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THE USE OF BEHAVIOURAL REMEDIES IN MERGER CONTROL

Competition authorities have tended to prefer structural to behavioural remedies when addressing concerns raised by mergers. The recent Tetra Laval/Sidel judgment by the European Court of Justice and two remedies reviews – one completed by the International Competition Network, another underway by the UK Competition Commission – may suggest greater scope for behavioural remedies in the future. This bulletin examines the circumstances in which behavioural remedies may provide acceptable alternatives to structural remedies in reversing a loss of competition due to a merger, or limiting its effects on customers and rivals.

When a merger is seen to pose a threat to competition, the regulator's next question is how to respond. There may be alternatives to outright prohibition. Remedies can often be devised that reverse any loss of competition, or limit the consequences of such a loss, whilst still allowing a transaction to proceed – at least in a modified form. →

To identify, and manage, the regulatory risks associated with a merger, it is essential to understand the range of potential merger remedies regulators may apply and how their choice will be made. For example, knowing whether – should competition concerns be raised – there are likely to be remedies acceptable to both the authorities and the merging parties can be critical to deal valuation and the decision to proceed. Similarly, where it is imperative to avoid a prolonged regulatory process, understanding the likely scope of acceptable remedies can inform the design of remedies packages necessary to obtain "phase I" clearance.

STRUCTURE AND BEHAVIOUR

Remedies imposed by competition authorities are commonly described as "structural" or "behavioural". Structural remedies require divestment by the merged firm – commonly of a subsidiary or business unit engaged in an area of activity where the merger raises significant competition concerns. In effect, the remedy reverses the merger in the areas where issues arise. Alternatively, structural remedies may involve the divestment of specific business assets – such as production facilities or brands – that actual or potential rivals may find difficult or uneconomic to develop themselves, but need if they are to provide effective competition for the merged firm. In either case, the primary objective is to create a new independent competitor or enhance the competitive capabilities of existing rivals in activities where the merger has led to a reduction in competition.

Behavioural remedies require merged firms to commit themselves to conduct business in certain ways. They may have to give undertakings not to engage in particular sales practices (e.g., forms of conditional selling or price discrimination) or to provide guarantees to provide rivals with access to certain inputs. Commitments to license a technology to rivals or to remove exclusivity provisions from customer contracts also fall into this category. Here too the objective may be to re-inject competition, by easing market access for actual and potential rivals and improving their ability to compete with the merged firm.

Alternatively, behavioural remedies may seek to address specific behavioural threats – for example, the ability and incentive for the merged firm to engage in exclusionary conduct. Vertical mergers, or mergers involving complementary products, typically involve no direct loss of competition but may give rise to concerns that the merged entity's increased scope for leverage will lead to a weakening of competition in the future. In such cases, commitments not to engage in tying or bundling practices across an enlarged product portfolio, or to provide reasonable access terms for rivals seeking inputs from a vertically integrated firm, may offer possible solutions.

In other cases, the primary concerns are that the merged entity will be able to exploit its position by increasing prices, worsening service or reducing choice. Rather than attempting to address such concerns through measures that increase competition in the market, behavioural remedies may be used specifically to limit the exploitation of increased market power by the merged entity. Commitments not to engage in price discrimination or increase prices post-merger, although not reversing a loss of competition, may serve to limit its effects.

WHAT'S IN A NAME?

The distinction between behavioural and structural remedies may, however, sometimes be misleading. Although divestment addresses issues of market structure rather more surgically, behavioural remedies can also be used to restore competition; in that sense, both can offer "structural" solutions. A more meaningful distinction between types of remedies may be based on:

- the extent to which they serve to reverse any loss of competition resulting from a merger (as opposed merely to controlling the negative effects on customers or rivals); and

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- the degree to which they offer a clean break (as opposed to requiring ongoing monitoring or market intervention by the authorities).

