Bargaining over Remedies in Merger Regulation

CENTRE FOR COMPETITION POLICY

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CCP Policy Briefing

BACKGROUND

- Merger regulation is the *ex ante* part of competition policy that aims to prevent the creation of market power by acquisition. Most jurisdictions have adopted a variant of 2-phase investigation for qualifying mergers, with a first phase deciding on whether there is a case for a more detailed investigation in a second phase.
- A competition agency usually has the power either to prohibit a merger, or to condition its approval on the merging firms agreeing binding undertakings. Most typically, these are to divest some of their assets but it may be to accept a package of behavioural restrictions. Such agreed conditions are known as 'remedies'.
- In most jurisdictions remedies can be agreed in either phase of investigation. EC practice is for the firms to make the final remedy offer to the agency, who can then either accept or reject it. Rejection in Phase I results in referral to Phase II, and rejection in Phase II results in prohibition.
- The European Commission decided on 3,170 qualifying mergers between September 1990 and the end of 2006. During this period, 140 were remedied in Phase I, 79 were remedied in Phase II, and just 19 were prohibited.
- This paper is the first to model how remedy negotiations affect merger control outcomes. The model is designed to answer the following questions:
    - Why are remedies sometimes agreed in Phase I but for other mergers only after Phase II?
    - To what extent should we expect remedies exactly to remedy the expected loss of competition?
    - When are remedies likely to be insufficient and when will they be excessive?
    - Should firms prefer a well-resourced competition agency or one that works to a very limited budget?

METHODOLOGY

- The paper develops a theoretical model of 2-stage merger control. It starts from the presumption that the purpose of an investigation is to discover information on the proportion of a proposed merger that would significantly impede competition. The competition agency is initially at an informational disadvantage compared with the merging firms, but it does have the benefit of being able to design the framework in which firms have to negotiate remedies. Discovering information is costly – the more that is invested in an investigation, the better is the agency's information.

- The agency would like to find the 'true remedy' that would resolve competition concerns while leaving the firms as free as possible to seek efficiencies. The firms want to maximise profits; in particular, they have an incentive to try to retain those parts of the merger that would impede competition, but it would prefer not to have to endure a costly Phase II investigation. From a wider perspective, we are interested in how this combination of agency and firms' objectives fares against the criterion of minimising the welfare cost of errors in agreeing remedies.

KEY FINDINGS

- Whether firms make excessive or deficient remedy offers in Phase I depends on the balance of two forces. First, firms want to avoid a costly Phase II investigation, so err on the generous side. Second, firms want to bluff the agency with a deficient offer.
- The model can be used to explain abandoned mergers, referrals to Phase II and prohibitions, as well as Phase I and Phase II remedies.
- Increased resourcing for the agency can sometimes lead to more severe errors in remedy agreements.
- Merging firms typically benefit from a better resourced agency (unless the agency is very poorly resourced in the first place).

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POLICY ISSUES

- There are inherent biases in remedy agreements, but these are more complex than they might appear. For example, it might be thought that firms which have an initial informational advantage should be able to use this to extract 'informational rents'. We find that this is not always true, and there are clear circumstances in which firms offer excessive remedies.
- Excessive offers will be made by firms that have high costs of Phase II. Indeed, offers will always be excessive if those costs are so high that the merger would be abandoned if there is failure to agree in Phase I. Put more formally, the agency incurs a Type 1 error.
- However, if the costs to the merging firms of going to Phase II are relatively low, they have a dominant incentive to bluff in Phase I with a deficient offer. If the agency's market testing turns out to be lucky for the firms, they will win Phase I approval and the agency incurs a Type 2 error.
- More precisely, the costs of Phase II to the firms should be relative to the potential profits of retaining marginal assets. Inasmuch as bigger mergers have more at stake, as well as the financial muscle to ride Phase II, they are predicted to offer less generous remedies in Phase I, and consequently they are more likely to be referred to Phase II. Note that this prediction is due to the bargaining stance taken by the merging firms, and is *not* due to a judgement by the agency that it is not worth pursuing small mergers or even that large mergers are more complex.
- What does our model have to say about the appropriate resourcing of a competition agency in Phase I? The answer depends on where we are starting from. For agencies that are initially either poorly or well resourced, an increase in the resources available leads to a lesser errors in remedy agreements. However, there is a difficult lacuna for an intermediately resourced agency, for which extra resources may be counterproductive.
- Would the firms subject to merger control welcome an increase in agency resources? We find that the answer is often 'yes'. This is because, if they would make excessive remedy offers, they will be able to divest fewer assets when dealing with an agency that better understands the market. On the other hand, if they would make a deficient offer, even though they will be able to bluff less well, this advantage is sometimes (but not always) offset by the reduced likelihood of prohibition.
- An implication of the last bullet point is that firms operating in a developed country with a reasonably well-resourced agency should support an increase in resources for the agency (to get it even more accurate); while firms operating in a developing or transition country, with a very poorly resourced and inaccurate agency, might prefer it to be even more handicapped so that there is more opportunity to obtain agreement to a deficient remedy in Phase I. A threshold for competence is therefore necessary for the corporate sector to buy into better competition policy.

FOR MORE INFORMATION
The full working paper (CCP Working Paper 07-3) and more information about CCP and its research is available from our website: www.ccp.uea.ac.uk

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