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## ABSTRACT

It is sometimes argued that the European Commission should take into greater consideration foreign subsidies when assessing mergers under the EU Merger Regulation. However, the Commission's decision-making practice confirms that foreign subsidies may be relevant for the assessment of mergers but only under strict conditions. First, sufficient evidence should be put forward to prove the existence of the said subsidies. Second, subsidized competitors must have the ability and incentive to successfully engage in deep-pocket predation. This relatively high standard of proof explains why foreign subsidies have not yet played any decisive role in practice. Yet, these conditions are consistent with the economic literature and lowering this standard may lead to type I and type II errors. Accordingly, to fully address the distortions arising from foreign subsidies, it seems preferable to introduce a new dedicated tool than to lower the standard of proof applicable in the field of merger control.

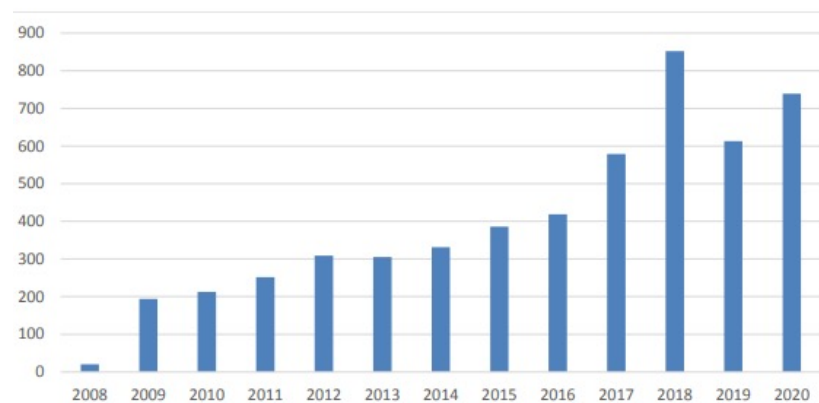
*Il est souvent reproché à la Commission de ne pas tenir suffisamment compte des subventions étrangères lorsqu'elle analyse des opérations de concentration. La Commission accepte pourtant de tenir compte de ce type d'éléments factuels, mais uniquement sous certaines conditions. Premièrement, l'existence de telles subventions doit être démontrée. Deuxièmement, les concurrents subventionnés doivent être capables et avoir l'incitation de s'engager efficacement dans une stratégie de prédation financière. Ces conditions strictes expliquent pourquoi les subventions étrangères n'ont encore jamais joué de rôle déterminant en pratique. Malgré tout, ce standard de preuve est cohérent avec la théorie économique et l'écartier pourrait entraîner des erreurs de type I et de type II. Afin de lutter contre les distorsions engendrées par les subventions étrangères, il semble donc préférable d'introduire un nouvel instrument dédié plutôt que d'abaisser le standard de preuve applicable en matière de contrôle des concentrations.*

\*The opinions expressed are strictly those of the author and do not reflect the position of the European Commission.

# The uneven playing field: How to deal with foreign subsidies when assessing mergers?

1. Foreign subsidies<sup>1</sup> have always attracted concerns as they may distort competition to the detriment of European companies. These concerns have grown over the years with the increasing number of subsidies worldwide. In this regard, Figure 1 provides an overview of the number of newly implemented subsidies between 2008 and 2020:<sup>2</sup>

Figure 1. Number of newly implemented subsidy measures (worldwide) by year



Source: Global Trade Alert (GTA)

2. As shown in Table 1, certain countries like China heavily rely on subsidies to support their domestic companies:<sup>3</sup>

1 The proposal from the Commission for a Regulation of the European Parliament and of the Council on foreign subsidies distorting the internal market, COM(2021) 223 final, 5 May 2021 (the "Draft Regulation"), defines foreign subsidies as financial contributions conferring a benefit to undertakings engaging in economic activities in the internal market and which are limited, in law or in fact, to one or more undertakings or industries. Under this definition, a foreign subsidy may take various forms, including a transfer of funds or liabilities, the foregoing of revenues, the provision or purchase of goods or services under advantageous terms and conditions (Article 2).

2 The Commission's staff working document on the impact assessment accompanying the Draft Regulation SWD(2021) 99 final, 5 May 2021.

3 Ibid.

**Table 1. Subsidy amounts reported to the WTO based on 2019 notifications by the EU's five main trading partners**

In million Euros	2017	2018
China	380,132.7	520,012.9
USA	14,932.8	17,008.4
UK	919.7	888.1
Russia	3,959.52	3,803.94
Switzerland	515.0	697.4

3. These subsidies, which usually form part of broader plans from the Chinese government (e.g., Made in China 2025, the Belt and Road Initiative), may take various forms (e.g., free to low-cost loans, subsidies to energy, key inputs, land or technology) and allow Chinese companies to undercut rivals. As Peter Navarro explains, export subsidies constitute one of the main contributing factors to the price advantage of Chinese companies on the international stage:<sup>4</sup>

**Figure 2. Relative contributions of the eight China price drives**

Wages	39.41%
Subsidies	16.71%
Network Clustering	16.02%
Undervalued Currency	11.44%
Counterfeiting & Piracy	8.63%
FDI	3.09%
Health & Safety	2.44%
Environmental	2.26%
<b>TOTAL</b>	<b>100%</b>

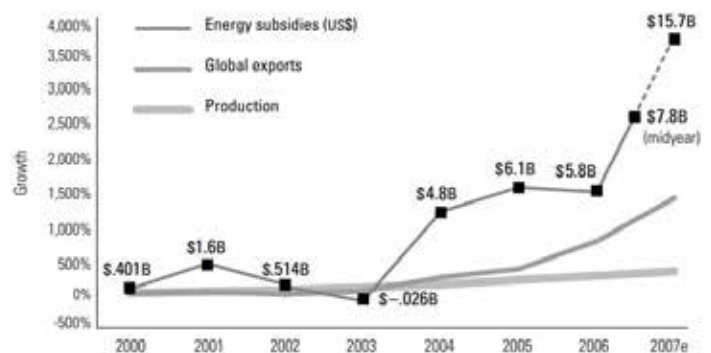
4. According to other authors, this price advantage would largely contribute to the over-representation of Chinese companies in a number of industries.<sup>5</sup> For instance, Myrto Kalouptsi explains that Chinese subsidies to domestic shipyards between 2006 and 2012 reduced the costs of Chinese shipyards by 13% to 20%. In the meantime, this author shows that the worldwide market share of Chinese shipyards has more than doubled since 2002:<sup>6</sup>