However, competition authorities have clearly tended to prefer structural (divestment) remedies. In the case of the European Commission (EC), this preference has been made explicit in its guidelines[1]. It is understandable, since structural remedies score highly on the two criteria set out above. Not only do they seek to restore competition, but will typically offer the cleanest solution – one-off divestments requiring no further regulatory involvement.

Attempts to constrain a merged firm to behave in the way it would have done, absent the loss of competition, will inevitably work imperfectly. Take, for example, an undertaking not to increase prices. How these would have evolved without the merger can never be gauged with certainty. Suppose that prices would actually have fallen. Then even an undertaking not to increase them would allow for prices to be higher than would otherwise have prevailed. Or suppose that a key concern arising from a merger is a loss of the dynamic benefits that competition can bring – the drive to create new products and new and better processes. The design of behavioural remedies that will require firms to be innovative is obviously challenging.

Moreover, behavioural remedies may have undesirable side-effects by distorting market outcomes, creating perverse behaviour and even restricting competition. Again, take the example of an undertaking not to raise prices. And this time, suppose that, even without a merger, prices would have risen. In this case, a freeze may damage competition by driving prices below competitive levels. The more wide-ranging the behavioural restraints required, and the longer these need to be in place, the greater the risk of these unwelcome consequences. To these implicit costs must be added the explicit costs of regulatory monitoring and enforcement. These will either divert the competition authorities from other policy activities or require extra government expenditure. In short, behavioural remedies tend to be the authorities' second choice at best because they are seen as treating the symptom rather than the cause, and involve the extra costs of ongoing regulatory oversight.

ANOTHER LOOK AT BEHAVIOUR

Put like this, structural remedies appear to win hands down. However, divestment may also be difficult to implement and uncertain in its effects. Will it actually be effective in creating a new competitor and restoring competition? Will a newly-created rival be viable or credible? Even outright prohibition of a transaction cannot always be guaranteed to restore competition to its pre-merger levels, if the ability to recreate separate entities has been compromised.

On a more positive note, behavioural remedies can also possess the attractive features typically associated with structural remedies. As noted previously, behavioural remedies can sometimes be used to re-inject competition into the market following a merger, and therefore do not necessarily involve substituting market regulation for competition. Moreover, to the extent that behavioural remedies inevitably involve some form of ongoing regulatory intervention in the market, this may in fact be relatively light-handed and may fall a long way short of requiring the authority effectively to engage in market management. As such, the explicit and implicit costs typically attributed to behavioural remedies may in certain circumstances be overstated.

The recent Tetra Laval/Sidel judgment of the European Court of Justice (ECJ) provided a warning against an automatic presumption in favour of structural remedies. It gave a timely reminder that behavioural remedies can be used to prevent a loss of competition as well being used to control the effects of a loss of competition, and that behavioural undertakings can offer effective remedies to the concerns raised by mergers.

The EC had rejected behavioural commitments offered to address its concern that the merged parties could engage in sales practices which would enable strong market

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positions in two distinct product areas to be leveraged, resulting in a weakening of competition. Commitments not to engage in these types of practices were rejected largely as a matter of principle, the EC highlighting its preference for structural remedies. But the ECJ determined that the EC was wrong not to have taken these commitments into account in assessing whether the merged firm was likely to engage in conduct which would create or strengthen a dominant position. The Court stated that:

...the categorisation of a proposed commitment as behavioural or structural is immaterial... commitments which are prima facie behavioural... may also be capable of preventing the emergence or strengthening of a dominant position[2].

The Court went on to stress that, in situations where the loss of competition following from a merger is expected to arise if and only if the merged firm engages in specific forms of conduct, it is all the more important to assess properly the scope for behavioural remedies.

In the UK, there appears to be renewed interest in the potential scope for using behavioural remedies to address competition concerns arising from mergers. Soon after his appointment as Chairman in 2004, Professor Geroski announced a review of remedy policy at the Competition Commission (CC) in response to its new powers to decide upon remedies under the Enterprise Act. In an interview with the *Financial Times*, Professor Geroski stated that the CC needed to:

... build up experience with behavioural remedies and one way to do that is to reach back into the past and see what worked and what didn't work[3].

