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The International Comparative Legal Guide to:

# Merger Control 2015

**11th Edition**

A practical cross-border insight into merger control issues

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# The International Comparative Legal Guide to: Merger Control 2015

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## Country Question and Answer Chapters:



# EDITORIAL

Welcome to the eleventh edition of *The International Comparative Legal Guide to: Merger Control*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of merger control.

It is divided into two main sections:

Four general chapters. These are designed to provide readers with a comprehensive overview of key issues affecting merger control, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in merger control in 51 jurisdictions.

All chapters are written by leading merger control lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editors Nigel Parr and Catherine Hammon of Ashurst LLP for their invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.co.uk.

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# The Quest for the Higgs Boson? Failing Firm and Efficiency Defences in EU and UK Merger Control



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## 1 Introduction

At times, failing firm and efficiency defences to otherwise anti-competitive mergers can feel somewhat like the quest for the Higgs Boson. Theory – including competition authorities' merger guidelines – suggests that these defences should exist, but they are often unsuccessful even after expending a substantial amount of effort and incurring large costs.

This article provides an overview of the failing firm defence under UK and EU merger control, including the extent to which mergers have been cleared on the basis of the failing firm defence since 2010, and the differences between UK and EU merger control guidelines. It also considers the wider implications of financially failing firms on merger control assessments, and the failing firm "offence". The failing firm offence is not a theory of harm to be found in merger control guidelines, but it has been important in a number of UK cases.

We also appraise the assessment of efficiencies under UK and EU merger control in relation to mergers between competitors, having particular regard to the UK and EU authorities' guidelines and their application in certain cases.

Given the fact-intensive nature of failing firm and efficiency arguments, it is appropriate to consider the assessment and importance of such arguments in two recent cases:

a. *Nynas/Shell* (2013), a phase II EU merger regulation case; and

b. *Imerys/Goonvean* (2013), a phase II UK merger case.

Finally, we highlight the conclusions to be drawn as to the development and presentation of credible failing firm and efficiency defences.

## 2 An Overview of the Failing Firm Defence

### The Failing Firm Defence Means That No Appreciable Loss of Competition is Attributable to the Merger

At the heart of any assessment of the competitive effects of a merger is a forward-looking comparison of competitive conditions if the merger proceeds and in its absence. In most cases, the best guide to competitive conditions in the absence of the merger, which is commonly referred to as the "counterfactual", are prevailing, pre-merger competitive conditions.

However, the counterfactual to a merger may well be a situation in which the intensity of competition between the merging parties changes.[1] The most commonly argued scenario under which competition is weakened absent the merger is if one of the parties to the merger is failing, such that it will exit the market in the near future even if the merger does not proceed.

The key point of the failing firm defence is that an otherwise anti-competitive merger may not in fact lead to a substantial lessening of competition (SLC, under UK merger control) or a significant impediment to effective competition (SIEC, under the EU merger regulation), because the *status quo* does not reflect the future competitive landscape if the merger were to be blocked. In particular, whilst a merger may reduce the number of independent competitors, the failing firm defence may mean that, even in the absence of the merger, a similar reduction in competition was inevitable due to one of the parties' businesses otherwise exiting the market. In such circumstances, competitive conditions in the absence of the merger may be no worse, or may even be inferior,[2] to what they would be if the merger proceeds.

In addition, even if a firm is not failing, it may be "flailing" in the sense that in the absence of the merger it would restructure its activities, such that its historical market share and competitive significance might overstate its current and future competitive position.

### The Relevance of the Failing Firm Defence From 2010 to Date

From 2010 to the end of August 2014:

- there have been 27 phase II decisions under the EU Merger Regulation. Of these cases, there have been only nine unconditional clearances (33%) and two of these were on the basis of the failing firm defence (namely *Nynas/Shell* (2013) and *Olympic/Aegean* (II) (2013));[3] and
- there have been 34 phase II decisions under UK merger control.[4] Of these cases, there have been 22 unconditional clearances (65%), and three of these were cleared on the basis of the failing firm defence (*Alliance Medical/IBA Molecular* (2014), *Optimax/Ultralase* (2013) and *Sector Treasury Services/Butler* (2011)).[5]

The Competition Commission's (CC) decision in *McGill/Arriva Scotland West* (ASW) (2012) is also an interesting case as it illustrates the flexibility of the failing firm defence and variants of that defence. The CC "decided, on balance, that, despite ASW's poor levels of profitability, it was less likely that Arriva would exit the business by closure than continue its operation, given, in particular, the reputational and redundancy costs that would have been incurred". Nevertheless, the merger was cleared unconditionally by the CC for two reasons:

- first, the CC concluded that, due to poor profitability, the competitive interaction between the two companies observed at the time of the acquisition was likely to reduce substantially over the foreseeable future, i.e., the current level of competition was not considered to reflect the future level of competition in absence of the proposed transaction; and


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- secondly, that post-merger McGill, as a smaller bus operator, would be constrained by the threat of entry by larger bus operators, particularly First Glasgow, but also Stagecoach.

The *Imerys/Goonvean* (2013) case discussed below also provides an illustration of the broader implications and application of the failing firm defence. As discussed below, the substantive issues in that case were that: (i) the target's exit from one product market in the very near future was attributable to there being more profitable uses for the key input which was in scarce supply; and (ii) the expected future market exit limited the duration of the competition concerns in relation to another market and this affected the CC's views as to the appropriate and proportionate remedies.

