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European Commission Directorate-General for Competition
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Draft revised Commission Notice on Remedies Acceptable under the Merger Regulation

Comments by Professors Davies and Lyons¹

We write as the authors of a recently completed study of mergers that were accepted by the European Commission subject remedies. Extracts of our forthcoming book, based on this research, are attached as an appendix. Our research was based on material from the original case file and supplemented by material from the DG Comp ex post study. We also conducted background research into the industries from which the mergers were selected. In this way, we were able to analyse problematic mergers right through from the identification of an impediment to competition, to remedy selection, remedy implementation and the following success (or failure) of the remedies. Apart from being academic outsiders, our work is distinguished from the much broader DG Comp study by a critical appraisal of the original decision to identify what alternative remedies were available. The extracts in the appendix to this note set out those of our main conclusions that are of direct relevance to the Draft Notice. This brief cover note highlights how some of the more significant implications relate to the Draft.

We begin by welcoming the revised Notice, much of which represents best practice if properly implemented. We highlight four issues on which the Notice could be improved. The first two relate to remedy selection and the second two to implementation.

1. Licensing as a remedy [section III 1.2 & III 3]

Licensing arrangements are discussed in #38 in the horizontal context and in more detail in #65-66 in the access context. The latter refers to “reasonable and non-

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discriminatory licensing (RAND) as used in some standardisation processes”. Standardisation processes often emerge through cooperation, which is not necessarily the atmosphere of a license offered under the ‘duress’ of a merger approval process. Furthermore, non-discrimination may be much harder to confirm in the latter.

In practice, licensing agreements in remedies have used terms like ‘adequate compensation’ and ‘normal and non-discriminatory commercial conditions’. These terms are open to abuse leading to ineffective remedies. Much clearer guidance is necessary to determine commercial terms and licence duration such that competition will be fully restored.

2. Behavioural remedies for horizontal problems in very small markets [III]

There is no mention of behavioural remedies in section III, except in relation to vertical issues. There is a strong statement in #22 in favour of structural remedies. This is almost always correct (at least for the size of merger normally addressed by DG Comp), but there should be exceptions. (This issue is also anticipated in #17.)

Our research has revealed a significant minority of cases where there is a national geographic market, and where the anti-competitive overlap is in a market that is very small. In such cases, some form of price and production commitment would almost certainly have been the better option to divestiture. This seems to be particularly the case where the merger has numerous product and geographic markets and the parties may be so keen to get the main part of the merger approved that they propose a divestiture when that is not in their customers’ best interests (e.g. there is no buyer with a serious interest in a small product, but who can be tempted by an appropriately low purchase price). We suggest the Commission should be much more willing to accept behavioural guarantees when the market is very small, there is a significant risk that potential purchasers of a divestiture will not invest in the product, and where the identity of customers makes it sufficiently easy for them to monitor undertakings.

3. Collusion between merging parties and purchaser of divested assets [V 2]

At the time of negotiations between the merging parties and a potential purchaser of divested assets, seller and buyer will agree a deal that maximises their joint profits. The distribution of such profits will be reflected in the purchase price. Joint profits will be maximised by a purchaser who does not intend to use the assets to compete directly with the merging parties. There is, therefore, a serious danger that a seller and purchaser collude to avoid the restoration of competition to the pre-merger level. In this context, we welcome the proposal that the Commission will discuss business plans with potential purchasers (#100). However, the Commission should take steps to ensure that these plans are credible and that they do restore competition.

4. Trustee loyalty and instruction [V 4]

The section on trustees is apparently tough on ensuring the type of person who can be expected to be impartial (both in monitoring and divestiture roles). However, two weaknesses from the past are not sufficiently addressed in the new draft. First, the merging firms both propose the trustee and determine the mandate, albeit with the approval of the Commission (#121). Our concern is not one of explicit bias, but of

the failure of the Commission to be the first to instruct the trustee on the reason for the divestiture. In the past, many have not been aware of the competition concerns, let alone the requirements necessary to restore competition. Indeed, this is typically not their expertise. Second, trustees are paid by the merging parties (#123). Combined with being appointed and instructed by them, this sets in stream a natural loyalty to the merging firms and to their shareholders. This holds even when the trustee is an experienced auditor. In addition to being the first to instruct a new trustee, it would be better if the Commission or some third party could pay them and claim back costs from the firms.

Bruce Lyons
Stephen Davies
21 June 2007

APPENDIX: *Extracts from our forthcoming book to be published by Edward Elgar November 2007.* These extracts have been selected to focus on research conclusions of direct relevance to the Draft Remedies Notice.