The International Competition Network's Merger Remedies Review Project reported its findings to the network's 2005 annual conference. Whilst recognising the reasons for a presumption in favour of structural remedies in many jurisdictions, the report clearly identifies the potential benefits of behavioural remedies and the circumstances when such remedies may be appropriate.

The willingness of authorities to accept behavioural remedies will to a large extent be driven by the availability or otherwise of "appropriate" structural remedies. Views will differ between jurisdictions. However, examples of the circumstances in which behavioural remedies may be considered include the following.

- **Where there is uncertainty about the effect of potential divestment packages.** Such situations may arise where there is a lack of credible potential purchasers for the assets. Alternatively, there may be uncertainty over which assets need to be divested in order to reinstate an effective independent competitor in the market or materially improve the position of existing rivals.

- **Where jurisdictional issues may limit the range of divestments that can be considered.** Mergers involving multinational firms can frequently involve filings in multiple jurisdictions. Only a subset of these may cause concern – for example, the potential loss of competition may be significant only in those national markets where the parties have enjoyed historically strong positions. Where core business assets – such as brands or production facilities – are used to serve multiple geographic markets, it may not be possible to identify country-specific divestments which meet the case. (The Dräger/Air-Shields merger, discussed below, provides an example of how multi-jurisdictional issues may constrain the use of structural remedies.) Apart from the legal issues, national authorities may feel uneasy about requiring divestments that have global implications – potentially undermining an entire transaction – when in other territories the merger may not raise concerns and may indeed be seen as beneficial.

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- **Where the principle of proportionality points away from structural remedies.** The existence and application of this principle differ between jurisdictions, but would appear as a minimum to imply that where a number of different (but equally effective) remedies are available, those that place the least burden on the parties should be adopted. If an effective behavioural remedy exists, it may well fit the bill. Structural remedies may be unnecessarily burdensome if there are particular complications involved in divesting assets. There may, for example, be contractual obligations that could not be honoured in the event of a divestment and from which the parties might find it costly to extricate themselves. (The Coloplast/SSL case involved such considerations.) Alternatively, a structural approach may be disproportionate if the size and scope of divestments needed to address competition concerns have commercial implications that stretch beyond the markets in question. In these circumstances, the surgery implied by structural remedies may be too radical, amounting effectively to a unwarranted prohibition of the transaction. (The FirstGroup/Scotrail case provides an example of these issues.)

- **Where the merger benefits would be greater with behavioural remedies.** Under the UK regime, there is explicit recognition that in determining remedies, their impact on the merger's benefits to customers should be taken into consideration. Mergers can yield benefits (new and better products and services) as well as costs (price increases). Not all customers will gain and lose in the same way: some may enjoy substantial price reductions as a result of efficiencies achieved through the merger while other customers may face price increases as a result of a loss of competition. Ideally, an authority would wish to apply remedies that reverse any loss of competition while leaving the potential benefits from the merger intact. However, such an ideal may not be possible. Where structural remedies involve substantial modifications to a transaction, they may severely reduce merger benefits. This may well cause the authorities to look more seriously for behavioural remedies.

In addition, there are certain circumstances in which the perceived weaknesses of behavioural remedies are simply irrelevant. For example, vertical and conglomerate mergers do not lead to a direct loss of competition. Here the authorities' concerns are focused on the future behaviour of the merged entity – whether it might ultimately weaken competition by acting to exclude competitors. In such cases as Tetra Laval/Sidel, behavioural remedies that prohibit such exclusionary conduct may indeed be seen to tackle the cause rather than merely the symptoms.