## Competition Authorities' Criteria for Accepting Failing Firm Defences

The European Commission's Horizontal Merger Guidelines[6] and the UK Merger Assessment Guidelines[7] provide some brief guidance on the multiple criteria which all need to be satisfied for the failing firm defence to be met. These are summarised below.

| EU Horizontal Merger Guidelines | UK Merger Assessment Guidelines |
|---|---|
| Exit – due to financial difficulties.[8] | Exit – due to financial difficulties, but also strategy change. |
| No less anti-competitive purchaser. | No less anti-competitive purchaser.[9] |
| Assets inevitably exit market. | Transaction is less anti-competitive than the exit of firm and its assets. |

The third criterion in the UK guidelines refers to the possibility that even if the firm and assets were to exit, sales might be dispersed across several firms. This could be a more competitive outcome than a merger, where the sales would be transferred predominantly to the acquiring firm.[10]

In our view, the fundamental challenge with the failing firm defence (and variants of this defence) is the body of evidence needed for such arguments to be credible. At the outset, it is important to appreciate that what is required is forensic accounting evidence as to profitability, restructuring expertise, and potentially industry expertise as to the nature of the competitive difficulties facing the failing business and the scope for these to be resolved. This need for evidence is not surprising as loss-making companies may be turned around successfully,[11] and competition authorities are bound to wish to be cautious about accepting the failing firm since it is only relevant where a merger would otherwise be anti-competitive.

## Wider Implications: What Does a Failing Firm Defence Mean for the Merger Assessment More Generally?

The failing firm defence may also be of broader relevance to the assessment of a merger in a number of respects.

First, the failing firm defence may be relevant to the assessment of barriers to entry. In particular, if the merging parties are arguing that one of their businesses is failing, it is appropriate to consider whether this is consistent with any arguments that barriers to entry and expansion are low. In assessing whether market entry is likely, this is usually judged on the basis of whether entry would be profitable on normal commercial terms.[12] If one of the leading competitors in a market is unprofitable at prevailing prices, this may raise obvious questions as to why entry would be profitable if it prevents *supra*-competitive price increases. One answer to this question may be to consider whether the failing firm faces specific difficulties which would not be faced by a new entrant, such as due to unsuccessful production technologies being adopted by the failing firm.[13]

Second, the UK Office of Fair Trading (OFT) has had regard to the failing firm defence in exercising its discretion not to refer a merger for detailed phase II investigation on the grounds that it was not of sufficient importance.

In particular, in *Midland General Omnibus/Felix Bus Services* (2012), the OFT decided that there was not sufficient compelling evidence at the time of the transaction to show that Felix Bus would have inevitably exited the market in the short-term. Felix was not unprofitable before the transaction and it did not provide compelling evidence to the OFT to show that its financial state was such that it would inevitably have closed in the absence of the transaction.

However, the OFT did note that Felix had approached several potential buyers, but only Midland General had made an offer. In addition, Felix had exited from all of its other businesses shortly after the transaction. Accordingly, the OFT had regard to the likelihood that the target firm was failing, and would thus cease to be an independent competitor regardless of the merger, in weighing up the materiality of its competition concerns and exercising its discretion not to refer the merger for detailed investigation on the grounds that it was not of sufficient importance.

Third, if the failing firm defence applies then this is also the relevant counterfactual against which any merger benefits should be appraised, with this being a particular issue in *Nynas/Shell* (2013) and *Imerys/Goonvean* (2013), as discussed further below.

Finally, it should also be borne in mind that if the failing firm defence is unsuccessfully advanced it may influence the competition authority's view as to the appropriate remedies, especially if evidence is advanced suggesting that the target faces material financial difficulties. In particular, it may be questioned whether another undertaking would purchase an unprofitable business and run it as an independent competitor. Competition authorities might well require an "upfront" purchaser before allowing the merger to proceed if there are doubts as to whether a suitable purchaser will be found[14] or otherwise increase the scope of the business being divested so as to increase its viability.

## The Failing Firm "Offence"

A further issue which should be considered arises where part of a business is acquired, and then the seller closes down the remainder of that business. In such circumstances, competition authorities may wish to assess whether the closure of the remainder of the business has adverse competitive effects, as well as the consequences of the acquisition of those business activities that are the subject of any formal merger agreement. This may be termed the failing firm "offence". Such issues were the key driver of the OFT's reference decisions in 2011 in *Stena/DFDS Irish Ferries* and *Ratcliffe Palfinger/Ross & Bonnyman*. Ultimately, the CC concluded on the facts that in each of these cases that these other businesses would have closed in the absence of the transaction, but this was certainly not sufficiently clear cut for the OFT at the time of its phase I decisions.


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## 3 The Assessment of Efficiencies in Relation to Mergers Between Competitors

### The Role of Efficiencies in Offsetting a SIEC or SLC

Both the European Commission's Horizontal Merger Guidelines and the UK authorities' Merger Assessment Guidelines envisage efficiency defences to otherwise anti-competitive mergers between competitors.[15] More generally, in our view, efficiencies should inform the merger rationale and the competitive effects arguments. Well thought out efficiency considerations impose a structure on the merger rationale and give coherence and credibility to the assessment of the likely competitive effects of a transaction.