Extracts from ch.1 provide background to the research base which informs our views. Extracts from ch.9 provide our research conclusions and policy recommendation.

ASSESSING THE CONSEQUENCES FOR COMPETITION OF EC MERGERS AND MERGER REMEDIES

by

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Chapter 1: Mergers and Remedies in the EU: overview

1.0 Introduction

...The focus of the research in this book is on the remedies that the European Commission sometimes requires before clearing prospective mergers...

...Ultimately, the effectiveness of a remedy depends on whether or not it achieves the same level of competition in the market as pre-merger, in particular in eliminating any harm the merger might have otherwise imposed on consumers.

1.1 Objectives of our research

The original objective of this research was to develop a practical methodology for assessing the effectiveness of remedies agreed by an antitrust authority as a condition for allowing a merger to proceed. ...

As the project developed, we were able to extend our objectives in a further direction. For all but one of our merger case studies, we were given the opportunity to review interview evidence gathered by DG Competition as part of a major internal study on the success and problems of past remedies. Together with our detailed knowledge of the competitive effects of the original mergers, these provided the foundation for our *ex post* assessment of remedies and recommendations on remedy implementation.

...

[Our seven merger case studies were drawn from two industrial sectors. Each merger was approved 1996-2000, subject to remedies; some in Phase I and others in Phase II. Each merger was complex and most covered many national and multiple product markets.] Paper was chosen as representative of 'traditional' industries which supply more or less homogeneous products, based on a mature technology, and in which competition is effected largely on the basis of price and quantity/capacity. Pharmaceuticals was selected to represent more 'dynamic' industries, in which innovation, marketing and product design are the main drivers of the competitive process. In each case, we provide an opening survey of the sector and the nature of competition therein. Specific mergers and, for each merger, specific product and geographic markets are earmarked to apply a range of basic simulation techniques. Following our *ex ante* case studies, which use only data that were available at the time of the merger and the Commission's decision, we provide an *ex post* review in the light of information collected for their follow-up study by DG Competition.

...

Finally, [Chapter 9 also] summarises the lessons from the *ex post* studies, and puts them together with our *ex ante* analysis and the broader literature to make some constructive suggestions for how the Commission should reform its remedy procedures.

...

Chapter 9: Conclusions and Recommendations

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9.3 Problems of remedy design and implementation

Divestiture to restore market structure or to restore competition?

Most of our cases involved the reinstatement of the *status quo* product market structure in selected member states by means of selective divestitures. Where this involved the entire overlap business of one of the merging parties, we have termed this ‘prohibition within the market’. Generally, these were effective to the extent that there was a buyer, the divestiture was completed in reasonable time, and the business remained a going concern around five years on. On the other hand, the buyer was not always as vigorous a competitor as was the acquired party before the merger. In one case, the buyer resold the assets the following day, and in another, the buyer was interested only in acquiring capacity and failed to continue the brand (which was the key vehicle for competition in the relevant market).

The last column of table 9.1 summarises some further problems encountered in the transfer of assets. For example: several divested businesses lost temporary or permanent market share; and divestiture of pipeline products may have delayed product development. Sometimes, it is difficult to tie problems to the divestiture itself,² but in many cases there is evidence that problems were at least exacerbated by the transfer of ownership.

Overall, it is important to recognise that the *restoration of market structure does not necessarily mean the restoration of competition*. While the Commission has taken care to ensure that buyers are suitably established firms, it has not necessarily taken other important issues into account; for example, the incentives to market and develop products when ownership is split across geographic markets.

Presumption that structural remedies are better than behavioural remedies

While it is generally true that an appropriate form of divestiture is the best remedy, it is not universally true. Divestitures can have large transaction costs, particularly in the European context where there may be a competition concern in only one national market. While it is obviously necessary to address those genuine concerns, simple, even Draconian, price controls combined with a commitment to continue supply could be a superior outcome for customers.³ This is especially so when the customers are large and can monitor such arrangements with ease. Alternatively, these might be enforced by a monitoring role for a long term trustee. Behavioural remedies may also be preferred by the merging parties if this geographic market is tiny and so has no serious effect on revenues, and the remedy maintains the integrity of unified global

² For example, the merging parties inevitably choose to sell the older generation, declining or less successful products from their combined portfolios, so it is not surprising that competition is sometimes reduced post-divestiture.