In other situations, an authority may conclude that a merger only results in a significant loss of competition because certain forms of conduct – such as exclusive supply or distribution arrangements – currently exist in the market. In the absence of these arrangements the loss of competition arising from the merger may not be seen as significant because remaining competitors would be more effective rivals. Again, behavioural remedies may be more likely to be seen as offering a pro-competitive solution.

There are also circumstances where the costs of monitoring and enforcing behavioural remedies may be insignificant. If the loss of competition flowing from a merger is expected to be short-lived, such remedies may be a useful stop-gap. And if the market is already highly regulated, the marginal costs – both explicit and implicit – of monitoring behavioural remedies may be low. A number of mergers involving medical products (discussed below) provide examples of this situation.

RECENT MERGER PRACTICE IN THE UK

In this bulletin, we have already highlighted a number of recent cases. To illustrate the range of arguments, and the way different arguments apply to different types of transactions and markets, we summarise below the UK merger cases over the past five years in which behavioural remedies have been applied.

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Financial year	Mergers reviewed by OFT	Undertakings in lieu	Behavioural undertakings in lieu*	Mergers referred to CC	Undertakings given**	Behavioural undertakings given
2000-01	315[A]	6	1	14	6	0
2001-02	356[A]	6	4	10	2	0
2002-03	414[B]	5	0	21	4	1
2003-04	267	2	0	12	9	2
2004-05	257	4	2	18	5	2

Undertakings in UK merger cases

Source: OFT annual reports (data for FY to end March, A = data for calendar years, B = data for January 2002 to March 2003), CC annual report & accounts (excludes mixed structural/behavioural undertakings and undertakings in defence cases. ** includes undertakings not to proceed with transaction.)*

As far as we are aware, the Office of Fair Trading (OFT) has only accepted behavioural undertakings in lieu of a reference on two occasions since 2002. These were in relation to the Arriva/Wales & Borders and IVAX/3M cases. The former involved the acquisition by Arriva of the Wales & Borders rail franchise, which operated regional passenger train services. The OFT considered that Arriva, which operated a range of other transport services in the region, might have had the ability and incentive to introduce its own multi-modal ticketing arrangements and deny third-party bus operators in the region access to those arrangements, thus possibly foreclosing bus routes into rail stations. The OFT accepted undertakings by Arriva to ensure that rival bus operators would be able to participate in any public transport multi-modal ticketing scheme run by Arriva "on fair and reasonable terms that are at least no less favourable than the terms applicable to Arriva's own bus operations".

The second case involved the acquisition by IVAX of 3M's distribution business for asthma products. The merger resulted in IVAX becoming the sole supplier of salbutamol breath actuated inhalers in the UK. As branded prescription medicines, the products were subject to price regulation by the Department of Health. The OFT nevertheless remained concerned that prices might rise following the merger. Undertakings in lieu of a reference to the CC were accepted. These involved commitments not to increase prices until a rival distributor had begun to supply product in the UK. In its decision the OFT highlighted the "particular structure of the sector" as a relevant factor in choosing this remedy.

Behavioural remedies have been accepted a little more frequently by the CC[4].

- **Coloplast/SSL:** Coloplast and SSL both provided continence care products and in particular competed in the supply of non-latex sheaths to the NHS. SSL supplied products on the basis of an agreement with a US firm, Mentor, under which it was licensed to distribute the Mentor sheath in the UK. The CC concluded that the best approach to remedying the loss of competition it had identified would be for Coloplast to renegotiate the terms of the Mentor agreement in order effectively to divest itself of the product previously supplied by SSL. However, the CC considered that a price cap, until the time that the agreement with Mentor expired, would be an acceptable alternative if the agreement could not be appropriately modified without "unreasonable economic damage" to Coloplast. In the event, the Mentor agreement could not be renegotiated and a price cap was introduced.