**Table 2. China's average quarterly market share before and after 2006**

	China market share, pre-2006 (%)	China market share, post-2006 (%)
Bulk carriers	17	57
Tankers	15	28
Containerships	16	39
Gas carriers (LNG/LPG)	7	21

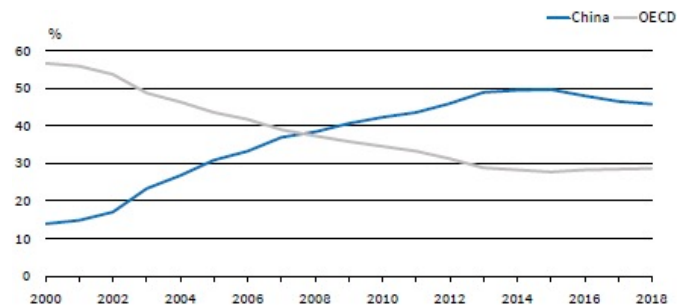
5. Likewise, in the steel industry, Usha and George Haley found a direct correlation between the energy subsidies granted by the Chinese government to steel manufacturers and steel exports from China:<sup>7</sup>

**Figure 3. Energy, subsidies, and steel**



6. In the meantime, the worldwide share of Chinese companies has largely increased:<sup>8</sup>

**Figure 4. China's relevance in the global steel market**



Source: OECD 2019

7. Against this background, European companies and governments often complain about foreign subsidies in the context of merger investigations. By way of illustration, following the Commission's prohibition decision in *Siemens/Alstom*,<sup>9</sup> the French and German governments published

4 P. Navarro, The Economics of the "China Price," *China Perspectives*, 68, November–December 2006. See also China's economy, Perverse advantage, *The Economist*, 27 April 2013. As Myrto Kalouptsi explains, the share of labour-intensive products in Chinese exports fell from 37% to 14% between 2000 and 2010, which contradicts the widespread belief that China's success as an exporting nation derives primarily from low labour costs (M. Kalouptsi, Detection and Impact of Industrial Subsidies: The Case of Chinese Shipbuilding, *Review of Economic Studies*, Vol. 85, Issue 2, 2018, pp. 1111–1158). This is consistent with the findings of U. Haley and G. T. Haley in The Hidden Advantage of Chinese Subsidies, *The World Financial Review*, September–October 2014 ("Our findings contradict the widespread belief that China's enormous success as an exporting nation derives primarily from low labour costs and deliberate currency undervaluation").

5 U. Haley and G. T. Haley, Subsidies and the China Price, *Harvard Business Review*, June 2008. See also P. Navarro, The Economics of the "China Price"; U. Haley and G. T. Haley, *Subsidies to Chinese Industry, State Capitalism, Business Strategy, and Trade Policy* (Oxford University Press, 2013), citing various industries including steel, glass, paper, auto-parts, solar panels.

6 M. Kalouptsi, Detection and Impact of Industrial Subsidies: The Case of Chinese Shipbuilding, *Review of Economic Studies*.

7 U. Haley and G. T. Haley, Subsidies and the China Price.

8 According to the Commission, however, the relevant geographic markets in the steel industry are EEA-wide (see e.g. Eur. Comm., dec. Art. 8, §2 R. 139/2004 of 7.05.2018, *ArcelorMittal/Ilva*, case M.8444, paras. 385 with respect to flat carbon steel products).

9 Eur. Comm., dec. Art. 8(3) R. 139/2004 of 6.2.2019, *Siemens/Alstom*, case M.8677.

a Joint Manifesto<sup>10</sup> urging the Commission<sup>11</sup> to take into greater consideration foreign subsidies when assessing mergers under the EU Merger Regulation (“EUMR”).<sup>12</sup>

8. According to the Franco-German Manifesto, “*there is no regulatory global level playing field. And there won’t be one any time soon. This puts European companies at a massive disadvantage. When some countries heavily subsidize their own companies, how can companies operating mainly in Europe compete fairly? Of course, we must continue to argue for a fairer and more effective global level playing field, but in the meantime, we need to ensure our companies can actually grow and compete.*”

9. A few years later, the European Commission published a proposal for a Regulation on foreign subsidies<sup>13</sup> (the “Draft Regulation”) which consists of three “modules” addressing the main distortive effects caused by foreign subsidies: in the internal market generally (module 1), in acquisitions of EU companies (module 2) and in EU public procurement procedures (module 3).<sup>14</sup>

10. Although this initiative is to be welcomed, it does not clarify the extent to which foreign subsidies may be taken into consideration when assessing mergers under the EUMR. In this respect, the economic literature on deep pocket predation (I.) and the Commission’s decision-making practice (II.) provide useful insights to identify the conditions under which the Commission may accept to take into account foreign subsidies when assessing mergers (III.).

## I. The “deep pocket” theory

11. “Deep pocket” predation refers to a specific type of predation, whereby a firm with substantial financial resources (the “deep pocket” or “long purse”) decides to engage in cutthroat competition with a view to foreclosing competitors.<sup>15</sup>

10 A Franco-German Manifesto for a European industrial policy fit for the 21st century, 19 February 2019 (the “Franco-German Manifesto”).

11 The Franco-German Manifesto recommended to (i) take into greater consideration the state control of and subsidies for undertakings within the framework of merger control; (ii) update current merger guidelines to take greater account of competition at the global level, potential future competition and the time frame when it comes to looking ahead to the development of competition to give the European Commission more flexibility when assessing relevant markets; (iii) introduce a right of appeal of the Council, which could ultimately override Commission decisions in well-defined cases, subject to strict conditions; (iv) make sure that State aid guidelines provide a clear framework, taking into account the aim to develop innovative industrial capacity in Europe; (v) involve public actors on a temporary basis in specific sectors at particular points in time to ensure their long-term successful development.

