MERGER REMEDIES:
An Economic Incentives Perspective

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Effective Merger Control

• Merger control is more than the analysis of competitive effects
  • Also requires taking appropriate policy action against mergers that create competitive concerns
• In US, an increasing fraction of mergers are now resolved by remedies rather than challenges or clearing
  • Percent of mergers investigated by DOJ that are resolved by remedy now more than 60%
• Similar emphasis elsewhere
  • In EU, more than 90 % of mergers resolved
  • In China, dozens of mergers all resolved by remedies since 2009
Remedies: The New Normal

- Appeal of remedies is that they offer a “third way,” that is, neither outright clearance nor complete rejection of mergers
  - But this puts a high premium on effectiveness
  - If ineffective, remedy becomes the equivalent of clearing a merger
- “Effectiveness” means that remedy should preserve or restore competition otherwise lost due to merger
- Despite importance, remedies have not always received same attention as analysis of competitive effects
  - Some aspects of remedies analysis are fundamentally different from effects analysis
  - And also different from the emphasis of remedies guides
Remedies Guides

• Several good remedies guides have now been issued
• New ICN Merger Remedies Guide is excellent handbook for enforcers
  • Notes that remedy design is case-specific and fact-intensive
  • Sets out criteria for effective remedy:
    • Tailored to harm
    • Should target competitive harm, have duration consistent with harm, be practical, and not have undue risk
    • Must be transparent and consistent with policy in other settings
    • Should recognize efficiencies of merger
    • Must consider “operating costs” of remedy
  • Then provides practical advice on each of these questions
• Remedies guides are mostly procedural, not based on economics
Economics of Merger Remedies

• Economics perspective on remedies focuses on incentives of firm
• Views remedy as either change in firm structure or a constraint on firm’s behavior
  • In either case, asks how a profit-maximizing firm will respond when subject to that remedy
    • If structure is changed, will incentives result in the goal of remedy?
    • If constraint is imposed and firm maximizes profit subject to that constraint, will this yield the goal?
    • Or given the firm’s inherent incentives, will it be able to evade and defeat the constraint?
    • Will firm behave in ways that create other distortions?
• Useful to illustrate this perspective by examining familiar types of remedies: structural (divestiture), conduct (behavioral)
Incentives Analysis of Divestiture Remedy

• Divestiture of an overlapping asset appears to be easy case
  • Often viewed as simply ensuring same number of separate products as prior to merger
• This is correct, but divestiture has more fundamental effects
  (1) Divested asset has no continuing relationship to either parent or to the merged firm. Establishes clear boundaries between firms
  (2) Takes decision-making over the overlapping asset away from the merging firm. Puts it in hands of fully independent agent
  (3) Preserves and ensures that each entity has its own profit-making incentives without compromise
• Economics predicts that this combination of structure-plus-incentives will result in competitive outcome
  • Moreover, does not require oversight or intervention by agency
Incentives Analysis of Conduct Remedies

• Several types of conduct remedies
  • Firewalls prevent exchange of information between divisions
  • Must-supply agreements require continued provision of crucial input to independent rival on appropriate terms
  • Anti-retaliation provisions prohibit the merged firm from punitive responses against rivals

• Common features of conduct remedies:
  • Merger is allowed to proceed
  • Merged firm subject to either restraints or requirements on its conduct

• From incentives perspective, fundamentally different than divestiture
  • One decision-maker is lost to the market
  • Merged firm either prohibited from certain profit-maximizing behavior, or required to assist independent rivals against own interests (blurring lines between firms)
Incentives and Effectiveness

- Crucial economic difference between remedy types is incentives
  - Divestitures harness the firm’s inherent profit-maximizing incentives
    - Predictably yields the competitive goal
  - Conduct remedies work only insofar as they actually prevent the firm from acting on its inherent incentives
    - Predictably result in firm seeking to evade and avoid
- Can the competition agency write rules that constrain the merged firm to do this?
  - Precedent for this question is traditional rate regulation, which also tries to prevent unconstrained profit-maximization by firm
  - Economics emphasizes limits to agency’s likely success due to information asymmetries, incompatible incentives, observability, and enforcement costs of regulation
Why Use Conduct Remedies at All?

