TOMORROW IS ANOTHER DAY!
MERGER REVIEW AND COUNTERFACTUAL ANALYSIS

Andrea Pezzoli

Keywords: counterfactual analysis, failing firm defense, merger control, antitrust, economics

Abstract
The choice of a counterfactual scenario other than the status quo is quite challenging. The investigation has to be particularly convincing if the deterioration of the competitive process which is likely to arise in the absence of the merger is related to a failing firm scenario – a special case of the more general counterfactual analysis. Could counterfactual analysis provide alternative tools to those required by the failing firm defense? Alternative but equally rigorous?
The extent to which a broader counterfactual analysis might be taken into consideration is discussed in the paper. More precisely it will be discussed i) if and when it may be desirable to focus the assessment not only on the most likely counterfactual, ii) if the incomplete fulfillment of the three requirements for the failing firm defense necessarily leads to a prohibition and iii) the role which may be played by entry and dynamic competition in the application of the failing firm defense. Finally, merger policy based on a broader counterfactual analysis is discussed in a bidding market context where tender design is not already set.

1. TOMORROW IS ANOTHER DAY

“Tomorrow is another day!” The famous line pronounced by Scarlett O’Hara (Vivien Leigh) at the end of *Gone with the wind* is not that familiar for economists involved in merger review. Their attitude is to look at tomorrow as a mere copy of today. In other words, the assessment of the merger impact compares the scenario with the merger with the scenario without the merger, the so-called counterfactual, traditionally identified with the status quo. In other words, the starting point for considering the effects of a merger are the competitive conditions prevailing at the time of the concentration. This may not always be the case. On the one hand, the deterioration of the competitive conditions taking place absent the concentration should be taken into account. On the other, the effects of the merger may also depend on the likely changes in the industry where the merger takes place. In both cases, the assessment has to focus only on the merger specific effects. At least in some cases economists are forced to put their feet in Scarlett’s shoes!

2. CHOOSING THE MOST APPROPRIATE COUNTERFACTUAL

The choice of a counterfactual scenario other than the status quo is quite challenging (Figure 1) and justifying any departure from it is not an easy task since it may require a rigorous and in-depth investigation.

---

1 Italian Competition Authority. The author’s opinions are his own and do no necessarily represent those of the Italian Competition Authority. The author wishes to thank Lara Magnani, Giovanni Notaro, Michele Pacillo, Giuseppe Quinto, Gianluca Sepe and Alessandra Tonazzi who provided valuable and timely comments.
This is particularly true in a failing firm scenario – a special case of the more general counterfactual analysis. Indeed the three criteria for the application of the so-called failing firm defense are quite difficult to fulfill: i) the target would in the near future be forced out of the market because of financial difficulties or bankruptcy in the absence of any merger; ii) there is no realistic less anti-competitive alternative; iii) in the absence of the merger the assets of the failing firm would inevitably exit the market.

Quite often at least one of them cannot be fulfilled, the third condition representing the most frequent obstacle.

In this perspective could counterfactual analysis provide alternative tools to those required by the failing firm defense? Alternative but equally rigorous?

The extent to which alternative counterfactual scenarios might be taken into consideration is discussed below. More precisely the article will discuss: i) if and when it may be desirable to focus the assessment not only on the most likely counterfactual; ii) if the incomplete fulfillment of the three requirements for the failing firm defense necessarily leads to a prohibition and iii) the role which may be played by entry and dynamic competition in the application of the failing firm defense.

3. LENIENT, PRAGMATIC OR JUST CONSISTENT WITH THE UNDERLYING PRINCIPLE OF THE FAILING FIRM DEFENSE?

Hopefully the recession seems to be close to an end. In the coming months mergers – whose numbers significantly dropped in recent years –
may start again. It seems reasonable that a large percentage of the new operations will be part of rationalization processes and will involve loss making firms.

The approach required by the failing firm defense will not necessarily fit all these situations since there might be other counterfactual scenarios – requiring less strict conditions than the failing firm defense – which still predict competitive conditions that are no worse than the post-merger scenario.

Considering more pragmatic alternatives might be useful if not necessary and the risks connected with “pragmatism” should not prevent case handlers from exploring solutions which are as rigorous as the failing firm defense requirements. In other words, I do not suggest the adoption of a more lenient policy but I will argue that competition authorities should consider the possibility of applying the general principles underlying the failing firm defense also in cases where the three criteria are not fully met. The EU Merger Regulation itself allows a broader view of the failing firm defense principle. In 2001 Commissioner Mario Monti underlined that in addition to the three criteria the “…Merger Regulation requires us to establish on a case by case basis that the deterioration of the competitive structure as a consequence of the merger is at least no worse than it would have been in the absence of the merger” 4.

