the HHI>2500 (an increase from 1800), the market will be highly concentrated
- in addition to this, if it holds a cumulative condition of an ΔHHI>250, then the merger is presumed anti-competitive.

These new updates were applied in order to align the thresholds in the Guidelines to the thresholds that are used in practice generally. However, the change does not imply a loosening of horizontal merger review standards.


The latest version of European Horizontal Merger Guidelines dates back to 2004. There were a few notable changes that were labeled as a ‘more economic approach’ to merger regulation. Most of these changes originated in the practice of merger regulation in US. Hence, the experience of US had a significant influence on the revision of European Guidelines as will be explained in more detail below.

The most important concept that was introduced from contemporary industrial economics is differentiation between coordinated and non-coordinated effects as possible anti-competitive consequences of horizontal mergers. This differentiation originated in the practice of US where unilateral effects were introduced to the Guidelines of 1992. While the remarks on coordinated effects largely represent a restatement of the traditional collective dominance concept, the inclusion of unilateral effects was meant to extend the scope of European merger regulation. In particular, the test of ‘significant impediment of effective competition’ was introduced which recognizes that in some cases mergers that would not lead to the creation of a dominant position could still harm consumers. The recognition of unilateral effects is
crucial in the differentiated product markets where the intensity of competition (the level of product substitutability) between the merging parties is crucial for the ability to increase prices. Federal Trade Commission realized the importance of unilateral effects in the early 90s and the European Commission finally followed the suit when they were drawing up new Horizontal Merger Guidelines in 2004.

Another important concept introduced by the 2004 Guidelines is the Herfindal-Hirschman Index (HHI). This new instrument, already used by Federal Trade Commission (‘‘FTC’’) is simply the summed squared of the market shares of all the firms inside the market analyzed. It varies between 0 (when the market is highly competitive) and 10000 (when the market has a monopolistic structure). In the US, the FTC uses the HHI as a proxy for the change in concentration, where the proxy is the difference between the post and pre-merger concentration index. Moreover, the FTC established the following thresholds:

- if the HHI is lower than 1000, the merger should be cleared
- if the 1000<HHI<1800 and ΔHHI<100, the merger should be cleared
- if the HHI>1800 and ΔHHI<50, the merger should be cleared

In all the other cases the proposed merger raises serious concerns and the rule of reason should be applied. On the other hand, the EU thresholds are slightly different, but from our experience these thresholds are not accurate predictors of the likely decision-making of the enforcement authorities.

Last but not least, for the first time efficiencies are approved as a countervailing factor although in order to be used as a defense the firm must fulfill three cumulative conditions: in the first place the efficiencies must be verifiable, secondly they must be merger specific and finally there must be a clear pass-on to the consumers (generally decreasing price). In the US the fact that mergers can introduce important efficiencies was recognized during the revision of the Horizontal merger Guidelines which occurred in 1997. Therefore, once again European Commission relied on the experience of their American colleagues while developing the European Guidelines.
To sum up, most of the important introductions (acknowledgement of unilateral effects, HHI index and acknowledgement of efficiencies that some mergers entail) to the Guidelines of 2004 were already implemented in practice by the FTC and outlined in the US merger guidelines. For this reason, we believe that the changes that were made in the 2010 Merger Guidelines could also have a significant impact on merger regulation in Europe. Having outlined the main changes in the 2010 Merger Guidelines we want to discuss briefly whether these changes will be welcomed in the future version of European Merger Guidelines and their impact on the merger regulation in EU.

In the first place, the gross UPP index is an interesting tool and we think it should be applied in Europe too. Indeed, traditional market concentration measures (i.e. HHI) will continue to serve as simple indicators while diversion ratios and UPP will be the key tools for assessing the alleged post-merger price increases. Following this indices CA will take in consideration not only whether differentiated products of the merging firms are each other’s close substitutes, but also whether products of other firms are closer competitors to the merging firms’ than the merging firms are to each other. Hence, CA will have a more clear view of the market structure and the assessment of potential unilateral effects will be facilitated.

Similarly, looking at the past experiences when the merger simulation models were applied, we conclude that merger simulation is a powerful instrument if it is used by experts in both economic and econometric fields; otherwise, the outcome of the case might be dire (ex. Oracle/PeopleSoft case). Nowadays CA are dealing with an increasing number of mergers where parties are producing differentiated products. Since we believe that GUPPI and related instruments is superior approach in estimating unilateral effects than the traditional market share approach in these cases, we think that the new European Merger Guidelines should include these instruments too.

Another change that we would like to see in European Merger Guidelines is recognition of competition on non-price dimensions. We believe that the section on innovation competition is necessary, because some mergers might raise significant competition concerns even if the merged entity’s ability of increasing prices is small. If the Commission will provide a good analytical framework for assessing non-price effects it might affect merger regulation significantly. The inclusion of this section is likely to have a significant impact in technology industries where it will be increasingly important to convince the agencies that mergers will not harm innovation and product variety. In industries where competition takes place on non-
price aspects such as content quality etc. the companies will have a clearer picture whether the proposed merger will be cleared. Consumers highly value non-price dimensions of goods and services. It is only natural that CA are going to spend more time analyzing non-price effects as well.