• Divestiture may be economically infeasible in presence of decisive economies of scale, and/or scope
• Example 1: Merger in a network industry
  • Two large airlines with several overlap routes, but mostly non-overlapping
• Classic divestiture of an overlapping route from A to B is infeasible:
  • Standalone service on a single route prohibitively expensive due to economies of scope (costs) and network effects (demand)
  • Service on a single route does not exist outside of network
• Same problem in other network industries: railroads, electric utilities
• Limited opportunities for structural remedy
  • Exception may be entry constraints like slots that can be removed
  • More often, requires conduct remedy such as access rights arrangements, such as trackage rights in railroads
Conduct Remedies: Vertical Integration

• Example 2: Merging firms have vertical as well as horizontal properties
  • One is dominant at its stage, but faces independent rival at another stage
  • Hence becomes both supplier and competitor
• Classic problem that integrated firm has incentive and ability to disadvantage or foreclose independent rival
  • May be possible to divest asset that creates incentive to foreclose
  • Otherwise, conduct remedy may be only alternative to prohibition
• Example of merger between large cable TV distributor (Comcast), and large supplier of video content (NBCU)
  • Concerns were that independent programming would face discrimination, that programming would be denied to other cable firms, that control of broadband would handicap new technologies
Conduct Remedies: Cross-Border Merger

Example 3: Cross-border mergers where parties’ assets lie in another country

- In this case, unlikely that affected country can force structural remedy elsewhere, unless it is major purchaser
- Otherwise, competition agency may settle for conduct and concessions in own country
  - This raises concern about coordination among countries that are simultaneously working toward a remedy solution
  - This too is addressed in ICN Merger Remedies Guide

- Note that conduct remedies generally may be used in conjunction with structural remedies, to help ensure effectiveness
Problematic Side of Conduct Remedies

• Many examples of problems with conduct remedies

(1) Comcast-NBCU: Independent Spanish language network denied access to Comcast systems more often since NBCU-Comcast has its own Spanish channel. (Entravision filing, FCC, 2014)

(2) Ticketmaster/Live Nation merger conditioned on ban on retaliation against independent promoters who might need ticketing services but do not want other services from integrated company. Unenforceable provisions. (Kwoka, 2014)

(3) Microsoft (non-merger) decree required Microsoft to develop software for compulsory licensing of certain communications protocols. Company succeeded in delaying for more than 9 years by claiming technological problems, inability to hire necessary personnel, etc. (First and Gavil, 2014)
When to Use Conduct Remedies?

• Nonetheless possible to identify circumstances where conduct remedies more likely effective
  • More likely effective when offending conduct is not fundamental to business plan of firm.
    • That is, where shadow price of remedy constraint is not too high
  • More likely when offending conduct can be specified with precision ex ante, and not easily altered by firm
  • More likely when violation results in effects observable to third parties, not just affected rival
  • Also, more likely effective where monitors used, and where penalties for non-compliance are severe
    • Severe penalties are ultimate method for changing firm’s incentives
Conduct Remedies: Some Specifics

- Firewalls more likely effective when information is in administratively and physically separated units, and when communications are logged in and subject to third party inspection.

- Must-supply agreements more likely effective when:
  - product is simple, standardized, and difficult to degrade
  - technology stable
  - price easily monitored

- Anti-retaliation provisions more likely effective when normal interactions are less crucial to independent firm:
  - Also, when there is an outside monitor
  - Monitors and penalties are important under all circumstances
Divestiture Remedies: New Challenges

• Divestitures are not without their limitations and risks
• Three issues:
  (1) Much experience underscores the importance of
      • Adequacy of the divested assets: must be viable and have adequate financing, management, supply, distribution, etc.
      • Capabilities of the buyer: must be have strong management, ability to integrate operations, etc.
      • Numerous examples of failures in early uses of divestitures
        • Agencies now much more attuned to these requirements
(2) Risks where divestitures are used to assemble assets to create a new enhanced competitor

- Example of Albertsons-Safeway supermarket merger in U.S.
  - Supermarket chains required to divest 168 retail stores in overlap areas
  - Competition agency sought to find buyer with certain capabilities not possessed by divested stores themselves
  - Most divested stores sold to Haggens—small regional chain of 14 stores
- Here “divestiture” involved effort by agency to determine necessary capabilities and arrange for their consolidation from different sources
- Effort failed: sales at divested stores collapsed
  - Haggens sued Albertsons, then filed for bankruptcy
  - Albertson’s had to re-acquire stores divested to Haggens
- Similar strategies attempted in other recently proposed mergers: US Foods-Sysco, Staples-Office Depot
(3) Further risks due to scale and structure of asset realignment

