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Under (and Over) Prescribing of Behavioural Remedies

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Preliminary Definitions

There are various ways to classify remedies in merger control, one of them based on the distinction between structural and behavioural remedies. Adopting this structural/behavioural classification, this working paper explores the policy considerations which may affect the willingness of competition authorities to prescribe behavioural remedies.

The term ‘behavioural remedies’ in this paper is loosely defined. The range of remedies which may be included within the behavioural category spans from general commitments to behave or not to behave in a certain manner, to obligations to licence key technology, provide access to infrastructure or key assets. Undoubtedly, this wide classification gives rise to a heterogeneous group of remedies with varied characteristics, spanning from ‘pure’ behavioural remedies to ‘quasi-behavioural’ remedies. A good example of this loose periphery is the treatment of access remedies. In some cases an access remedy may share similarities with a one-off structural remedy. In others it may require ongoing implementation and monitoring, subsequently resembling a more classical behavioural remedy.

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Policy considerations

Conditional clearance of merger transactions comes at a price. Commitments accepted by the competition agency may give rise to monitoring and implementation costs. The *ex-ante* assessment of remedies involves risk and uncertainty and may result at times in failure to address the competitive detriment. Within this context commitments accepted have to effectively resolve the anticompetitive effects.

By large, structural remedies are considered superior to behavioural remedies. They address the competitive detriment directly, and result in a permanent change of structure. The permanent nature of the structural remedy and its timely implementation are commonly regarded as apt to ensuring the conditions for the emergence of a new competitive entity or for strengthening existing competitors. Subsequently, these remedies require relatively limited monitoring post-transaction and are generally cost-efficient.

On the other hand, behavioural remedies are considered more burdensome and less effective in addressing the competitive detriment. Arguably, whereas structural remedies ensure the competitive structure of the market, some behavioural remedies are based on active intervention attempting to resolve the anticompetitive effects resulting from an anticompetitive market structure, without rectifying the market itself. In addition, their relative complexity and lengthy execution impedes on the certainty of achieving their desired results. These difficulties may be viewed through the direct and indirect costs that are associated with behavioural remedies.

Direct operating costs exist at the design, monitoring and enforcement stages. The competition authority may lack information while it attempts to devise a proportionate remedy in the short period of assessment. In the case of behavioural remedies, asymmetric information may result in a failure of the competition authority to fully understand the business model of the particular industry. Subsequently, the designed remedy may result in under, or over, fixing.

At the monitoring and enforcement stages, costs are typically linked to the complex and lengthy implementation of the 'tailor made' behavioural remedy. Monitoring and enforcement activities may involve constant gathering and processing of information and may transform the competition authority into a market regulator. As the merging undertakings may favour lax

implementation of the remedy, monitoring may require close scrutiny and investment of time and effort in dispute resolution in case of complaints.

Behavioural remedies may also generate various indirect costs. By their nature, behavioural commitments are more vulnerable to manipulations and may be eroded of their effectiveness. Following the conditional clearance the merged entity may attempt to evade the spirit of the remedy. Such ‘crawling compliance’ is often the result of the disparity of incentives which exists between the undertakings and the competition authority. In general, strategic transactions are often aimed at increasing the market power of the parties to the transaction. At the same time, this increase in market power is precisely the centre of the competition authority’s concern. This disparity may translate into the undertakings attempting to undermine the effectiveness of the remedy. In effect, the complexity of the behavioural commitment may result in loopholes which the undertakings may take advantage of, whilst not constituting a blatant breach of the commitment.

Indirect costs may also occur when the behavioural remedy results in distortion of competition. When the remedy is applied over a long period of time and involves direct intervention in the market it may distort competition and generate inefficiencies. The remedy may affect the incentives in the market or may provide competing undertakings with a distorted picture of barriers to entry, potential competition and profitability. Similarly, when the behavioural remedy involves cooperation between the merged entity and third parties, it may facilitate the exchange of information between competitors and facilitate collusion.

The direct and indirect costs described above reflect the increased risk and uncertainty associated with behavioural remedies. Yet, despite these drawbacks behavioural remedies can, and do, play a significant role in conditional clearances.

Behavioural remedies are widely used to support structural commitments and ensure the viability of divested business. As an ‘independent tool’, they may provide an adequate solution when the absence of a suitable buyer makes divestiture impossible. In other circumstances, even when divestiture is available, a structural remedy may generate costs, risks or inefficiencies which would render it inappropriate. A behavioural remedy may provide a suitable alternative in such cases.

It is broadly accepted that some competitive detriments may be better dealt with by a behavioural remedy than a structural one. This may be the case, when the merger involves vertical elements and may limit access to infrastructure and result in foreclosure. In such circumstances divestiture is likely to be less effective and generate unnecessary costs. On the other hand, a behavioural remedy of non-discriminatory open access may address the competitive detriment successfully while preserving the efficiencies associated with the transaction. Additionally, the flexibility and reversibility of behavioural remedies make them superior tools for the competition authority in dealing with changing market realities. This would especially be the case in new or changing markets, technology markets or network industries. Conversely, structural remedies are generally irreversible and cannot be changed if found not to yield the expected benefits, or if found to impose excessive burdens on undertakings.

The ability to avoid over fixing is significant when considering heterogeneous market realities. Behavioural remedies may be useful in addressing competitive detriments confined to specific markets, for example in the enlarged European Union. These remedies may allow addressing unique market realities in one of the member states through behavioural commitments, without resorting to a European wide divestiture. Subsequently they may assist in preventing over fixing when the competitive detriment is confined to one territory.