12 Regulation (EU) No. 139/2004 of 20 January 2004 on the control of concentrations between undertakings, OJ L 24, 29.1.2004, p. 1.

13 See the Draft Regulation and the Commission’s staff working document on the impact assessment accompanying the Draft Regulation dated 5 May 2021.

14 While module 1 would rely on an ex-officio basis, Modules 2 and 3 would rely on a system of prior notification of foreign subsidies.

15 J. Tirole, *The Theory of Industrial Organization* (7th ed., MIT Press, 1994); M. de la Mano and B. Durand, A Three-Step Structured Rule of Reason to Assess Predation under Article 102, Discussion Paper, version dated 2 February 2010; M. Motta, *Competition Policy: Theory and Practice*, Cambridge University Press, 2004.

12. Telser (1966) was among the first to offer a formal exposition of the deep pocket theory.<sup>16</sup> He argued that if the prey must incur some fixed cost to remain in operation, then, by driving the market price below variable costs resulting in a loss at least as large as fixed costs, the predator may exhaust its rival’s reserves, driving it out of the market.<sup>17</sup>

13. In this scenario, predation would be both feasible and rational, provided the monopoly rents are sufficient to compensate for the foregone profits during the predatory episode. However, this model failed to explain why the prey would not be able to borrow funds even though this mere possibility would deter the predator from ever attempting to predate.<sup>18</sup>

14. This is why according to the most recent economic literature, financial predation is credible only if lenders do not have complete information allowing them to assess the prey’s performance (i.e., in case of asymmetric information).<sup>19</sup> In this situation, a firm’s assets<sup>20</sup> will determine its ability to raise external funds,<sup>21</sup> which in turn may make it rational for a firm with extensive internal resources to lower its prices with a view to limit the profits of a competitor with less financial resources.

15. According to these theories, the predator simply needs to be financially stronger than its competitors,<sup>22</sup> so there is no requirement for the predator to be the incumbent.<sup>23</sup> Likewise, the exit of competitors is not a requirement, i.e., the predator may simply try to prevent smaller firms from adopting innovations or growing, without forcing

16 L. G. Telser, Cutthroat Competition and the Long Purse, *Journal of Law and Economics*, Vol. 9, 1966, pp. 259–277.

17 M. de la Mano and B. Durand, A Three-Step Structured Rule of Reason to Assess Predation under Article 102.

18 Price war losses are “sunk” when a firm decides to exit. Even if a price war has drained a firm’s financial reserves, if the firm has access to a profitable duopoly opportunity, it should be able to secure external financing. Only potential future profitability should matter both to capital markets and to a victim of predation. This fact should be known by the predator and prevent it from engaging in predation.

19 If the lenders can monitor managerial behavior sufficiently well, however, they can reduce or eliminate the asymmetries of information that underlie this model. Venture capitalists, for instance, are often very involved in the day-to-day operations of a firm, which reduces the asymmetry of information between the creditors and the firm and thereby lowers the cost of financing new projects (J. Tirole, *The Theory of Industrial Organization*).

20 e.g., cash and retained earnings.

21 Lenders face a dilemma: on the one hand, continuing supply of funds sufficient to deter predation invites opportunistic conduct by the prey, and on the other hand, if the lender attempts to impose financial discipline on the firm with repayment obligations and collateral requirements, it may invite predation by rivals. According to several authors, there is no satisfactory solution to this dilemma and ultimately, the lender can only protect its interests by demanding the prey to put up a significant fraction of its own capital as collateral (e.g., retained earnings). Accordingly, only firms with access to significant internal resources may be able to raise external finance to fend off a predatory attack. In contrast, if capital markets were to be perfect, only the profitability of an investment should influence the ability of a firm to raise funds, irrespective of the firm’s assets (M. de la Mano and B. Durand, A Three-Step Structured Rule of Reason to Assess Predation under Article 102).

22 However, a strong market position is a necessary condition for predation. Predation involved monetary losses that a firm can hope to recoup in the future only if it enjoys enough market power (M. Motta, *Competition Policy: Theory and Practice*).

23 S. Bougheas and S. Thananittayaudom, Financial Predation by the “Weak,” *International Journal of Business and Economics*, Vol. 5, Issue 3, 2006, pp. 231–244.

them out of the market.<sup>24</sup> As a result, below-cost pricing should not be regarded as a requirement for deep-pocket predation to be credible.<sup>25</sup>

16. In light of the above, foreign subsidies can be relevant for the assessment of mergers, but only if subsidized companies can be regarded as deep-pocket firms with the ability and incentive to successfully engage in deep-pocket predation.<sup>26</sup>

## II. The Commission's approach to foreign subsidies under the EUMR

17. When dealing with foreign subsidies in merger investigations, a distinction can be made depending on whether foreign subsidies were granted to the merging parties (1.) or competitors of the merging parties (2.).

### 1. Foreign subsidies granted to the merging parties: The "foreign subsidy offense"

18. According to Article 2(1)(b) EUMR, when assessing a merger, "the Commission shall take into account (...) the market position of the undertakings concerned and their economic and financial power."<sup>27</sup> Although the Commission considers that the parties' financial strength is insufficient in itself to give rise to dominance, it is a relevant factor, which together with other criteria, is relevant to assess whether a concentration significantly impedes effective competition.<sup>28</sup>

24 M. Motta, *Competition Policy: Theory and Practice* ("Exit, with or without bankruptcy, is not necessarily the most common outcome of such a predation (...) the prey can stop expanding or modernizing rather than run the risk of going bankrupt").

25 P. Milgrom and J. Roberts, *New Theories of Predatory Pricing*, in *Industrial Structure in the New Industrial Economics*, G. Bonanno and D. Brandolini (Clarendon Press, 1990), p. 123: "[E]ven in the deep-pocket approach, there would seem to be no implication that price will be below marginal cost; all that is needed is that there be a negative cash flow. Moreover, it is the costs of the alleged prey, not those of the predator, that are relevant."