The European Commission's Horizontal Merger Guidelines treat efficiencies as part of the overall assessment of competitive effects, focusing on how efficiencies may affect the ability and incentives of the merged entity to act pro-competitively for the benefit of consumers. The UK Merger Assessment Guidelines identify the relevant considerations in very similar terms, but they envisage that rivalry must be enhanced, rather than the merger delivering offsetting benefits to consumers *per se*. The potential significance of this distinction is considered further below in the discussion of the CC's *Imerys/Goonvean* (2013) decision.

| EU Horizontal Merger Guidelines | UK Merger Assessment Guidelines |
|---|---|
| Benefits to consumers: no worse off, timely and sufficient to counteract the competition concerns. | Efficiencies enhance rivalry so no SLC, which requires efficiencies to be timely, likely and sufficient. |
| Efficiencies must be merger specific (i.e., there is no less anti-competitive way of achieving the same benefits). | Efficiencies must be merger specific. |
| Verifiability — merger parties need to provide evidence. | Verifiability — merger parties need to provide evidence. |

To date, the only case where efficiencies *alone* have influenced the European Commission's assessment of whether there is a SIEC in particular markets due to a merger between competitors is its decision in *TNT/UPS* (2013).[16] At first sight, however, this is not a particularly appealing precedent to cite as to the relevance of efficiencies as this is a prohibition decision, which has been appealed. Whilst this decision has not been published, a summary has been published,[17] the European Commission published a memo on the case,[18] and staff have commented on the decision.[19] The Commission's central competition concern was associated with the loss of rivalry between the parties in the international intra-EEA express delivery of small packages, and that the merger would reduce the number of competitors from four to three (UPS/TNT, DHL and FedEx) and even three to two (UPS/TNT and DHL) in various countries across the EU.

The Commission found that the merger would lead to annual cost savings of €400-550m in three main areas:

- management/administrative overheads;
- ground transportation costs; and
- air network costs.

The Commission accepted that these various cost savings were merger specific, but the substantive issue was the extent to which they would benefit consumers. In line with the Commission's Horizontal Merger Guidelines (and similarly the UK Merger Assessment Guidelines), the Commission disregarded the fixed cost savings associated with the reduction in management/administrative overheads, with such fixed costs not generally being viewed as influencing short run profit maximising prices.[20]

The Commission confirmed as verifiable certain cost savings relating to the European air network and ground handling arising after completion of the merger. These savings were allocated to individual countries based on UPS volume and cost data.

The Commission then estimated the pass-on of variable cost savings using the estimate of the impact of total average cost changes on the prices of international intra-EEA express deliveries provided by the parties following their price-concentration study. The Commission admits that this is likely to underestimate the actual pass-through of variable cost savings. The Commission's concession seems sensible as average costs will include fixed and variable costs, and one would generally expect variations in variable costs to have a greater influence on prices than variations in average costs (as noted above).

The Commission then carried out a country-by-country analysis estimating a modified version of the parties' price-concentration model,[21] estimating predicted price increases without and with efficiencies and also having regard to a variety of other information. The key point to appreciate is that the European Commission's statement of objections identified competition concerns in 29 countries, but the Commission's final decision concluded that customer efficiencies outweigh the predicted price rises in 15/29 countries. Indeed, UPS published a statement on the publication of the summary of the Commission's decision observing that the Commission had accepted that 95% of the combined TNT and UPS business was not problematic. It is also striking that, in a number of the countries where the Commission still concluded that competition concerns would arise, having regard to efficiencies materially reduced the magnitude of the net price increase expected. It will be interesting to see the extent to which this analysis is considered in the appeal.

In the UK, the Competition and Markets Authority (the CMA) may decide in either a phase I or phase II investigation that a merger does not lead to an SLC due to rivalry-enhancing customer benefits. However, there are very few phase I cases in which the OFT identified rivalry-enhancing customer benefits. The main case is *Global Radio/GCap Media* (2008), but even in this case, the OFT emphasised that "its concerns in London are marginal in the sense of a finely balanced or marginal judgment as to whether there is even a realistic prospect — let alone a likelihood — of anti-competitive effects, even before consideration of efficiencies".

For the first time ever since the UK Enterprise Act 2002 (the EA) came into force, in March 2014 the CC found that there would be rivalry-enhancing customer benefits in connection with the *Tradebe/Sita* joint venture that concerned healthcare risk waste. In this case, the CC emphasised that it "would usually be extremely concerned about the effect on competition and choice of a three-to-two merger". However, the CC found that there were two important factors which alleviated its concerns. The first of these factors was the strength of a much large competitor, SRCL, as a rival to the JV. In particular, the CC only identified two cases where the parties were the two lowest-price bidders (and these were both outside the relevant geographic market) and the CC did not identify any cases where a customer switched between the parties. The CC therefore


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concluded that the merger would not lead to higher prices, but the CC's analysis did not stop there.

The second factor which the CC emphasised in its clearance decision was that the efficiencies generated by the merger would have a significant impact on the ability of the parties to bid competitively in future tenders in the overlapping area of 50 miles around Birmingham. In some cases, where Tradebe or Sita was already the lowest cost competitor, the efficiency benefits resulting from the merger would be retained by the JV and customers would not benefit. However, in the majority of cases, the CC found that customers would benefit through lower prices because the JV would be able to bid to undercut the existing supplier (in all cases SRCL) to win the customer. The CC thus concluded that the merger would be rivalry-enhancing, and that the overall effect of the merger efficiencies would be to reduce average customer prices by over 5% in this area.

It is notable that in *Imerys/Goonvean* (2013), which created a near monopoly in various UK specialist kaolin markets, one of the principal reasons which the CC gave for why it considered that the merger would not lead to any rivalry-enhancing efficiencies was: "In particular, it was not clear how and against whom rivalry would be enhanced in the UK kaolin markets we identified". This was notwithstanding that the CC accepted that there were relevant customer benefits (RCBs) for the purposes of UK merger control, as discussed further below. This approach is potentially narrower than that identified by the European Commission which focuses on the lack of consumer detriment.

In addition, one exception to the CMA's duty to refer a merger for detailed phase 2 investigation is if it would lead to RCBs which outweigh the SLC and any adverse effects of the SLC. However, this exception has never been applied by the OFT or CMA in any sector since the EA came into force.[22]

### Efficiencies May Influence the Appropriate Remedies (If Any) To Adopt?

If, following a detailed phase II investigation, the CMA concludes that a merger may be expected to lead to an SLC, then it will have regard to broadly defined RCBs (including price, quality, choice and innovation in any market in the UK) in considering the appropriate remedies to adopt, if any. However, any such RCB must be likely to accrue within a reasonable period and unlikely to accrue without that or a similar SLC.