Whenever possible a more pragmatic application of the principles underlying the failing firm defense may be more efficient than a strict application of the defense itself which quite often results in clearing the merger with the contribution of a much less tight (and sometimes definitely “flexible”) assessment of the remedies. A more pragmatic approach may also be preferred to a reconsideration of the most likely counterfactual scenarios, (pretty close to a previous prohibition), especially when the merger does not affect dynamic and rapidly changing markets.

4. TIMES THEY ARE A CHANGIN’… AND MARKETS TOO

The failing firm defense has a long history in European merger cases but has seldom been successful, at least in its “pure” version. In the past Kali&Salz (1994), Basf/Eurodiol/Pantochim (2001) and JCI/VB/Fiamm (2007) were the leading cases 5. The approach privileged by the Commission has been traditionally stringent. However, the broader principle of counterfactual analysis has been helpful in more than one case. Regardless of their distinctive features, it can be argued that mergers like Boeing/McDonnell Douglas (1997), Andersen France and Andersen UK (2002), even though they could not be cleared on traditional failing firm grounds, could largely benefit from a broader application of the underlying principle of the failing firm defense rather than a myopic counterfactual analysis 6.


The same may be argued for the experience of the Italian Competition Authority which has never explicitly accepted a failing firm defense, though its decisions in some cases have been clearly inspired by the broader principle underlying it. FiatImpresit/Mannesmann/Techint-Italimpianti (1996), Banco di Sicilia/Sicilcassa/Mediocredito Centrale (1998), CanalPlus/Stream (2002) and Cin/Tirrenia (2011) provide significant examples of “pragmatism”.

More recently two other relevant cases were cleared by the Commission on the basis of a “pure” application of the failing firm defense: Olympic Air/Aegean Airlines (2011, 2013) and Nynas/Shell/Harburg Refinery (2013)\(^7\). However both clearing decisions are quite peculiar. The former because it follows the prohibition of the same merger decided only two and a half years earlier. The latter because of the presence of an alternative purchaser of the target which in principle would have been provided a less anti-competitive (in terms of market shares) but not sufficiently likely and with uncertain effects in terms of efficiency.

In Olympic Air/Aegean Airlines the first criterion of the failing firm defense was the most deeply investigated. The protracted adverse economic conditions in Greece, the difficult financial situation of the parent company and, above all, its limited ability and incentive to financially support Olympic Air (the crucial novelty with respect to the 2011 prohibition) convinced the Commission that in 2013 times had changed and that the counterfactual scenario would not have been better than the scenario with the notified merger.

In Nynas/Shell/Harburg Refinery the Commission had to deal not only with the first criterion but also with the likelihood of a less anti-competitive alternative purchase. The assessment of the only credible alternative purchaser of the refinery assets, Ergon, a US based competitor, has been extremely sophisticated (almost an additional counterfactual scenario), since such scenario was “credible”, though not the most likely one. The Commission concluded that no other firms but the acquirer, Nynas, had the ability and the incentive to take over the Harburg refinery assets in the absence of the notified merger. The other potential buyer was considered not sufficiently likely. Even if in the past it seriously negotiated for the acquisition of the Harburg refinery, at the date of the transaction its interest and incentives were considered significantly weaker. In particular, the Commission considered that in the event of a prohibition, the Harburg refinery assets’ capacity would leave the market and Ergon would benefit of the new situation and the resulting higher prices.

---

\(^{7}\) See C2227 FiatImpresit-Mannesmann-Telecom/Techint/Italimpianti (14/12/1995); C2988 Banco di Sicilia/Sicilcassa/Mediocredito Centrale (29/01/1998); C5109 CanalPlus-Telepiù/Stream (13/05/2002) and C11613 Cin/Tirrenia (21/06/2012).

5. The Day After Tomorrow: Failing Firm Defense, Dynamic Setting and Entry

On a theoretical ground a more pragmatic approach and a greater sophistication in assessing the most appropriate counterfactual scenario (i.e. the most likely world “but for” the merger) may be justified, at least in some specific cases, if one considers the failing firm defense in a dynamic setting with uncertainty. In particular some authors suggest that the assessment of the failing firm defense should take into account the impact on the case of exit or, which is the same, the effect of the policy rule on the incentives for entry. In their view, a reasonably significant share given to the failing firm should not cast doubt on the soundness of the failing firm defense. A broader application of the general principle of the failing firm defense (the authors explicitly advocate for a “more lenient policy”) may make exit less costly in time of financial distress, thus encouraging entry in the medium term. Restrictions due to higher concentration might be more than offset because of the welfare improvements determined by new entry.

Other authors are quite skeptical about the possibility of a “more lenient” approach. They even call for a more stringent application of the test (and particularly of the third criterion) because permitting an incumbent to own a huge capacity as a consequence of the merger, rather than encouraging entry in the future may raise entry barriers. The merged firm can strategically increase output without the need of creating new capacity, thereby eroding the profit opportunities of new entrants. In some circumstances, firms can strategically embark on a merger which makes other players fail and then buy exiting firms, aiming at a monopolization of the market. In these circumstances (i.e. in markets characterized by fixed capacity and difficult entry) “pragmatism” in assessing rescue mergers may be extremely slippery. In these markets even if a dynamic view is adopted, a broader approach should not be used and the failing firm defense would only be counterproductive.