- **Centrica/Dynergy:** Centrica is active in retail gas supply and has upstream interests in gas fields. Centrica wished to acquire control of Dynergy's interests in the Rough

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gas field – the largest storage facility in the UK. The CC was, amongst other issues, concerned that Centrica would be able to discriminate between customers in giving access to capacity at Rough and use to its advantage in the retail market sensitive information gained from Rough's operation. The CC proposed a package of eleven behavioural remedies. It concluded that the adverse consequences of the merger did not justify a divestment, particularly given that partial divestment was not feasible and effective behavioural remedies were available.

- **Carlton/Granada:** The CC was concerned that their merger would allow Carlton and Granada (two ITV franchises) to increase the rates charged for television advertising. It considered several remedies, including the creation of two independent sales houses to compete in the sale of the advertising airtime of the two franchises. Ultimately a price control remedy was accepted. Advertisers were given the right to renew their contracts and continue to achieve post-merger the terms and conditions that had been agreed pre-merger. They were thus given the protection of having their pre-merger contract terms as a fall-back position in subsequent negotiations. The CC made the point that this behavioural remedy was well-suited to a situation where its competition concerns were expected to diminish over time as the penetration of multi-channel platforms, and thus the choice available to advertisers, increased. Moreover, this remedy was believed to place a lesser burden on the parties than the creation of two sales houses and was thus more appropriate.

- **Dräger/Air-Shields:** Dräger Medical and Air-Shields both manufacture neonatal warming therapy products, selling these worldwide. In the UK, these products were sold via two distributors that were wholly owned by the companies. All manufacture took place outside the UK. The CC determined that the UK constituted a distinct geographic market and that there would be a significant lessening of competition in the supply of three products, but that a prohibition of the merger would not be practicable or appropriate given the worldwide nature of the transaction and the fact the manufacture took place overseas. The divestment of one or other of the UK distribution arms of the manufacturers was considered as a potential structural remedy. However, the CC believed that the need to ensure that an independent distributor had appropriate access to product on the right terms would require excessively complex arrangements. It therefore rejected this remedy. As an alternative, the CC made recommendations to the Department of Health designed to encourage market entry from overseas suppliers and improve the buying practices of NHS trusts. In order to limit any problems before these measures took full effect, the CC proposed price controls as well as commitments to maintain the range of products available.

- **FirstGroup/ScotRail:** FirstGroup operates five passenger rail franchises and is a leading supplier of bus services in the UK, operating a number of routes in Scotland. FirstGroup was selected as the preferred bidder for the ScotRail franchise for passenger rail services in Scotland. The CC was concerned that the merger would lead to a significant lessening of competition on those routes where bus and rail services overlapped, and on the wider network, given the opportunities for multi-modal ticketing. However, since only a small number of customers would be affected, the CC reached the view that divestment would be a disproportionate remedy, particularly since behavioural remedies were available. It proposed a package of these, including controls linking prices on overlap routes to those on competitive routes, requirements to maintain service standards, and measures to encourage the use of multi-modal tickets whilst limiting potential exclusionary effects.

CONCLUSION

Behavioural remedies are clearly back on the agenda. Their relevance can only be considered on a case-by-case basis: but no competition authority seriously concerned with protecting and promoting competition can rely entirely on structural remedies. A preference for such remedies survives, for good reasons, but should be no more than

a preference. The use of behavioural remedies in the UK in recent years provides an indication of their potential role in merger control – a role that may be extended as the understanding and experience of such remedies grows.

SOURCE	1. *Commission Notice on remedies acceptable under Council Regulation (EEC) No 4064/89 and under Commission Regulation (EC) No 447/98.* 2. *ECJ, Tetra Laval vs. Commission, paragraph 86.* 3. *Competition regulator to review merger 'remedies', Financial Time, 12 April 2004. Professor Geroski's review is being carried out by the new remedies division of the CC. Since this will involve a detailed analysis of past cases, it is unlikely to be completed before the end of 2005.* 4. *Frontier advised Coloplast in Coloplast/SSL, Dräger in Dräger/Air-Shields, and Granada in Carlton/Granada.*
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