26 Commission guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, OJ C 31, 5.2.2004, p. 5, para. 36.

27 According to the Commission, however, "whilst under Article 2(1)(b) of the Merger Regulation, economic and financial power are important criteria for the appraisal of whether a concentration is compatible with the common market, in the absence of other indicators financial strength as such will not be sufficient to lead to the creation or strengthening of a dominant position as a result of which competition will be significantly impeded" (Eur. Comm., dec. Art. 6(1) R. 139/2004 of 21.10.2002, *Deutsche Post/DHL (II)*, case COMP/M.2908 para. 32). Eur. Comm., dec. Art. 8(1) R. 139/2004 of 5.5.2008, *STX/Aker Yards*, case COMP/M.4956, para. 87: "Generally, it is unlikely that a company which is not in a leading market position could become dominant on the basis of financial strength only." For a detail discussion in this respect, see C. Bright and J. Schmidt, *Financial Strength as a Relevant Criterion in EC Merger Analysis: A Search for Meaning*, *European Competition Journal*, Vol. 1, Issue 2, 2005, pp. 293–314.

28 C. Bright and J. Schmidt, *Financial Strength as a Relevant Criterion in EC Merger Analysis: A Search for Meaning*.

19. In this respect, the General Court (then Court of First Instance) made clear in *RJB Mining* that when assessing mergers, the Commission has to take into consideration the effect of State aid previously granted to one of the merging parties.<sup>29</sup> This case is interesting for the discussion on foreign subsidies as the notions of aid and subsidies are similar.<sup>30</sup>

20. Since the *RJB Mining* ruling, the Commission has examined the effect of State aid in a number of merger decisions.<sup>31</sup> In *Deutsche Post/DHL (II)*, for instance, several competitors argued that Deutsche Post had received illegal State aid and used excessive revenues deriving from its postal monopoly in Germany to cross-subsidize its activities open to competition and to finance acquisitions in those areas.<sup>32</sup> In response, the Commission noted that "financial strength as such will not be sufficient to lead to the creation or strengthening of a dominant position"<sup>33</sup> but nevertheless examined whether the financial power of Deutsche Post could allow it "to increase DHL's market position by systematically undercutting competitors' prices in such a way that DHL's existing or potential competitors are marginalized."<sup>34</sup>

21. In this regard, the Commission compared the main financial indicators of Deutsche Post<sup>35</sup> with that of its main competitors (FedEx, UPS and TPG) and found that Deutsche Post did not have a specific financial advantage.<sup>36</sup> As a result, the Commission concluded that Deutsche Post's competitors had "sufficient financial strength to be able to counteract any possible attempts by Deutsche Post to force them out of the market by means of predatory pricing strategies."<sup>37</sup>

29 CFIEC, 31 December 2001, *RJB Mining PLC v. European Commission*, case T-156/98, ECR II-337, para. 114: "[I]n adopting a decision on the compatibility of a concentration between undertakings with the common market the Commission cannot ignore the consequences which the grant of State aid to those undertakings has on the maintenance of effective competition on the market." See also CFIEC, 3 April 2003, *BaByliss v. Commission*, case T-114/02, ECR II-1279.

30 The Draft Regulation defines foreign subsidies as financial contributions conferring a benefit to undertakings engaging in economic activities in the internal market and which are limited, in law or in fact, to one or more undertakings or industries. This definition is similar to the definition of State aid under Article 107(1) TFEU.

31 See, e.g., Eur. Comm., dec. Art. 6(1) R. 4064/89 of 25.4.2002, *HDW/Ferrostaal/Hellenic Shipyards*, case COMP/M.2772 (the state funding was intended to facilitate privatization and was not dependent on the identity of the buyer, with the consequence that any advantage arising from the state funding was not caused by the concentration); *Deutsche Post/DHL (II)*, case COMP/M.2908 (the Commission found that there was no causal link between State aid that had previously been paid to Deutsche Post and the purchase of DHL as that purchase was made at market value; the Commission also emphasized that Deutsche Post's rivals were of similar or greater financial strength); Eur. Comm., dec. Art. 6(1) R. 139/2004 of 28.9.2010, *Foxconn/Dell (Products) Poland*, case COMP/M.5765 (past aid that had been transferred to the target and was "in the price," i.e., not transferred to the purchaser); Eur. Comm., dec. Art. 6(1) R. 139/2004 of 24.11.2005, *Deutsche Post/Excel*, case COMP/M.3971; Eur. Comm., dec. Art. 6(1) R. 139/2004 of 25.6.2010, *Foxconn/Sony LCD TV Manufacturing Company in Slovakia*, case COMP/M.5870; Eur. Comm., dec. Art. 6(1) R. 4064/89 of 14.11.2000, *Hypo Vereinsbank/Bank Austria*, case COMP/M.2125; Eur. Comm., dec. Art. 6(1) R. 4064/89 of 21.6.2002, *Metronet/InfraCo*, case COMP/M.2694; Eur. Comm., dec. Art. 6(1) R. 139/2004 of 26.3.2007, *Iberdrola/Scottish Power*, case COMP/M.4517; Eur. Comm., dec. Art. 8(2) R. 139/2004 of 28.8.2009, *Lufthansa/Austrian Airlines*, case COMP/M.5440.

32 *Deutsche Post/DHL (II)*, case COMP/M.2908, para. 31.

33 *Ibid.*, para. 32.

34 *Ibid.*, para. 34.

35 Turnover, EBT, EBIT margin, EBITDA, value of assets, equity and equity ratio.

36 *Deutsche Post/DHL (II)*, case COMP/M.2908, para. 35.

37 *Ibid.*, para. 36.



22. Interestingly, the Commission seems to adopt a similar approach when dealing with foreign subsidies.<sup>38</sup>

### 1.1 STX/Aker Yards

23. This case concerned the acquisition by STX of Aker Yards. A competitor (Fincantieri) claimed that STX benefitted from State subsidies in South Korea, which would enable it to undercut prices post-transaction and to drive existing competitors out of the market.