6. A Broader View. Not a More Lenient Policy

We all hope that, after their significant contraction during the crisis, an increase in mergers and acquisitions signals the onset of a lasting economic growth. After a long economic crisis (whose real effects, particularly those on employment are far from reversing) a significant percentage of the upcoming transactions will involve loss making firms and rescues. Merger review will be forced to abandon the comfortable attitude which identifies the counterfactual scenario (i.e. the situation, absent the merger) with the status quo (i.e. the pre-merger situation). In a number of cases the failing firm defense might be raised. In quite a few cases the criteria required by a pure application of the test will not be met. For example, in Italy lots of providers of future may raise entry barriers. The merged firm can strategically increase output without the need of creating new capacity, thereby eroding the profit opportunities of new entrants. In some circumstances, firms can strategically embark on a merger which makes other players fail and then buy exiting firms, aiming at a monopolization of the market. In these circumstances (i.e. in markets characterized by fixed capacity and difficult entry) “pragmatism” in assessing rescue mergers may be extremely slippery. In these markets even if a dynamic view is adopted, a broader approach should not be used and the failing firm defense would only be counterproductive.


local public services are rather close to failure but it is most unlikely that their assets would leave the market (the third criterion is not fulfilled). They might be the target of restructuring and acquisition activity. The outcome of some of these transactions might raise competitive concern. But they will not necessarily determine a competitive structure which is worse than the prevailing scenario, were the mergers blocked. Therefore, before concluding that the merger is detrimental, the most likely counterfactual scenario should be seriously investigated. In particular in a forward looking perspective, it should be considered whether in the market at hand there is room for further mergers allowing competitors to match the efficiency levels reached by the merger under review and if the authorization of the merger may encourage new entry. Predicting efficiencies, further mergers and entries is not an easy task but we cannot forget that merger control is mainly a predictive exercise.

However, in some cases the task may be much easier, at least on a technical ground. In such circumstances, it is quite clear that the purchase of the failing firm is strictly instrumental to the acquisition of a monopoly rent and to entry deterrence. For example, in industries where the only workable competition is competition for the market (i.e. in bidding markets) mergers among current and potential competitors may take place some period in advance of the actual execution of the tenders, which will then determine the future market structure. In this setting, the uncertainty related to the tenders, in terms of timing, likelihood and design (e.g. the definition of the perimeter of the services included in the tenders) will play an important role in defining the most likely counterfactual scenarios. For instance if tenders are not meant to take place in the near future or if the design of the tenders is such that it will discourage potential competitors, then the merger assessment might lead to a clearing decision since the deterioration of the competitive structure determined by these factors cannot be attributed to the merger. In these cases, a more lenient policy is clearly not encouraging entry. If the design of future tenders is not yet set before the merger occurs, the identification of the most likely scenarios with and without the merger (the factual and the counterfactual) is quite complicated and it is not easy to attribute to the merger the hypothetical deterioration of the competitive structure. In these cases, the merger effects can be identified by making reference to the status quo. If instead the design of the tender is already set (and both the scenario with the merger and without the merger are different form the status quo), it is easier to identify the merger specific effects (i.e. the weakening of potential competition and a lower number of players when the tender will eventually take place) and even easier to predict that a prohibition would not deter new entry. In other words, leaving the reassuring traditional counterfactual (the pre-merger scenario) or abandoning the straightjacket of the “pure” failing firm test does not necessarily lead to privilege a more lenient policy. Just a broader one.

In a recent interview, the Director General of DGComp, Alexander Italianer, stressed that EU merger regulation is flexible enough to take

---

economic crises into account. However, he was also very firm in reminding that merged firms will still be there once the crisis is over and, hence, that there is no reason why merger policy should be softer (or even suspended) in economic troubled times\textsuperscript{13}.

In concluding, let me point out four remarks: i) Scarlett’s tomorrow is often different from the status quo; ii) the pure failing firm scenario is just one of the options that has to be considered - though a crucial one; iii) possible reactions by rivals (further mergers and new entry) should be properly taken into account, when the likelihood of other credible tomorrows is assessed; iv) in some circumstances an explicitly flexible merger review may be preferable to a tight application of the failing firm test followed by a softer approach in the design of remedies. We cannot avoid discretionality in merger policy but we may try to make it more transparent.

Tomorrow is another day but perhaps Scarlett should have a clue on how the day after tomorrow is going to look like.

REFERENCES


14 Andrea Pezzoli, Tomorrow is another day! Merger Review and Counterfactual Analysis. DOI: 10.12870/iar-9932.