The negotiation of remedies

The difficulties in designing, monitoring and enforcing behavioural remedies may lead competition authorities to under prescribe behavioural remedies, even when in theory they may yield efficiencies. The inherent limits of behavioural remedies and the lack of capacity to successfully monitor their implementation may tilt the balance in favour of the more certain structural remedy even when it is excessive. In other words, the competition authority may at times have an inherent preference for structural remedies even in circumstances where these might under perform compared to behavioural remedies.

The inclination toward over fixing in merger remedies may become apparent when considering the way in which a hypothetical competition agency might approach the appraisal of transactions. In general, while assessing a merger transaction the competition agency may stumble into two types of errors. A *Type I* error will occur when a beneficial transaction is

prohibited, thus depriving the market of attaining the efficiencies associated with it. A *Type II* error will occur when a harmful transaction was not detected by the competition agency and is cleared thus resulting in competitive detriment. The competition agency is likely to try to avoid both types of errors equally, as both may be detrimental to competition, generate public criticism and result in appeal procedures.¹

However, when approaching a conditional clearance of a transaction, the risk of a *Type II* error may be more prominent. Subsequently, the competition authority may strive to address the competitive detriment through wider than necessary remedies.² In practical terms as the *ex-ante* mechanism is characterised by asymmetric information, the competition agency may prescribe wider remedies than necessary and engage in ‘over-fixing’ to ensure compliance. This will especially be the case when the competition authority lacks power to correct *Type II* errors. In these cases the risk of a permanent detriment to the market structure post merger might increase the tendency to over-fix.³ The appeal process and public scrutiny, although moderating the competition agency’s power, may leave room for error.

The possibility for over fixing may be better understood when considering the process of negotiation of remedies. Merger appraisal tends to be inherently dominated by the authority’s power. It is the competition agency that identifies the competitive detriment and it is in this context that the remedy is sought. Limited judicial review may further strengthen the authority’s position. The disparity of bargaining powers may lead the undertakings accepting or even suggesting remedies even when these are excessive. The undertakings placed in a vulnerable position while the concentration is put on hold, may be willing to accept far reaching commitments to facilitate the clearance of the transaction. In theory, the undertakings, although favouring an outright clearance, may be willing to accept far reaching commitments as long as these do not eradicate the economic rationale at the base of the transaction.

Interestingly, the repercussions from the above may lead to potential over fixing at two levels. First, due to the objective drawbacks of behavioural remedies, the competition authority may under-prescribe behavioural remedies even when in theory these could generate greater

¹ Empirical evaluation of merger transactions in the EU suggests that both type I and type II errors occur with similar probability. See: Duso, DJ Neven & LH Roller, “The Political Economy of European Merger Control: Evidence using Stock Market Data”, <http://econ.lse.ac.uk/events/papers/sticio-130603.pdf>, March 2003.

² In principle, Type I error will still occur when the transaction was unnecessarily modified.

³ For example consider the US powers to undo mergers or order break-ups of a dominant undertaking and contrast with the powers of the European Commission under Regulation 1/2003 (Note especially Article 7 and Recital 12).

efficiencies than structural commitments. This alleged over-fixing comes at a cost of lost efficiency, yet is likely to remain undetected when the structural remedy is accepted and not challenged by the undertakings.

Second, in cases where the competition agency accepts a behavioural remedy, the relative weaknesses associated with monitoring and implementation may lead to over-fixing. The competition agency may wish to ensure the eradication of the competitive detriments through over subscribing behavioural remedies. Limited capacity to monitor compliance and the fear of future abuse by the undertakings of potential loopholes in the commitments may result in the prescription of disproportionate behavioural remedies.⁴ Such approach may undermine the usefulness of the remedy as well as its attractiveness for the undertakings. This may especially be the case when the competition agency deploys a range of behavioural commitments, some loosely connected to the competitive detriment, as a general shield against anticompetitive threats.

Whilst the tendency to favour a structural alternative may be criticised in theory, it may well be justifiable in practice. The assertion that a behavioural remedy may yield similar efficiencies as a structural one encompasses a twofold assumption. *First*, the remedy has to be capable of addressing the competitive detriment. *Secondly* the competition agency has to be capable of effectively designing, monitoring and enforcing it. In practice, the latter assumption may fail to materialise as competition agencies may lack capacity to engage in effective design, monitoring and enforcement. Consequently, practical difficulties may legitimise the under prescription of behavioural remedies.

Interestingly, to some extent these practical difficulties are a derivative of the competition agency's policies and practices. The agency's views on the role of merger control and the use of commitments are likely to affect its investment in capacity building. An unfavourable approach to behavioural remedies in the first place would lead to under investment in effective monitoring design and enforcement. This in turn is likely to diminish the effectiveness of the behavioural remedy, thus justifying the under prescribing of the remedy, even in cases where in theory it could have yield effective results. In other words, in their actions, competition agencies

⁴ The harmful effect may be in the form of providing competitors with greater access to facilities than necessary, encouraging inefficiency, keeping up float non-profitable undertakings, or distorting competition on the market through lengthy intervention in conduct.

are not only reacting to the effectiveness of the behavioural remedy, but to a certain extent also determining it.

This working paper is to be followed by a more elaborate inquiry into the application and scope of behavioural remedies under the European Merger regime.