The CC's guidance on the substantive assessment of mergers (adopted by the CMA) makes it clear that RCBs do not necessarily mean that remedies will not be required:

"relevant customer benefits that will be foregone due to the implementation of a particular remedy may be considered as costs of that remedy by the CC. The CC may modify a remedy to ensure retention of a relevant customer benefit or it may change its remedy selection, for instance it may decide to implement a remedy other than prohibition or, **in rare cases, it may decide that no remedy is appropriate**." (Emphasis added.)

In fact, since the EA came into force, RCBs have explicitly influenced the CC's choice of remedy in only two cases. The first case was over six years ago, *Macquarie UK Broadcast Ventures/ National Grid Wireless* (2008), where long-term behavioural remedies were agreed (including long-term contracts and the sharing of cost savings with customers in the form of lower prices). The CC decided that these behavioural remedies would be effective in addressing the adverse effects of the acquisition, whilst preserving the benefits that could arise from the acquisition, including reducing the risks associated with the digital switchover process (when analogue TV transmissions were switched over to digital transmissions) and passing back cost savings to customers. Digital switchover was clearly a fairly unique set of circumstances.

The second case is *Imerys/Goonvean* (2013) which is discussed further below.

In contrast to the position in the UK, neither the EU Merger Regulation, nor the European Commission's Horizontal Merger Guidelines nor its notice on remedies indicate that customer benefits are relevant to the choice of the appropriate remedy. However, Alistair Lindsay and Alison Berridge's excellent book, *EU Merger Regulation: Substantive Issues*, lists a number of cases in which the Commission has taken account of the benefits of the transaction for consumers in assessing proposed commitments.[23] For example, in *Intel/McAfee* (2011) the Commission's press release specifically emphasised that the commitments offered by Intel were suitable to remove the conglomerate competition concerns identified "while preserving the efficiencies of the merger", because they are designed to maintain interoperability between the merged entity's products and those of their competitors, thereby ensuring competition on an equal footing between the parties and their competitors.

## 4 Failing Firm and Efficiency Defences

Given the highly fact-intensive nature of failing firm and efficiency defences, it is appropriate to indicate their successful application in two recent phase II cases, *Nynas/Shell Harburg* and *Imerys/ Goonvean*.

### A. *Nynas/Shell Harburg*

*Nynas/Shell Harburg* provides a very rare example of a transaction where the European Commission found that the merger has "positive effects on competition" because the buying party "would achieve significant reductions of variable costs [that] are likely to be passed on to consumers to some extent". While the transaction was not cleared solely on the basis of an efficiencies defence, efficiencies strengthened the arguments in favour of clearance.

The Commission's clearance decision was based on two pillars:

- *failing firm/division*: if the transaction were prohibited, the capacity at Harburg would very likely be lost. The merger should therefore be assessed with reference to that scenario as opposed to the *status quo*; and
- *pro-competitive efficiencies*: the merger would lead to improvements in capacity and in cost reductions that would likely be beneficial for customers when compared to a prohibition decision, and potentially leave customers better off than would otherwise be the case.

The Commission took the view that prices would likely be lower if it allowed Nynas to acquire the Harburg facility than if the acquisition were prohibited. Even though it considered that a prohibition decision would allow an existing US-based competitor to grow its share in the EEA at Nynas' expense, the Commission deemed that this would likely result in higher prices because the third party would face only limited competitive constraints from Nynas in the EEA due to Nynas' capacity constraints.

The Nynas case provides a useful illustration of some evidentiary issues pertaining to merger rationale generally and failing firm and efficiency arguments specifically. In particular, the credibility of the arguments put forward was affected by the actions taken by each of the parties involved, including the interested third party.


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### Background

Nynas is a producer of naphthenic base and process oils for industrial use — used to produce other products such as lubricants, adhesives, and rubber — and transformer oils, which serve as an insulator for transformers in electricity networks. Nynas had agreed to acquire assets at Shell's Harburg site to ease its on-going production capacity constraints, which would give Nynas control of all functioning naphthenic base oil production capacity in Europe.

Nynas was convinced that its position in Europe would not give rise to competition concerns on the grounds that its naphthenic oils were constrained by paraffinic alternatives and GtL-based products, and that imports of naphthenic oils from North America would prevent it from raising prices. However, the Commission took the view that the relevant product market for base and process oils only included naphthenic oils and that the relevant geographic market was no wider than the EEA. Pre-merger, Nynas and Shell had a combined EEA market share of 73% (with an increment of 10% – 20%) in the supply of naphthenic oils and 50% – 60% (with an increment of 5% – 10%) in the supply of transformer oils.

Nynas also argued that the merger would benefit its customers by expanding its production capacity. At the same time, Shell indicated to the Commission that it was planning to shut down the base oil manufacturing capacity at Harburg unless a buyer could be found. Additionally, Ergon, a US-based competitor which had established a presence and distribution network in Europe a few years earlier, expressed to the Commission potential interest in acquiring the Harburg assets.

The Commission therefore had to examine the likely consequences of a prohibition decision — i.e., in the absence of the merger, whether Harburg would close, whether Shell would continue operating it, or whether the US-based competitor would buy and operate the plant — and whether the relevant outcome was more desirable than allowing the transaction to proceed.

Ultimately, the actions taken by the notifying parties gave credence to their arguments that capacity would fall if the transaction were prohibited: the Harburg production assets would exit the market because there were no credible alternative buyers and Nynas was unlikely to be able to expand its own capacity to offset the closure of the Harburg plant. Moreover, allowing Nynas to acquire Harburg would lead to customer benefits.