In contrast, we think that inclusion of price discrimination of targeted customers was a bad decision and at the moment we would not recommend it to be included in European Merger Guidelines. Economic theory states that the effects of PD are ambiguous and uncertainty is not welcomed in merger cases where decisions should be made quickly. Markets might become too narrow and the amount of type 1 errors is likely to increase. Only if American merger regulation practice shows that the introduction of this section has positive effects in terms of won cases, we would agree that it should be included in European Merger Guidelines too.

Taking everything into account, merger regulation in US had a significant impact on the merger regulation in Europe in the past. In 2010, the FTC once again introduced significant changes to the Horizontal Merger Guidelines. We show that these changes are welcomed from an economic point of view and that the European Commission is advised to take the role of the follower again.

6. Conclusions

Over the years the U.S. Horizontal merger Guidelines had a significant influence over merger regulation world-wide. Often they have led the way in the improvement of merger regulation. We believe that the 2010 Merger Guidelines is no exception. There were few welcomed changes from the last version of Guidelines. Table 1 summarizes them.
### Table 1. Summary of the new features in the 2010 Merger Guidelines

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<th>Feature</th>
<th>Advantages</th>
<th>Disadvantages</th>
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| Reduced importance of market definition      | In differentiated goods industries a merger between producers of close substitutes can lead to a price increase even if merging firms do not have significant combined market share in the industry. | 1. Uncertainty over the role of HHI  
2. Inconsistency with the case law. Courts may not welcome this change. |
| Value of diverted sales and UPP index        | Useful quantitative tools to assess whether the merger have unilateral effects.                      | Guidelines do not explain in a clear manner how these tools are going to be implemented in practice. |
| Merger simulation models                      | Merger simulation allows predicting post-merger price increase, internalizing the effects of possible entry, efficiencies, repositioning and efficiencies in the model. | One has to be careful when imposing various assumptions.  
Incorrectly specified model is the best opportunity to win the case. |
| Competition on non-price dimensions          | Innovation competition is becoming more and more important in many industries. Price increase is not the only effect that harms consumers. | Guidelines provide no definitive framework for analyzing non-price competition. Many questions are left unanswered. |
| PD of targeted customers                     | Price discrimination might be used to exclude rivals. Thus, if the merger allows the parties to do price discrimination, anti-competitive effects might arise. | 1. Market definitions might become too narrow leading to more type 1 errors.  
2. PD has positive effects. Higher profits can lead to more investments and innovation. |
| Countervailing buyers power                  | Strong buyers might constrain merged parties’ ability to increase prices. Positive European experience. | Strength of buyers might be overestimated. |
| Change in HHI thresholds                     | 1. Thresholds are aligned to the ones that are used in practice.  
2. Horizontal mergers review standards is not loosened. |                                                                                        |
To sum up, these Guidelines makes clear that while market definition is important in assessing competitive effects and that the market must be defined at some point in the process, ultimately merger analysis must rely on the competitive effects of a merger. Furthermore, the Guidelines make a substantial contribution by listing a variety of innovative or updated empirical tools which should help to detect those competitive effects. For instance, the value of diverted sales, the GUPPI and the merger simulation models are powerful instruments to prove the existence of unilateral effects, despite the fact that they are difficult to implement in practice. Moreover, the Guidelines do not explain accurately how to apply them in particular conditions, such as the implementation of GUPPI in a case where non-price dimensions are relevant.

The 2010 Guidelines made a “big step forward” considering the innovation competition, which is becoming more and more relevant characteristic in several economic areas such as the high-tech fields. Recognition of countervailing buyer power is also welcomed; bearing in mind that strong buyer power of the customers might clear a merger even if the merging parties combined market share is high. Finally, the price discrimination of targeted consumers seems to be the most controversial addition. While it is true that if the merger allows the parties to do price discrimination, anti-competitive effects might arise, but, on the other hand, this process could lead to wrong market definition (too narrow relevant market). Taking everything into account, we conclude that all the updates of the 2010 US Guidelines can be useful to improve the future European Guidelines, with the exception of price discrimination of targeted consumers. In our opinion, this change will provoke more problems than benefits.

The new guidelines are intended to be flexible and cannot account for all possible situations. Nevertheless, the emphasis placed on potential competition in the new Guidelines calls out for more guidance from the CA, so that merging parties will have a better ability to assess likely responses of agencies and the method by which their proposed merger will be analyzed. The 2010 Guidelines are not the final word in substantive merger assessment, but they are an important step forward in the horizontal merger evaluation. For this reason, we believe that the European Commission should take a role of follower again when drawing up the new version of European Horizontal Merger Guidelines.
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