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MERGER & ACQUISITION STRATEGIES

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RETAINING THE COMPETITIVE ENVIRONMENT AMID THE GROWTH IN MERGERS AND ACQUISITIONS

Professor Allan Fels

Chairman

Australian Competition and Consumer Commission

Introduction

Over the more than twenty year life of the *Trade Practices Act 1974*, mergers have probably received more publicity than most other matters. They have also featured prominently in litigation undertaken by the Australian Competition and Consumer Commission (the Commission), and its predecessor the Trade Practices Commission.

Given the emphasis on mergers in recent years, it is somewhat surprising that early anti trust legislation lacked specific provisions against mergers. The *Australian Industries Preservation Act 1906* was the earliest attempt by the Federal Parliament to legislate in the field of restrictive trade practices. This Act attempted to cover foreign, trading, and financial corporations, and persons not being corporations who were engaged in interstate, overseas trade or commerce. The *Trade Practices Act 1965* became operative on 1 September 1967. This version of the Act, and its 1971 successor, lacked a specific mergers provision. It was not until the 1974 Act (the Act) was passed that this was rectified. Essentially, early legislation intended to deal with trade practices focused on conduct and did not seek to limit future problems by considering the implications of structural changes resulting from mergers for conduct.

Why The Focus On Mergers?

The reason why mergers have been the focus of attention over the last twenty years or so arises from recognition of the link between market structure and conduct.

Market structure may change through time and this may have implications for the competitive process. Such changes may result from firms which are very successful in the market driving less successful competitors out of business. This is simply the outcome of the competitive process. Alternatively, structural changes may result from new entry (a more competitive industry) or from exit (a more concentrated industry) in response to changing market conditions. Mergers have a variety of possible purposes but may result in a reduction in competition by reducing the number of sellers competing in the market and in some cases by raising the barriers to new entrants, for example by gaining control of an essential raw material or a particularly favourable location. In the absence of a mergers provision in the trade practices legislation, if collusive conduct is a breach of the Act, then a merger could provide a means to the same end; the acquisition obviates the need to enter into an agreement.

The Competition Test

Since 1993, section 50 of the Act has prohibited mergers or acquisitions which have the effect or likely effect of substantially lessening competition in a substantial market. Section 50 operates subject to the Commission's ability to authorise (grant legal immunity to) mergers which would be likely to result in such a benefit to the public that the acquisition should be allowed to take place. Moreover, section 87B is available for undertakings to overcome the anti-competitive effect of mergers where appropriate.

The Commission examines joint ventures in a similar way. Although the reasons why parties enter into mergers and joint ventures might be substantially different, the Commission's interest lies in the effect they have on a market. In most cases, the effects of mergers and joint ventures are very similar.

Where governments privatise, they normally refer questions about the competitive effect of acquisitions to the Commission. In addition the Commission believes that section 50 generally applies. Scrutiny of privatisations has become a significant part of the Commission's mergers work.

In 1997-98, of the 176 mergers considered by the Commission, only 5 were opposed.

The ACCC Approach to Mergers

I would now like to comment on the approach that the Commission follows when assessing merger proposals. This process is substantially the same regardless of whether it is a purely domestic merger or whether the merger forms part of an international merger.

As a guide for industry, the Commission published its revised Merger Guidelines in 1996 setting out the process for, and issues relevant to, its administration of the merger provisions. The guidelines do not bind the Commission, but they provide parties with an indication of what the Commission considers when investigating mergers and importantly indicate to industry what the Commission is looking for in a submission outlining a proposed acquisition. These Guidelines are currently being finetuned and the new Guidelines will be available soon.

The guidelines provide a five stage process for the Commission's assessment of substantial lessening of competition. The steps are:

> First, the **market is defined**. In establishing the market boundaries, the Commission seeks to include all those sources of closely substitutable products, to which consumers would turn in the event that the merged firm attempted to exercise market power.
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> **Market concentration** ratios are assessed. If the merger will result in a post-merger combined market share of the four (or fewer) largest firms of 75 per cent or more and the merged firm will supply at least 15 per cent of the relevant market, the Commission will want to give further consideration to a merger proposal before being satisfied that it will not result in a substantial lessening of competition. In any event, if the merged firm will supply 40 per cent or more of the market, the Commission will want to give the merger further consideration. If the market concentration ratio falls outside the thresholds, the Commission will determine that substantial lessening of competition is unlikely;
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> Potential or real **import competition** is looked at. If import competition is an effective check on the exercise of domestic market power, it is unlikely that the Commission will intervene in a merger.
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> In the fourth stage of its merger assessment, the Commission looks at the **barriers to entry** to the relevant market. If the market is not subject to significant barriers to new entry, incumbent firms are likely to be constrained by the threat of potential entry, to behave in a manner consistent with competitive market outcomes. A concentrated market is often an indication that there are high barriers to entry.
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> Finally, the Commission looks to **other factors** which are outlined by the legislation (s50(3)). They include whether the merged firm will face countervailing power in the market; whether the merger will result in the removal of a vigorous and effective competitor; or whether the merger is pro-competitive, not anti-competitive.