### The Credibility of the Failing Firm Arguments

Shell's stated intention of closing the Harburg production facility was supported by an assessment of the profitability of the assets required to continue production of naphthenic base oils at Harburg and by its actions.

To assess whether a firm or division satisfies the criteria to be deemed a "failing firm", it is necessary to take into account the long-term viability of the asset. That is, even if the operating profit is positive, it may be that continued operation will require significant investments in the near future that render it more profitable to cease operation when these investments are required, subject to shut-down or conversion costs.[24]

Moreover, an assessment of the profitability of an asset also needs to take into account its alternative uses. In the case of Harburg, Shell considered that it would be more profitable to convert the site to a terminal than to operate it as a fuel refinery. It would not have been possible for Shell to continue production of base oils if Shell closed its fuel refinery, because the fuel refinery provided inputs for the production of base oils. Nynas, on the other hand, could provide inputs from its own facilities. This illustrates the importance of taking into account the wider context in which the asset in question is operating: even if the base oil assets had been profitable to Shell, the wider operation that supported this production was not, in particular once alternative uses were taken into account.

Finally, the Commission's decision illustrates the usefulness of so-called "commitment devices", which are a way to bind oneself to a certain course of action and which make failing firm arguments credible. In this case, pre-merger Shell had already converted parts of its refinery which were not being sold into a terminal, including shutting down equipment, which could not be reversed without substantial investment. Accordingly, reneging on its stated intent of shutting down production of base oils would have required a costly reversal of its actions, further shifting Shell's cost-benefit analysis in favour of shutting down production of base oils at Harburg. In other words, Shell's actions constituted a (possibly inadvertent) commitment device that made it likely that it would carry out its stated intention of shutting down production of base oils at Harburg.

### Was There a Credible Alternative Buyer?

The failing firm argument also requires that the transaction has to be the least anti-competitive alternative. In absence of binding alternative offers for the assets/business in question (as opposed to non-binding expressions of interest), there is a significant degree of uncertainty associated with such an analysis. Any such alternatives therefore need to be carefully scrutinised for desirability, i.e., whether they are less anti-competitive than the proposed transaction, and their credibility (a mere expression of possible interest in buying an asset is very different to a willingness to complete such a transaction). This means that the alternative purchasers' incentives need to be such that in the event of a prohibition decision, the more desirable alternative buyer must be able and willing to buy the assets in question. Insofar as the alternative buyer is able (for example, if it has the necessary funding), then it needs to be established that in the event of a prohibition decision the alternative buyer will find it more profitable to buy and operate the assets in question than not to do so.

In *Nynas/Shell Harburg*, the Commission accordingly considered whether a prohibition decision might lead a more desirable player operating the Harburg assets instead. In particular, Ergon indicated that it would potentially be interested in acquiring the assets. However, in previous negotiations with Shell in 2011 to acquire the assets, Ergon had failed to even make a credible binding offer when Nynas was also competing to buy the assets. In the event of a prohibition decision, there would be no need for Ergon to acquire the Harburg assets to prevent Nynas from buying them, and Ergon could use its idle capacity in the USA to supply most of the EEA market. Accordingly, the Commission concluded that Ergon's strategic interest and incentive in acquiring Shell's refinery assets would most likely diminish if the merger were to be prohibited.

### Efficiencies

Efficiency arguments helped strengthen the case for clearance by complementing other evidence to allow the Commission to conclude that a clearance decision would be likely to leave consumers better off than a prohibition decision.

These efficiency arguments have multiple dimensions. First, in the absence of the merger, the Commission concluded that it was likely that Ergon would respond to higher prices by increasing its EEA sales, with Nynas remaining capacity constrained. However, the likely higher market share which Nynas was likely to capture if the merger proceeded was primarily due to Nynas becoming more competitive relative to closure and not higher prices.


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Second, the Commission carefully assessed whether there would be more or less capacity in the absence of the merger, including whether Nynas' acquisition would result in a verifiable capacity increase by not only preventing the loss of the current capacity in the Harburg capacity, but also increasing its capacity to a level which will largely exceed EEA demand.

Nynas needed to establish the credibility of its estimates of efficiencies, the merger specificity of these efficiencies, and their benefit to consumers. Nynas' intention of investing in the Harburg assets was supported by a detailed cost-benefit analysis. The existence and magnitude of the merger efficiencies was established through detailed analyses and documentation to show that Nynas was currently capacity constrained and that the transaction would allow Nynas to reduce its reliance on more expensive, externally sourced supplies, which in turn would reduce the marginal cost of Nynas supplying additional volume.

The credibility of the proposition that Nynas would be unlikely to achieve comparable capacity increases if the transaction were blocked was confirmed by decisions taken before Harburg was put on the market — i.e., the choices which were made when there was no option of acquiring the Harburg assets. The more recent, less favourable market conditions made the alternative ways of increasing capacity to acquiring Harburg even less attractive than they were at the time, so the Commission had a high degree of comfort that Nynas did not have a credible alternative to the transaction if it wanted to grow its capacity significantly.

The Commission also found that the transaction would be likely to benefit consumers, in particular when compared to the counterfactual. The US supplier would continue to be able to constrain prices in the EEA (its ability to compete was unaffected by the merger), and the reduction in Nynas' variable cost of incremental sales meant that the transaction would place downward pressure on prices. Nynas identified and produced extensive documentation that demonstrated that its incentives were to pass-on the cost reductions to customers once it had brought the additional capacity online.

## Compare and Contrast: *Olympic/Aegean (II) v Nynas/Shell*

To sum up, in the *Nynas/Shell* case the efficiency and failing firm arguments were closely related, and both were actively tested given the presence of a possible alternative purchaser of the target business. Ultimately, the decisive factor was the credibility of the evidence provided by the parties, including that their pre-merger behaviour was consistent with both the claimed efficiencies and the exit of the target business.

