Copenhagen Economics

FOREIGN SUBSIDIES REGULATION IN THE CONTEXT OF MERGERS:

TRACING THE CAUSE AND EFFECT

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The Foreign Subsidies Regulation ("FSR") seeks to address potential distortions caused by foreign subsidies on the internal market.[1] The underlying concern is that foreign subsidies may undermine the level playing field between companies bound by the EU state aid rules and those receiving foreign aid to help boost their competitive position in the internal market. The FSR has sparked a myriad of legal and economic questions, not least because of the uncertainties surrounding the burden mandatory notifications may create on many companies. One important question – discussed in this note – concerns the potentially distortive effects foreign subsidies could have on mergers and acquisitions.

The FSR seeks to address potential distortions related to mergers via an obligation to notify concentrations above certain thresholds.[2] This gives the Commission the ability to review any such transaction and identify whether it is affected by foreign subsidies with an adverse effect on competition within the internal market. If such harm is concluded, the Commission will then have to access whether that harm is countervailed by benefits via a balancing test. If not, the Commission can either block the merger or impose remedies, in a similar way to the Merger Control Regime.

While the economic case for securing a level playing field in mergers may seem clear, the implementation of the FSR to address distortive state-backed mergers is not clear cut. How might foreign subsidies have adverse effects on competition through their effects on mergers, and how can the role of foreign subsidies be disentangled?

[1] Regulation (EU) 2022/2560 of the European Parliament and of the Council of 14 December 2022 on foreign subsidies distorting the internal market OJ L 330, 23.12.2022, p. 1–45. Available online at https://eur-lex.europa.eu/eli/reg/2022/2560/oj.

[2] At least one of the parties or the joint venture generates an aggregate turnover of EUR 500 in the EU and is established, and the parties together have received financial contributions from third party countries amounting to at least EUR 50 million in the three years prior to the announcement of the acquisition. Foreign Subsidies Regulation, Article 20. For the purposes of the FSR, a "financial contributions from third party countries" is distinguished from foreign subsidies, which are those financial contributions which confer a benefit, and are limited to one or more undertakings or industries (Foreign Subsidies Regulation, preamble, paragraph 11).

1 CAN FOREIGN SUBSIDIES POTENTIALLY HAVE A DISTORTIVE EFFECT ON COMPETITION BY ENABLING MERGERS?

From an economic perspective, assessing the potential distortive impact of any subsidy starts by identifying the mechanism through which that subsidy could harm competition. Once the mechanism has been identified, the actual situation needs to be compared with the hypothetical situation where no foreign subsidy exists (the "counterfactual").

The assessment of foreign subsidies resembles that of state aid by using the same two-step test[3]: First, determine the existence of a foreign subsidy, and second, see whether that foreign subsidy is compatible with the FSR.

In the case of mergers, the FSR is particularly concerned with foreign subsidies with the potential to facilitate a concentration.[4] This could occur (i) by triggering an acquisition that would otherwise not occur, (ii) by benefitting a certain prospective buyer over alternative buyers, or (iii) by benefitting a particular target over alternative available targets. Such a subsidy could distort competition if the concentration that is facilitated itself distorts competition. For example, such adverse effects could arise from crowding out efficient competitors, an inefficient allocation of resources, a distortion of market rents and long-term incentives, or undue market capacity accruing to a less efficient competitor.

For example, consider *Firm A,* which has received a direct grant that has been established to constitute a foreign subsidy. *Firm A* then participates in a bidding situation to acquire a target (*Firm C*) active in the EU. *Firm A* outbids the only competitor (*Firm B*), and the acquisition goes through.[5] How would one assess the impact of a foreign subsidy in this situation?

We can consider three potential scenarios (see Figure 1 below):

I. the foreign subsidy increased *Firm A*'s bid, which would have been lower than that of *Firm B* absent the foreign subsidy;
II. the foreign subsidy increased *Firm A*'s bid, but *Firm A* would have outbid *Firm B* regardless of the foreign subsidy; and
III. the foreign subsidy had no impact on *Firm A*'s bid.

In theory, the adverse effects of the foreign subsidy could be present in all three scenarios. In Scenario I, the foreign subsidy facilitates the concentration by allowing *Firm A* to outbid *Firm B*. If Firm B is a more efficient purchaser of the target, the subsidy would then facilitate a potentially anti-competitive transaction. In Scenarios II and III, any potential adverse effects would likely be more indirect, because they would involve the transfer of funds achieved through the foreign subsidy to the target or its owners.

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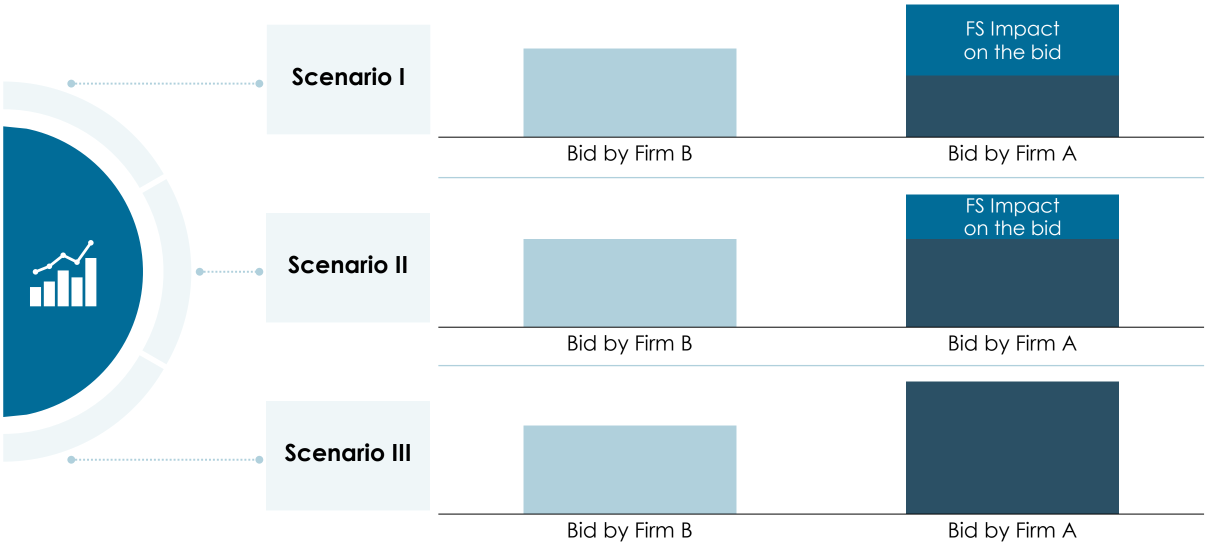
3 For state aid this is commonly referred to as 1) existence of aid, 2) compatibility of aid.