24. In its decision, the Commission emphasized that it has no obligation under the merger regulation to carry out an analysis comparable to a State aid procedure in order to establish whether financial measures adopted by third countries constitute subsidies.<sup>39</sup> As a result, “clear evidence” needs to be put forward to prove the existence or likelihood of foreign subsidies.<sup>40</sup>

25. In this respect, Fincantieri referred to a series of past<sup>41</sup> and future<sup>42</sup> transactions between STX and South Korea, alleging that these transactions would amount to foreign subsidies. The Commission analyzed each transaction and concluded to the lack of sufficient evidence, in particular because Fincantieri did not prove that the said transactions were not in line with market conditions.<sup>43</sup>

26. The Commission nevertheless assessed the potential effects of the alleged subsidies<sup>44</sup> and took into account several criteria, which can be classified into three broad categories.

27. First, the Commission looked at financial indicators to compare the financial position of STX with that of the target and Fincantieri.<sup>45</sup> In light of these indicators, the Commission concluded that STX did not have a greater financial power<sup>46</sup> and that this situation was unlikely to change in the future.<sup>47</sup>

28. Second, the Commission examined whether potential future subsidies could have a significant impact on STX’s costs. In this respect, the Commission noted that the alleged future subsidies would take the form of future loans (PSLs) which would be available only for South Korean shipyards. These loans, however, would only serve to cover part of the production costs of STX—namely, the costs incurred to finance the production of cruise ships,<sup>48</sup> which represent only 4% of the overall costs. Accordingly, the Commission concluded that even if these alleged subsidies were to exist, they would not confer a significant cost advantage to STX.

29. Third, even if these future subsidies were to significantly reduce the costs of STX, the Commission concluded that STX would not acquire a dominant position because of the market features of the shipbuilding industry. In particular, the Commission took the view that STX would remain constrained by the significant countervailing buyer power of large and sophisticated customers.<sup>49</sup>

30. In light of the above, the Commission rejected the complaint of Fincantieri and ultimately approved the transaction unconditionally.

### 1.2 Abu Dhabi Mar/ThyssenKrupp Marine Systems

31. In the same vein, in *Abu Dhabi Mar/ThyssenKrupp Marine Systems*, which concerned the acquisition by Abu Dhabi Mar (ADM) of ThyssenKrupp Marine Systems (TKMS), a competitor alleged that ADM was subsidized by the UAE, which would allow it to engage in predatory pricing strategies.<sup>50</sup>

32. The Commission considered the issue but rejected the argument on the ground that “[f]irst, the combined market shares of the merged entity are limited and do not lead to any affected market. Furthermore, there is no evidence that the merged entity would have access to subsidised finance. According to information provided, ADM has so

38 STX/Aker Yards, case COMP/M.4956, para. 85: “In principle, the Commission is obliged to take into account in its merger analysis any subsidies as factors potentially increasing a merged entity’s financial strength, in so far as evidence supports the existence or the likelihood of such subsidies.” See also J. M. Carpi, EU Merger Control in a globalised economy, available at SSRN: <https://ssrn.com/abstract=3797497> (“Subsidies granted by a foreign government may also form part of the overall assessment of a firm’s financial strength and market position”). This explains why the Form CO expressly asks for a list and description of “any financial or other support received from public authorities by any of the parties and the nature and amount of this support” (Form CO, Section 3.4).

39 STX/Aker Yards, case COMP/M.4956, para. 85: “[I]f there is no clear evidence of the existence of such subsidies provided by third countries, the RJB Mining judgment, contrary to what is claimed by the complainant, does not provide grounds for imposing a general obligation on the Commission in a merger control procedure to carry out an independent analysis – comparable to a state aid procedure under Article 88 of the Treaty – in order to establish whether financial measures extended by third countries are granted on non-market terms and therefore constitute subsidies. Any alleged inadequacies of the international procedures, such as the WTP procedures, are not relevant in this respect.”

40 Ibid.

41 Fincantieri argued that past subsidies had been granted to STX in the context of (i) a South Korean program in support of technological development, (ii) an investment loan of USD 400 million granted by four South Korean banks (including two privately owned banks) and (iii) the financing of the acquisition of Aker Yards.

42 Fincantieri argued that future subsidies would be granted to STX by the South Korean government, via a state-owned bank (KEXIM) through preferential loans and guarantees specifically targeted at certain shipbuilding projects (namely, pre-shipment loans (PSLs) and advanced payment refund guarantees (APRGs)).

43 STX/Aker Yards, case COMP/M.4956, paras. 95–122.

44 Ibid., para. 86: “Even though this finding suggests that there is not sufficient evidence for any increase in financial strength on the basis of such financial transactions, the Commission has undertaken additional steps to evaluate the likelihood, and the potential effects of such alleged subsidies, on the basis of the available data.”

45 Ibid., para. 90, including turnover, gross profit, EBITDA, EBITDA margins, EBIT, EBIT margins, net profit, liquidity ratio, net debt, equity and total assets.

46 In particular, while Fincantieri had no net debt, STX had a net debt amounting to 2.7 times its EBITDA.

47 The Commission also analyzed the specific financial transactions allegedly concluded between STX and the South Korean government but ultimately concluded that these transactions would not significantly increase STX’s financial strength even if they were to include elements of subsidies (STX/Aker Yards, case COMP/M.4956, paras. 94–108).

48 I.e., the costs incurred to borrow working capital.

49 STX/Aker Yards, case COMP/M.4956, paras. 149–155.

50 See, e.g., Eur. Comm., dec. Art. 6(1) R. 4064/89 of 25.4.2002, *HDW/Ferrostaal/Hellenic Shipyards*, case COMP/M.2772; Eur. Comm., dec. Art. 6(1) R. 139/2004 of 31.8.2010, *Abu Dhabi Mar/ThyssenKrupp Marine Systems*, case COMP/M.5943, paras. 47–48.

far received financing for its shipping projects at regular market conditions. Abu Dhabi does not have a state aid regime in place to support the shipbuilding industry.”<sup>51</sup>

33. Interestingly, the Commission did not stop there and further stressed that “neither ADM nor TKMS has a historic track record of low pricing. Therefore, it is unlikely that the merged entity will engage in any predatory pricing strategy.”<sup>52</sup> This second point is interesting as it focuses on the effect of the alleged subsidies and illustrates the relevance of past strategies for assessing the ability and incentive of subsidized competitors to engage in deep-pocket predation.