It is also worth contrasting the broader outcomes of the *Nynas/Shell* and *Olympic/Aegean (II)* cases. In the *Nynas/Shell* case, the Commission emphasised the pro-competitive benefits of the merger in lowering prices. In *Olympic/Aegean (II)* the Commission recognised the validity of the failing firm defence, but expressed concern that the merged entity would abuse its monopoly position on the five domestic routes, which warranted Commissioner Almunia asking his competition service and the Greek competition authority "to monitor very carefully any possible abuse of the dominant position that Aegean, for sure, will have on these five routes".[25]

## B. *Imerys/Goonvean*

The acquisition by Imerys of Goonvean's kaolin business concerned the extraction, processing and sale of kaolin, which is commonly referred to as china clay and used in a variety of applications, including in paper manufacture, tableware and in commodity performance mineral (CPM) applications (such as in paint and adhesives). Prior to the merger, Goonvean produced kaolin and, as a bi-product, secondary aggregates. Imerys only acquired the less profitable kaolin business and Goonvean's previous parent company retained the secondary aggregates business.

The CC was persuaded that there were no competition concerns as regards the supply of kaolin into paper filler and sanitaryware applications, largely due to the absence of significant pre-merger competition between the parties in paper filler applications and due to the competitive constraints as regards sanitaryware applications particularly from an alternative UK supplier remaining and some customer buyer power.

However, in its provisional findings the CC was concerned about the position as regards tableware and CPM applications where the merged entity would have a UK market share exceeding 80%.

Potentially counter-balancing these competition concerns, there were significant efficiencies to be gained from the transaction which could be uniquely accessed by Imerys. These synergies particularly arose due to the proximity of the parties' quarries and the artificial boundaries between these quarries. The merger would consequently enhance the overall economic life of the quarries, increase output and lower extraction costs. However, as noted above, the CC considered that these efficiencies were not rivalry-enhancing given the merged entity's near monopoly position. In addition, the CMA emphasised that Imerys' business plans assumed no pass-on of these efficiencies in the form of lower prices and that these efficiencies had in part been paid out in purchase price. Nevertheless, the CMA accepted that greater output would be a RCB.

A further issue was whether the failing firm defence, or some variant of this defence, would apply. However, in its submissions to the CMA, Goonvean's previous parent company indicated that the integrated Goonvean kaolin and aggregates business had "only been loss making in [Financial Year] FY09 and FY12 and that it had continued to generate significant cash despite these losses". Moreover, "the board was unanimous in its view that it would seek to ensure that the company would survive, although the prospects for the next few years appeared poor".

In this regard, a review of the management accounts of Goonvean's kaolin and aggregates business indicated that this combined business had been historically cash generative. However, even this integrated business was arguably a failing firm because:

- costs were rising faster than prices, due to a combination of declining overall volumes reflecting declining demand, the loss of customers, and increasing transport costs (as kaolin was increasingly sold by Goonvean further afield);
- the returns on capital employed (ROCE) achieved by Goonvean had been either negative or negligible for many years;
- Goonvean's limited positive cash flows were due to a long-standing policy of replacing equipment only when it fails. Capital expenditure in recent years had been substantially lower than historical expenditure and less than depreciation. In addition, the previous shareholder had made a deliberate decision to take cash out of the business, reflecting accumulated historical profits and proceeds from property disposals, rather than invest in the business;


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- Goonvean's manufacturing facilities required major capital investments, particularly those at its Greensplat facility; and
- the business had a large pension deficit, which was sizeable in both absolute terms and relative to Goonvean's sales.

Moreover, contrary to the submissions of the previous parent company, Goonvean's current position and future prospects (as evidenced by specialist expert reports) were poor:

- it was experiencing growing cash losses, and this would have been the case even if the aggregates business had been retained, due to customer losses/rising costs; and
- Goonvean was running out of economic reserves of high grade kaolin used to make its more profitable products.

Accordingly, the CC accepted that in the absence of the merger Goonvean would not have refurbished its Greensplat facility when this was required. The disagreement between Imerys and the CC concerned the timing of the exit: whether it would occur in the near future or in a few years' time, with the CC being uncertain as to when refurbishment would be required.

The CC also accepted in the final report, reversing its provisional findings, that Goonvean would have progressively exited from the supply of kaolin for tableware applications in the very near future. This meant that the CC did not reach an adverse finding as regards this application. The CC's conclusion was based on the fact that economic reserves of the specific grade of kaolin used in the main tableware grades (referred to as G1) was in short supply, and there was an "opportunity cost" in using this grade in tableware applications as this would lead to foregone sales in more profitable life sciences applications.

The CC identified two effective remedies:

- in order to generate interest from prospective purchasers, the full divestiture of Goonvean's kaolin business, potentially further assets from Imerys, the exclusion of certain liabilities and/or a restructuring of its commercial relationships relating to the supply of secondary aggregates between Imerys and the aggregates business retained by its previous parent company. This would have been a very harsh remedy, but its severity primarily reflects the fundamental unviability and limited scope of the kaolin business which Imerys had acquired; and
- inflation-based price controls for UK customers purchasing kaolin clay for use in CPM applications. These remedies are for only five years as the competition concerns were not expected to persist (as noted above, the CC judged it unlikely that the target's main production facility would be refurbished when required, so effectively accepting a variant of the "failing firm" defence). The CC also considered that these limited price controls would not dissuade new entry/expansion.

On the facts, the CC considered that price controls would be as effective as divestment, but that price controls would be more proportionate and preserve the RCBs. In particular, the CC accepted the merger would yield RCBs by increasing its output as the merger of two adjacent mining/extraction businesses would increase the merged undertaking's access to lower cost reserves and expand the life of the mines.