4 Foreign Subsidies Regulation, Article 5 1 (d).

5 One could also extrapolate this example to a situation where no bidding occurred and instead the bid of firm B refers to the target's reservation price.

Figure 1
Foreign subsidy impact on merger



Note: in Scenario III, foreign subsidies are assumed not to have an impact on the value of Firm A's bid.
Source: Illustration by Copenhagen Economics.

2 FOREIGN SUBSIDIES CAN INFLUENCE ACQUISITIONS DIRECTLY AND INDIRECTLY

The illustration above builds on the notion that the impact of a foreign subsidy can be directly identified and precisely measured. In practice, this is unlikely to be the case, as acknowledged in the FSR:

"*It is possible that the lack of transparency concerning many foreign subsidies and the complexity of the commercial reality make it difficult to unequivocally identify or quantify the impact of a given foreign subsidy on the internal market.*"[6]

To determine distortion, the FSR notes that "*it therefore appears necessary to use a non-exhaustive set of indicators.*"[7] Indicators mentioned in the regulation are the size of the subsidy, its size in relation to market size or the value of the transaction, and market activity by the parties. These indicators could be sufficient if the link between foreign subsidies and the alleged adverse effect on competition is evident.

A more complex situation is when subsidies are not aimed at specific transactions, but may nevertheless put the recipient in an advantageous position. For example, if a firm receives a capital injection, how can this impact the firm's merger activity?

[6] Foreign Subsidies Regulation, para. 18.
[7] Foreign Subsidies Regulation, para. 18.

The overarching mechanism of concern is that capital injection improves the firm's financial strength by providing "deeper pockets".[8] If a firm receives a capital injection, it can directly improve financing possibilities through lower cost of capital, improved liquidity, reduced borrowing costs, or improved credit rating. Other things equal, a company receiving, say, a capital injection on terms not available in financial markets will be better positioned to finance any acquisitions. The question is whether an acquisition would not have taken place in the counterfactual of no subsidy. In other words, an economic analysis would seek to establish whether the cost of providing capital on market terms would have been too high to pursue the acquisition (i.e., whether the acquisition would have been net present value (NPV) negative).

Looking at annual returns to investors, assessing the ability to take loans, and looking at past merger activity can all contribute to the assessment of the counterfactual and therefore the potential adverse effects of the subsidy. Furthermore, as shown in the illustration above, the impact of the subsidy should also be viewed relative to the firm's competitors or the reservation value of the seller if competitors operating on market-based terms have stricter financing conditions.

Relevant questions in such cases include the following: Could the acquiring company have had access to financing without the subsidy? Did the acquiring company have constrained liquidity before being granted a subsidy? How would borrowing conditions be if the subsidy was absent?

Answering these questions requires a detailed understanding of the counterfactual scenario. When developing the counterfactual scenario, we believe that, ultimately, it will be necessary to assess several indicators together. These indicators could include, for example, benchmarking several financial indicators of the firm before and after the subsidy; looking at several comparable competitors; reviewing the market and modes of competition; or even using credit rating methodologies standardly used to determine the price of credit. All of these methodologies could form part of determining the counterfactual outcome.

3 DO 'HARMLESS' MERGERS REQUIRE DISENTANGLING OF THE EFFECT OF FOREIGN SUBSIDIES?

Linking the foreign subsidy to a specific acquisition will not be straightforward. As acknowledged in the FSR, the link can be determined using a list of indicators, which is likely to vary on a case-by-case basis.

Although challenging, it may be worthwhile for companies to pursue an analysis of the plausible link between a foreign subsidy and its impact on competition at an early stage. Assessing indicators of plausible mechanisms through which a subsidy may potentially harm competition can give an indication of the likely outcome of the Commission's investigation. While it remains to be seen how the Commission will assess the effects of foreign subsidies on mergers, assessing and documenting (where relevant) either a lack of any potential competitive harm or that the benefits of the foreign subsidy are sufficiently large that the balancing test is likely to be met in any event, could simplify the assessment. For example, in some cases, it may become relevant to set out evidence of the benefits to European consumers that any subsidy could bring in the form of cheaper prices, as well as explaining how the original objectives of the subsidy (e.g., environmental or other social objectives) will also be transferred to European customers in order to assess the balancing test.

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[8] OECD (2022), Subsidies, Competition and Trade, OECD Competition Policy Roundtable, p.2 off.

Understanding the competitive implications of subsidies may even be sufficient to write off concerns early on. If the subsidies are unlikely to have any material adverse effects on EU competition, the link between the foreign subsidy and the transaction becomes of secondary importance.