### 1.3 Alitalia/Etihad

34. Likewise, in connection with the acquisition by Etihad of de facto joint control over Alitalia, several European carriers expressed concerns according to which Etihad would receive subsidies from the state of Abu Dhabi.<sup>53</sup>

35. The Commission took the view that these allegations were not sufficiently substantiated to prove the existence of the alleged subsidies. In addition, the Commission explained that no evidence was put forward to show that Etihad used past subsidies in an anti-competitive fashion<sup>54</sup> and stressed that the assessment of the transaction “would not change when applying ‘deep pocket’ considerations” because Etihad acquired de facto joint control over Alitalia and would not be able to decide alone of a particular strategy for Alitalia, “let alone a very aggressive or even a short term loss making strategy.”<sup>55</sup>

36. As a result, the Commission concluded that “the mere alleged fact that Etihad possesses a strong financial capacity, is not per se indicative of competition concerns and does, as such, not give rise to serious doubts as to the compatibility of the Transaction with the internal market.”<sup>56</sup>

37. In all these cases, the Commission distinguished the issue of the existence of foreign subsidies and the issue of their effect, i.e., whether the merged entity would engage in deep-pocket predation as a result of these subsidies. This is consistent with the Commission’s approach in cases where the merging parties argue that subsidized competitors will exert significant competitive pressure on the merged entity.

## 2. Foreign subsidies granted to competitors: The “foreign subsidy defense”

38. Over the past years, there has been an increasing number of cases in which merging parties raised arguments based on foreign subsidies with a view to alleviating the concerns expressed by the Commission in connection with their transaction. These arguments may take various forms depending on the overall context of the case. By way of illustration, it is sometimes argued that foreign subsidies may reinforce the competitive pressure exerted by subsidized competitors<sup>57</sup> importing products into the EEA<sup>58</sup> and/or increase the likelihood of entry of these players.<sup>59</sup>

39. According to press articles, arguments of this kind were put forward in a number of recent cases, including in *Fincantieri/Chantiers de l’Atlantique*,<sup>60</sup> *Danfoss/Eaton Hydraulics*, *Hyundai Heavy Industries Holdings/Daewoo Shipbuilding & Marine Engineering*,<sup>61</sup> and *Cargotec/Konecranes*.<sup>62</sup> Not all these cases, however, gave rise to publicly available decisions.<sup>63</sup> This is why there are only a limited number of public decisions in which the Commission expressly examined foreign subsidies granted to competitors of the merging parties. *Arsenal/DSP* and *Danfoss/Eaton Hydraulics* are cases in point.<sup>64</sup>

### 2.1 Arsenal/DSP

40. In this case, the Commission investigated the issue of alleged state support from China to Chinese companies competing with the merging parties. The notifying party explained that subsidies granted to Chinese companies pursuant to the Chinese legislation were relevant for assessing the competitive constraint placed on the new

51 *Abu Dhabi Mar/ThyssenKrupp Marine Systems*, case COMP/M.5943, para. 48.

52 *Abu Dhabi Mar/ThyssenKrupp Marine Systems*, case COMP/M.5943, para. 48.

53 Eur. Comm., dec. Art. 6(2) R. 139/2004 of 14.11.2014, *Alitalia/Etihad*, case COMP/M.7333, para. 342.

54 *Ibid.*

55 *Ibid.*, para. 343.

56 *Ibid.*, para. 344.

57 Eur. Comm., dec. Art. 8(2) R. 139/2004 of 9.1.2009, *Arsenal/DSP*, case COMP/M.5153.

58 *See*, in this respect, Eur. Comm., dec. Art. 8(2) R. 139/2004 of 7.5.2018, *ArcelorMittal/Iva*, case M.8444, in which the Commission discussed the issue of subsidies incidentally when assessing the competitive pressure exerted by subsidized imports (paras. 159–183 and 623–746).

59 Eur. Comm., dec. Art. 8(2) R. 139/2004 of 18.3.2021, *Danfoss/Eaton Hydraulics*, case M.9820.

60 *Fincantieri and Chantiers de l’Atlantique* put a fresh spin on ‘European champion’ argument, *MLex*, 2 May 2019.

61 *Danfoss-Eaton review factored in potential for Chinese competition in EU: Insight*, *MLex*, 26 November 2021.

62 Competition and Markets Authority, Anticipated merger between Cargotec Corporation and Konecranes Plc, Provisional findings report, 26 November 2021, paras. 6.48 *et seq.*

63 *Fincantieri/Chantiers de l’Atlantique* was withdrawn, whereas *Hyundai Heavy Industries Holdings/Daewoo Shipbuilding & Marine Engineering* and *Cargotec/Konecranes* are still pending.

64 Interestingly, the Commission did not expressly address the issue of foreign subsidies in *Siemens/Alstom* (*Siemens/Alstom*, case M.8677).

entity post-merger.<sup>65</sup> In response, the Commission took the view that “*the notifying party did not provide any specific evidence concerning either the Chinese legislation on subsidy schemes or employment conditions and did not show the direct effects of these alleged benefits on the Chinese producers in comparison with the cost structure of the EEA producers.*”<sup>66</sup>

41. Although the response of the Commission is relatively succinct, it is consistent with the Commission’s approach previously described. First, the Commission examined whether the existence of foreign subsidies was established, then the Commission analyzed the effect of the alleged subsidies on the market.

42. On the first point, the Commission noted that no sufficiently clear evidence was put forward to prove that the Chinese legislation included a subsidy element. On the second point, the Commission stressed that no specific evidence was put forward to demonstrate the “direct effects” of these subsidies. Interestingly, the wording of the decision suggests that such a demonstration would have required to assess the impact of the alleged subsidies on the cost structure of the recipients, which is consistent with the assessment of the Commission in *STX/Aker Yards*.