## 5 Conclusions: Key Lessons

Our central conclusion is that credible failing firm and even efficiency arguments are plausible. The key evidence for failing firm defences relates to the underlying viability of the business, which requires forensic accounting and restructuring expertise. The key information for efficiency defences relates to how merger specific efficiencies will incentivise the business to set lower prices, render investment/capacity expansion more profitable or otherwise improve its competitive offering, which requires merger integration and economic and accounting expertise.

It is unsurprising that competition authorities are sceptical as to failing firm and efficiency defences, given that the merging parties may have superior information on these points to the competition authority and such defences are only required where a merger would otherwise raise competition concerns. Efficiency defences are potentially most relevant where the loss of competition between the parties is modest but still significant, and the merger will increase rivalry with other larger competitors. This certainly fits the CC's clearance decision in *Tradebe/Sita*.

Failing firm defences are inherently more plausible not only where they are supported by financial statements and internal documents as to future business plans, but by pre-merger actions which signal a commitment to market exit as they are costly to reverse, as revealed by the *Nynas/Shell* case. The *Goonvean/Imerys* case also illustrates the willingness of a competition authority to look at the facts as to viability, even in the absence of the previous parent company fully recognising the scale of the competitive challenge faced by the target business.

## Endnotes

1. Competition between the merging parties might increase in the absence of a merger if, for example, one of the parties was about to enter or expand its position in a market predominantly served by the other merger party.
2. Competitive conditions might be inferior if the merger were to be blocked if, for example, the merger were to lead to market output to be higher than would otherwise be the case, since this will generally depress prices. In addition, the merger may ensure continuity of supplies to the target's customers (who might otherwise face costs in switching to other suppliers) and may enable various merger efficiencies to be achieved.
3. Historically, the failing firm defence has been accepted considerably less frequently by the European Commission than by the UK authorities.
4. In this regard, it is striking that since 2010 it has been nearly twice as likely for a UK phase II merger investigation to lead to an unconditional clearance decision as an EU phase II merger investigation. It will be interesting to observe whether the new UK Competition and Markets Authority, which has taken over responsibly for both phase I and phase II merger investigations from the Office of Fair Trading and Competition Commission respectively, continues to clear unconditionally such a high proportion of mergers following phase II investigations.
5. The failing firm defence has occasionally been accepted by the OFT in some phase I merger cases. For example, in *Kingfisher/Focus* (2011) the OFT issued its clearance decision a mere 19 days after it received a satisfactory submission. The background to the case was that the DIY chain Focus went into administration on 5 May 2011. The OFT accepted the failing firm defence as regards 10 of the 11 potentially overlapping stores as these stores would have exited the market in any event and there would not have been an alternative purchaser of the stores that would result in a less anti-competitive outcome. However, Kingfisher withdrew from the purchase of one of the Focus stores after the OFT's initial assessment that the acquisition of this store raised *prima facie* competition concerns, because there was evidence which suggested that there was a rival national DIY purchaser for that store. This single store was released back to the administrator, so that it could be marketed to other potential buyers.