³ Price controls and some other behavioural remedies may raise particular problems for a supranational competition authority to enforce and monitor. These tasks would probably need to be delegated to a national authority, in particular when the relevant market is at the national level. The choice of national authority would then be an issue (e.g. a national authority like the OFT in the UK may have an existing competence, or certain industries like pharmaceuticals may have existing national regulatory frameworks). In other cases, an independent auditor funded by the merging parties may be suitable.

product ownership. Very careful attention is required on the detail of any undertakings. For example, it is important that customers should have recourse to an arbitrator because court remedy is too expensive and unreliable. Such attention to detail has not always been evident in Commission remedies.

Licensing as a clean break remedy

Once again, insufficient attention was also paid in several cases to licensing terms, concerning royalties, arbitration, and duration. While terms like ‘adequate compensation’, ‘supply the product at a price which will ensure that the third party distributor can compete effectively in the market’, and ‘normal and non-discriminatory commercial conditions’ are referred to in decisions, these are insufficient to ensure an effective remedy. *In the absence of a genuinely clean break* (including indefinite duration, no continuing royalty payments between the parties and no split of property rights across markets) *licensing does not restore ex ante incentives, even when it restores ex ante market structure*. Furthermore, it is important to recognise that even when the licensee is happy with the deal, this does not necessarily mean that it is good for customers because the licensee may be compensated by the seller in some other way.

Design of remedy package

Much has been learnt from the pioneer FTC study (e.g. it is appropriate to divest an existing, self-standing business, rather than a carve-out wherever possible). However, some typically European concerns were apparent in some of our cases. Residual barriers to the internal market mean that some geographic markets are often quite small national markets. Combined with narrow product markets, as is the case for pharmaceuticals, the relevant market for competition analysis can be very small. This means that a viable business within one relevant market can only attain that viability in the context of part of a product portfolio (e.g. to support distribution economies of scope). This means that either or both geographic and product markets need bundling. On two occasions in our sample, the parties chose to bundle more than the Commission-required minimum in order to make a viable divestment. On the other hand, from the perspective of the capabilities of the buying firm, smaller buyers might become unbalanced if they were to absorb the full range of products in an existing business that ranged wider than the potential buyer’s core competence; and larger buyers are often uninterested in niche products with low sales. Thus, the design of the divestiture package might need to be *flexible in response to the different needs of prospective buyers*.

Furthermore, the successful design of remedies may take some time, and this *time may not be available during a Phase I investigation*. This raises some important trade-offs that we have been unable to quantify in this study. The apparent use of routine procedures by the Commission⁴ to allow early clearance may, as we have found, superficially restore market structure, but not restore competition. This suggests the benefits of a more considered approach which might entail a Phase II inquiry. However, such investigations have substantial costs which must be weighed in formulating the most appropriate policy. The balance will depend *inter alia* on the availability of strong buyers for divested assets.

⁴ At the time of the Decisions reviewed in this study.

Use of divestment trustees

Firms typically have an incentive to run down assets prior to a divestiture, in order to reduce their competitive success. *Trustees (as currently used) appear to have been reasonably effective monitors until asset transfer, but were weak on their interest in, and understanding of, how to preserve long run competition.* Their attitude is broadly that of an independent auditor paid by the merging firms to ensure a fair sale. They do not see themselves as being responsible to the Commission, other than to provide the required progress reports. This was typically their only ‘contact’ with the Commission. They were not even briefed on the competition issues.

9.4 Recommendations for better practice

...

Finally, our *ex post* analysis suggests a number of areas in which Commission practice should be tightened up, in particular in the detail of specifying and implementing remedies. Some of these are also obvious and have been made in the parallel study by DG Competition. In addition, our detailed reworking of our case study mergers, combined with the *ex post* interviews, lead us to recommend the following:

- For divestitures, the business plans of the buyers should be a routine requirement to ensure that they intend to continue with the business in a way that will at least maintain competition (and not, for example, immediately sell the business or discontinue a competitively significant brand). Also, divestiture trustees should be briefed by the Commission on the competition issues motivating the remedy – this should be a formal requirement.
- For licensing, the Commission should recognise the competitive importance of the detailed terms (e.g. royalties, duration), and give more thought to specifying these in their decisions, with a view to creating a clean break remedy.
- The Commission is in a unique position as a competition authority, in so regularly having to deal with products which compete in a large number of national markets. Where competitive conditions vary across national markets, the Commission should be concerned about the incentives to further develop products if the remedy results in divided ownership across geographic markets. Where a small national market is the only one creating a competitive concern, the Commission should be willing to consider a strong, simple set of behavioural remedies

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