- Example of Teva-Allergan:
  - Each drug company had portfolio of about 400 drugs
  - Required to divest 80 overlaps as condition of merger
- Net effect of merging non-overlapping assets is company of 700 drugs, now far larger than second largest
  - Are there any “portfolio effects” giving advantages to merged firm?
  - Also, does it matter if the 80 divested assets go to 1 or 10 firms?
- Does agency understand business economics sufficiently to re-arrange assets and thereby restructure firms and industry?
  - Are there business and management issues that this narrow product-oriented divestiture policy overlooks?
Suggested Remedy Template I

• Is the basic competitive concern with overlapping products, or are there substantial vertical issues?

• If the issue is overlap, can such products be separated, or are economies decisive?

  ➢ If separable, do assets require other capabilities for effective competition, or can they operate on standalone basis?
    ▪ If they do not require more, then DIVEST
    ▪ If they require more, exercise caution, consider PROHIBITING

  ➢ If not separable, are there forceful indirect remedies, such as opening up entry?
    ▪ If there are forceful indirect remedies, then probably use these
    ▪ If none or not forceful, then probably PROHIBIT
Template II

• If concern also involves significant vertical issues, is the asset that creates vertical concern subject to divestiture?

  ➢ If YES, then DIVEST and permit rest of merger

  ➢ if NO, is the competitively offensive conduct central to firm operation?
    ▪ If it is, probably PROHIBIT
    ▪ If not, are vertical gains large?
      If not, then simply PROHIBIT
      If yes, consider CONDUCT
Empirical Evidence: Agency Cases

• Two major sources of evidence with respect to remedies in practice
• One source is compilations of case studies by competition agencies
• FTC Divestiture Study (1999) surveyed all divestitures in previous 6 years
  • Found that assets remained viable in market in 75% of cases, but did not examine effectiveness
  • Major reasons for failures: capabilities of buyers, adequacy of divested unit
• Most other studies (UK, EU, CCB) draw same conclusions: remedies work, structural remedies generally better, practical issues important
  • Only study that tried to examine effectiveness of remedies was EU (2005)
  • Looked at post-divestiture market share of assets as proxy
• FTC is now doing more comprehensive ex post review of remedies
  • Will include conduct remedies as well as divestitures
  • Important that it attempt to evaluate effectiveness
Empirical Evidence: Retrospectives

- Second type of evidence uses actual performance outcomes from carefully studied mergers subject to remedies
- Kwoka (2013, 2015) used compilation of all qualifying merger retrospectives
  - Standard methodology is difference-in-difference
  - About 50 such studies that examine merger outcomes
- Public documents and records then used to determine whether some remedy was employed, and if so, which type, in each case
- Permits correlation between remedy and outcome
  - Effective remedy should result in no net price increase
- Findings:
## Price Effects: Kwoka Study

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<th>MERGER</th>
<th>PRICE EFFECT</th>
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<tbody>
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<td>All mergers</td>
<td>7.2%</td>
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Subject to:

| Divestiture          | 7.1%         |
| Conduct remedy       | 16.0%        |
DGComp Study

- DG Comp commissioned Centre for Competition Policy at East Anglia to replicate Kwoka study for EU mergers
  - Used similar but not identical methodology
  - Compiled information on 27 EU mergers studied in some systematic fashion
- Report to DC Comp (2015) assessed evidence on outcomes of mergers and remedies
- Findings:
# Price Effects: DG Comp study

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<td><strong>Those mergers:</strong></td>
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<tr>
<td>Cleared</td>
<td>4.7 %</td>
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<tr>
<td>Subject to remedy</td>
<td>1.6 %</td>
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Conclusions and Recommendations

(1) As substitute for clearing problematic mergers, remedies can be very useful, but
(2) Divestitures require care in design and implementation, and
(3) Conduct remedies should be used rarely and only in circumstances where they are likely to succeed
(4) Evidence suggests many remedies ineffective, perhaps indicating overuse of remedies relative to challenging mergers outright
(5) Agencies should do more studies of outcomes of mergers and remedies. Should require merging parties to provide postmerger data as a regular practice to allow for follow-up.
References

- ICN, *Merger Remedies Guide* (2016), citing other guides and studies