## 2.2 Danfoss/Eaton Hydraulics

43. This case concerned the acquisition of Eaton Hydraulics by Danfoss, two leading manufacturers of hydraulic components used to make hydraulic systems for various kinds of machinery.<sup>67</sup> The Commission expressed concerns and opened an in-depth investigation on the ground that the transaction would lead to higher prices and less choice for certain hydraulic components used in mobile machinery—namely, hydraulic steering units (“HSUs”), electrohydraulic steering valves (“ESVs”), orbital motors and pumps.

44. To alleviate these concerns, the parties argued that the competitive pressure exerted by Chinese suppliers would increase in the future as a result of the subsidies received from the Chinese government. Some participants in the market investigation supported this view by explaining that “*funding from the Chinese government might accelerate the speed in which Chinese manufacturers become competitive and will enter the EEA markets.*”<sup>68</sup>

65 Arsenal/DSP, case COMP/M.5153, para. 226 (“The notifying party also argued in response to the Statement of Objections that Chinese manufacturers enjoy (...) significant cost advantages over their EEA competitors, as (...) manufacturers benefit from ‘all sorts of government subsidies’”). Interestingly, the notifying party also argued that the relevant geographic market should be broadened to include China *inter alia* because of the subsidies granted to Chinese manufacturers: “[T]he parties argued that the competitive advantage in relation to transport costs and custom tariffs enjoyed by EEA-based producers over their Chinese and US competitors must be considered in relation to the fact that Chinese manufacturers enjoy very sizeable cost advantages over their EEA competitors (for example, the existence of lower labour costs and government subsidies)” (para. 119). However, the Commission rejected this argument because “regardless of any hypothetical cost advantages which Chinese producers of sodium benzoate might enjoy as compared to EEA-based producers, the parties themselves have recognised in internal documents the additional obstacle that ocean freight and customs duties present to export sales and the advantage that their absence confers” (para. 120).

66 *Ibid.*, para. 227.

67 Danfoss/Eaton Hydraulics, case M.9820.

68 *Ibid.*, para. 436.

45. In its decision, the Commission did not rule out the possibility that China’s industrial policy might affect competition in relation to the supply of hydraulic components through financial support of internal and/or external growth.<sup>69</sup> However, the Commission did not find “*any specific evidence of any such government support in relation to HSUs, ESVs, orbital motors and pumps in its investigation.*”<sup>70</sup>

46. In addition, the Commission emphasized that it did not find any concerns expressed by the parties in their internal documents with respect to China’s industrial policy and Chinese government funding. As a result, the Commission took the view that “*the impact of China[s] Industrial Policy and related initiatives remained vague.*”<sup>71</sup>

## III. Analytical framework for the assessment of foreign subsidies in merger investigations

47. In all these precedents, the Commission examined whether foreign subsidies should be taken into account when assessing mergers. This means that the Commission accepts to give consideration to foreign subsidies<sup>72</sup> but only under strict conditions.

48. First, clear evidence should be put forward to prove the existence of past subsidies and/or the likelihood of future foreign subsidies.<sup>73</sup> The standard of proof in this respect is necessarily high as there is no obligation under the EUMR to carry out an analysis comparable to a State aid procedure in order to prove the existence of foreign subsidies.<sup>74</sup> Proving the existence of foreign subsidies may thus be challenging, especially because government subsidies are difficult to detect and measure.<sup>75</sup> This is all the more so where the parties (or third parties) need to establish that a given transaction entered into between an undertaking and a foreign state is not in line with market conditions.

69 *Ibid.*, para. 439.

70 *Ibid.*

71 *Ibid.*

72 J. M. Carpi, EU Merger Control in a globalised economy (“Subsidies granted by a foreign government may also form part of the overall assessment of a firm’s financial strength and market position”).

73 Arguably, this condition could also be addressed as a relevant criterion for the assessment of the ability to engage in deep-pocket predation (*see below*).

74 *STX/Aker Yards*, case COMP/M.4956, para. 85.

75 M. Kalouptsi, Detection and Impact of Industrial Subsidies: The Case of Chinese Shipbuilding, *Review of Economic Studies*, Vol. 85, Issue 2, 2018, pp. 1111–1158.

49. In this context, the most effective way to prove the existence of foreign subsidies is probably to refer to the Commission's trade investigations and/or WTO panels. The Commission's draft proposal for a Regulation on foreign subsidies could help in this respect, even though this is not its primary goal, as it will complete the corpus of decisions and investigations to which the parties (or third parties) may refer with a view to proving the existence of foreign subsidies.<sup>76</sup>

50. In the absence of prior finding of foreign subsidies, economic models like the one developed by Myrto Kalouptsi may be helpful, but the reliability and accuracy of such models should be carefully reviewed on a case-by-case basis.

51. Second, it should be established that subsidized competitors will have the ability and incentive to successfully engage in deep-pocket predation. The mere fact that a recipient has received subsidies is insufficient in itself.<sup>77</sup> It must be established that the market shares of subsidized companies<sup>78</sup> will increase; otherwise, the current market shares of these companies should already reflect the net competitive advantage associated with these subsidies. In this respect, the following conditions should be satisfied:<sup>79</sup>

– Ability: foreign subsidies should provide a significant cost and/or financial advantage for subsidized companies to be able to engage in deep-pocket predation. In this respect, attention should be paid to:

(i) the amount of subsidies received and/or to be received: in absolute<sup>80</sup> and relative terms<sup>81</sup> (e.g., compared to the total costs and variable costs of the recipients). The greater the amount of the subsidies received, the more likely the recipient will be able to engage in deep-pocket predation;

(ii) the cost structure of subsidized companies: the latter are more likely to engage in deep-pocket predation if the subsidies they receive have a direct link with their production levels (e.g., because they reduce the variable costs of the recipients<sup>82</sup>);

(iii) the financial indicators and conditions of access to finance:<sup>83</sup> if subsidized competitors benefit from a financial advantage<sup>84</sup> and/or preferential access to finance<sup>85</sup> (e.g., preferential interest rates compared to competitors in a similar situation), this may allow them to engage in deep-pocket predation and reversely.<sup>86</sup>

– Incentive: further evidence should be put forward to prove that subsidized competitors would have the incentive to engage in deep-pocket predation. To this end, regard can be had to:

(i) past strategies: subsidized competitors are more likely to engage in deep-pocket predation if they have a track record of aggressive pricing and if previous subsidies have allowed them to undercut prices in the past;<sup>87</sup>

(ii) the ability to recoup losses: the existence of countervailing buyer power, for instance, may limit the ability of subsidized competitors to recoup losses and thus reduce their incentive to engage in deep-pocket predation;<sup>88</sup>

(iii) the ownership structure: in cases involving acquisitions of companies financed through foreign subsidies, the ownership structure of the target company post-transaction may be relevant. By way of illustration, if a recipient of foreign subsidies acquires a co-controlling minority shareholding in a company, this recipient is less likely to pass on the subsidies received to the target and engage in deep-pocket predation as it would only be able to recoup part of the associated gains.<sup>89</sup>

– Effect: finally, it should be established that a strategy of deep-pocket predation is likely to be successful (i.e., the market shares of subsidized competitors are likely to increase if they were to engage in deep-pocket predation). This would require to look at a number of elements, including:

(i) the correlation between past subsidies and the market shares of subsidized competitors: if certain competitors have received foreign subsidies in the past, but their market shares have not increased, future subsidies are unlikely to be any different;<sup>90</sup>

76 By the same token, the merging parties or third-party complainants could refer to previous subsidy decisions from DG Trade or WTO panels (see, e.g., *STX/Aker Yards*, case COMP/M.4956, paras. 121–122).

77 For instance, a recipient may suffer from a significant competitive disadvantage and past subsidies granted to this recipient may not suffice to compensate for this disadvantage or the current market share of this competitor may already reflect the advantage conferred by past subsidies.

78 When subsidized companies are potential competitors, this condition would require to demonstrate that the subsidies received by these competitors further increase their likelihood of entry.

79 These conditions may partially overlap as some of the criteria listed below may be relevant for the assessment of several conditions in practice. For instance, the amount of subsidies received may be relevant both for the assessment of the ability to engage in deep-pocket predation and for analysing the effect that such a strategy is likely to have on the market.

80 See, e.g., *STX/Aker Yards*, case COMP/M.4956, paras. 97, 105.

81 See, e.g., *STX/Aker Yards*, case COMP/M.4956, paras. 131–146; *Arsenal/DSP*, case COMP/M.5153, para. 227.

82 See, e.g., *STX/Aker Yards*, case COMP/M.4956, para. 103; *Arsenal/DSP*, case COMP/M.5153, para. 227.

83 See, e.g., *STX/Aker Yards*, case COMP/M.4956, para. 90. See also, *Deutsche Post/DHL (II)*, case COMP/M.2908, para. 35.

84 In light of their main financial indicators, e.g., turnover, gross profit, EBITDA, EBITDA margins, EBIT, EBIT margins, net profit, liquidity ratio, net debt, equity and total assets

85 Despite a high debt ratio, subsidized competitors may have the ability and incentive to engage in deep-pocket predation if they benefit from better access to finance. Hence the importance to also compare the financing conditions of subsidized market participants (e.g., interest rates), for instance with that of their competitors with a similar credit rating.

86 The question of whether subsidized competitors benefit from preferential credit conditions is sometimes discussed to determine whether loans granted by state-owned banks include a subsidy element.

87 *Abu Dhabi Mar/ThyssenKrupp Marine Systems*, case COMP/M.5943, para. 48.

88 *STX/Aker Yards*, case COMP/M.4956, paras. 149–155.

89 *Alitalia/Eithad*, case COMP/M.7333, para. 343.

90 See, e.g., *STX/Aker Yards*, case COMP/M.4956, paras. 163–173.



(ii) the market features: a deep-pocket predation strategy is more likely to be successful in industries where access to finance constitutes a significant barrier to entry and expansion<sup>91</sup> or in markets with homogeneous products, low switching costs and no other significant barrier to expansion;

(iii) countervailing factors: external factors may limit or neutralize the comparative advantage conferred by subsidies (e.g., the existence of countervailing duties or the existence of equivalent State aid received by other competitors).

**52.** This list is not exhaustive, and the above criteria should be assessed together<sup>92</sup>, in light of other evidence, including internal documents and the responses received from market participants in the course of the market investigation.<sup>93</sup>

## IV. Conclusion

**53.** It follows from the above that the Commission accepts to take into account foreign subsidies when assessing mergers, but the standard of proof in this respect is high. This explains why foreign subsidies have not played any decisive role in the context of a merger investigation to date.

**54.** Yet, the standard set by the Commission is in line with the economic literature on deep-pocket predation. Lowering this standard may overestimate the actual market power of subsidized competitors, which in turn could lead to both over-enforcement (where one of the merging parties has allegedly received foreign subsidies – type I error) and under-enforcement (where the parties compete with allegedly subsidized competitors – type II error).

**55.** In order to address the distortive effects of foreign subsidies, instead of lowering this standard of proof, it would thus be preferable to introduce a dedicated tool, which is the purpose of the Commission's draft proposal for a Regulation on foreign subsidies. ■

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<sup>91</sup> *Ibid.*, para. 92.

<sup>92</sup> At national level, the review by the Bundeskartellamt of the acquisition of Vossloh by CRRC illustrates how these different criteria may be taken into account. In this respect, Andreas Mundt explained that “Possible state subsidies [...] were considered in the competitive assessment of the merger. We also looked into the threat of low-price dumping strategies and the cost advantages resulting from CRRC's state-subsidised activities in many other markets. CRRC plays an important role in China's industry strategies [...]. However [...] Vossloh Locomotives' competitiveness has considerably decreased over the last few years and new competitors offering innovative traction technologies have entered the market. Vossloh now has several strong competitors. CRRC, on the other hand, has only been a small player on the European market so far [...] this case shows that while Chinese state-owned companies enter markets with substantial economic power, this does not necessarily pose a threat to effective competition” (Bundeskartellamt, press release, 27 April 2020, Railway Industry, Chinese company CRRC can acquire Vossloh's shunter division).

<sup>93</sup> See, e.g., *Danfoss/Eaton Hydraulics*, case M.9820, paras. 436–439.