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6. See §89 to §91 of the EU Horizontal Merger Guidelines.
7. See §4.3.8 to §4.3.18 of the CC's and OFT's Merger Assessment Guidelines, September 2010, CC2 (Revised) and OFT1254.
8. Accordingly, the failing firm defence may not apply to undertakings, such as banks or possibly state owned hospitals, if they may receive further state funding if they face financial difficulties.
9. A good illustration of the circumstances in which there may be a less anti-competitive purchaser is provided by the CC's decision in *Eurotunnel/Sea France* (2013). In this case, the CC's merger counterfactual, which was also the basis of its core theory of harm, was that some of the vessels acquired by Eurotunnel would otherwise have been acquired by DFDS. Indeed, the CC concluded that Eurotunnel's rationale for the acquisition of the SeaFrance assets was that it would protect or enhance Eurotunnel's future profitability by preventing the other main bidder (DFDS) from acquiring them and competing aggressively on price, and also by enabling Eurotunnel to rationalise the level of capacity on the short sea in the future.
10. Even if the target's sales would be distributed amongst a number of competitors in the absence of the merger, it should not be presumed that this would be a more pro-competitive outcome than for the target's sales to be largely retained by the merged entity. For example, if the competition concerns relate to the creation or strengthening of co-ordinated effects, then the loss of the target firm as an independent competitor would still not be a consequence of the merger. In addition, a merger might increase or reduce market share asymmetry between competitors, and greater asymmetries in market shares may reduce the risks of anti-competitive coordination. Merger efficiencies might also reduce the risks of anti-competitive coordinated effects by increasing the incentives of the merged business to compete independently (this point is expressly acknowledged at §82 of the Commission's Horizontal Merger Guidelines), and customers might also benefit from continuity of supplies from the otherwise failing target business. More generally, the competition authority will need to explain why, if a merger will enable part or all of a target's capacity to continue to be operated, this is not a more pro-competitive outcome, since this can be expected to depress prices. This is one of the issues which the CC considered in *Eurotunnel/Sea France* (2013), as discussed in the previous endnote.
11. For example, Kodak emerged from Chapter 11 after being transformed into a technology company focused on imaging for business, approximately $3 billion in legacy liabilities were shed, and its earnings before interest, tax, depreciation and amortisation (EBITDA) were improved by over $300 million. The wide ranging restructuring included a settlement with the Kodak U.K. Pension Plan (KPP) in April 2013, resulting in a spin-off of Kodak's consumer businesses to the KPP in exchange for the release of all of the company's worldwide obligations to the KPP (including the waiver of its $2.8 billion bankruptcy claim) and a $325 million cash payment from the KPP to Kodak. Ultimately, this transformation and restructuring repositioned Kodak, kept the KPP solvent and created two well-positioned businesses: a reorganised Kodak, owned by U.S. creditors; and Kodak Alaris, owned by the KPP. See further: http://www.alixpartners.com/en/MediaCenter/PressReleases/tabid/821/articleType/ArticleView/articleId/1353/AlixPartners-Honored-by-Turnaround-Management-Association-For-Work-at-Kodak.aspx.
12. See, for example, §69 and §72 of the European Commission's "Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings" (2004/C 31/03) (the EU Horizontal Merger Guidelines).
13. This was an issue in *Long Clawson Dairy Limited/Millway* (2009) where the CC found that Millway had been loss-making for many years and had been dependent on the support of its parent company. At the time of the merger, Millway had recently lost many of its most significant customers, principally due to recurring problems with the quality and consistency of its product. The CC found that: "One of the causes of these problems appeared to be the introduction in 2001 of a highly mechanised continuous vat production process, which had been used to produce other types of cheese, but which had never previously, and has not subsequently, been used to produce Stilton".
14. For example, the OFT's document on "Exceptions to the duty to refer and undertakings *in lieu* of reference guidance", December 2010, OFT1122, indicates that the OFT will require an upfront buyer where it has reasonable doubts as to the commercial viability of the divestment business (most obviously where this business is only marginally unprofitable or is unprofitable) or there are few suitable potential purchasers (§5.33).
15. The European Commission's Guidelines on the assessment of non-horizontal mergers also envisage that vertical and conglomerate mergers may yield efficiencies (see, for example, §54-57 and §117-118), and the UK Merger Assessment Guidelines envisage that mergers may yield a wide range of efficiencies (see section 7). For example, whilst the European Commission did not clear the *Tom Tom/NAVTEQ* or *Nokia/Tele Atlas* mergers on the basis of efficiencies, it did find various vertical efficiencies to be plausible (see http:// ec.europa.eu/competition/publications/cpn/2008_3_70.pdf for a good discussion of these cases by European Commission staff).
16. The European Commission's White Paper of July 2014 "Towards more effective EU merger control" provides an overview of substantive merger assessment since 2014 and cites only two cases where merger efficiency arguments were relevant, namely *TNT/UPS* (2013) and *Nynas/Shell* (2013).
17. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.C_.2014.137.01.0008.01.ENG.
18. http://europa.eu/rapid/press-release_MEMO-13-48_en.htm.
19. https://www.coleurope.eu/sites/default/files/uploads/event/64th_lunch_talk_-_ups_tnt_-_slides_simon.pdf.
20. This is based on the intuition that it is profitable for a firm to increase sales volumes by reducing prices until the addition to total revenue from selling one more unit of output (which is referred to as marginal revenue) is no longer greater than the associated increase in total costs (which is referred to as marginal cost). Marginal costs exclude fixed costs which do not vary with output. In fact, some costs may be semi-variable in the sense that they may increase if output varies beyond certain ranges. There will also be circumstances, particularly in the context of long-term contracts, where firms may set prices with regard to the fixed costs associated with supplying under these contracts as such fixed costs are avoidable according to whether the contract is won or lost.
21. This was based on a model originally submitted by the parties which sought to estimate the relationship between pricing and the number of competitors on the various markets at issue on the basis of the prices actually charged by UPS and TNT in the recent past. The model included as explanatory variables the number of competitors, distance, costs, customer characteristics and market size. This analysis predicted that prices would increase (absent efficiencies) in 29 EEA countries, with there being a dispute between the parties and the Commission as to the extent to which higher concentration was associated with higher prices.
22. OFT staff have indicated that such customer benefits might be of particular relevance in connection with public-sector


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hospital mergers. See further "Finding customer benefits in NHS hospital mergers – mission impossible?" (2014), by Bruce Den Uyl, Mat Hughes, and John Maloney, available at www.practicallaw.com.

23. See section 20-012 of "The EU Merger Regulation: Substantive Issues", Fourth Edition, Alistair Lindsay and Alison Berridge, Sweet & Maxwell, 2012.

24. In particular, the Commission emphasised that continued operation of the Harburg refinery assets would lead to double the losses in net present value terms than closure, despite closure costing $300-550m. In addition, Shell forecast large on-going annual losses and the plant had on average been loss making for over five years.

25. Commissioner Almunia's speech on this decision sets out a clear body of evidence as to why the failing firm defence should apply to this case:

- the Greek crisis has seen a drop of 26% in demand for domestic air passenger transport from Athens from 2009 to 2012, with the decline continuing in the first half of 2013;
- Olympic has never been profitable since its privatisation in 2009 and it has received considerable financial support from its sole shareholder, Marfin;
- the Commission concluded that "it's extremely unlikely that the company will become profitable in the foreseeable future, under any business plan". In short, the Commission concluded that Olympic would be forced to leave the market soon, with or without merger; and
- there is no other credible purchaser interested in acquiring Olympic or its very few assets, including the Olympic brand, which is owned by the Greek state (see http://europa.eu/rapid/press-release_SPEECH-13-800_en.htm).


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Noteworthy recent second stage UK and EU mergers include the *Imerys/Goonvean* and *Nynas/Shell* mergers outlined in this chapter. AlixPartners' economics practice also engages in a range of other competition economics work. Members of the team are currently acting in relation to the European Commission investigations into credit default swaps and e-books, and the UK Competition and Markets Authority investigations into payday lending and private motor insurance. AlixPartners' experts are highly experienced in antitrust damages work, having worked on many high-profile cases including *Copper Tubes, Gaviscon, Auto Glass, Libor, Recolight, Enron Coal, Gas Insulated Switchgear, Ice Cream,* and *Vitamins*. The team also provides monitoring trustee services, which focus on the design and implementation of commitments.


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