Critical Mass Arguments

Business people frequently raise the question of whether or not the merger provisions of the Act prevent the mergers necessary for Australian firms to be of the size necessary to take part in global markets. The answer to this is rarely, if ever, and, if so, then only in circumstances where it is on balance undesirable because of the anti-competitive effect in the Australian market.

It is often argued that Australian industries need to develop the "critical mass" necessary to compete internationally. However, I think it is important to point out that obstacles to export growth may face industry participants of all sizes. It is not apparent that, simply by entering a collaborative arrangement like a merger or joint venture, a participant's ability to compete internationally is enhanced. Size is often not necessary to enhance the ability to compete on world markets. It has been convincingly argued that, in many cases, domestic rivalry rather than national dominance is more likely to breed businesses that are internationally competitive. When firms merge with the aim, for instance, of enhancing exports, there is the prospect that domestic prices may rise until they reach import parity (if the goods were previously priced below import parity) while exports are at a lower price. A merged entity may use its market power to increase domestic prices and so subsidise its export price. Ultimately, Australian consumers and industry may be forced to pay a higher price in order to underpin the merged entity's export sales. A report last year to the government which reviewed business programs in the context of an increasingly competitive global market noted that a lack of domestic competition was one of a number of impediments to building globally sustainable firms in Australia.

While size may not be necessary to enhance export opportunities, correct and complete market information is crucial. Small and medium sized enterprises may be disadvantaged when it comes to having access to adequate information -something that is often claimed to be an advantage of operating under a single desk system. However, ongoing improvements in information technology and electronic commerce suggest that this is likely to be less of an issue in the future.

Merger Policy

Merger policy makes an important contribution to the achievement of a competitive and productive Australian economy. Regulation of anti-competitive mergers is an important part of National competition policy. Trade practices merger law conforms with the principles of natural competition policy agreed to by all Australian Governments. These principles included:

1. No participant in the market should be able to engage in anticompetitive conduct against the public interest;
2. Conduct with anticompetitive potential said to be in the public interest should be assessed by an appropriate transparent assessment process, with provision for review, to demonstrate the nature and evidence of the public costs and benefits claimed.

Merger policy is not some necessary evil. Rather it has a positive contribution to make to Australia's international competitiveness. If mergers are allowed to occur without the application of competition law, then our exporters and import competitors will be supplied uncompetitively and inefficiently and their capacity to compete in world markets will be hindered.

A general point which needs to be made about mergers is that most of the matters that receive detailed consideration from the Commission are mergers which are close to the margin, that are, in other words, borderline. Critics could sometimes argue that there is inconsistency in decisions. Whilst I do not agree with this, the significance of the criticism must be placed in context. When a series of close mergers is considered by the Commission, it is not so difficult to mount a case of apparent inconsistency. Often there will be very similar structural circumstances, but the Commission will go in different ways depending on the weight accorded to particular factors. The fact that the Commission has to make difficult 'on-

balance' decisions about a few borderline mergers each year does not mean that there is not general consistency in the application of the Act to the vast majority of mergers which it must consider.

Deregulating Sectors

The real agenda of merger policy relates largely to the deregulating sectors of the economy. Deregulation gives rise to circumstances in which mergers are likely to occur. Some mergers are necessary for efficiency and should not be blocked. Others are sought to undo the pro-competitive effects of deregulation and may need to be opposed. As I have said earlier, the present test is superior to the dominance test in dealing with those matters.

In recent years State, Territory and Commonwealth governments have initiated various pro-competitive reforms, involving horizontal and vertical disaggregation of government owned monopolies, corporatisation or privatisation and the removal of various restrictions on the operation of free markets. These initiatives were given further impetus by the Competition Principles Agreement, whereby all governments agreed to a systematic review of all legislation restricting competition.

As a consequence of this, the assessment of privatisation proposals has become a much more significant part of the Commission's work in recent times. In many cases involving individual asset sales, a number of bidding consortia require individual consideration. The Commission role is to ensure that the acquisition of an asset does not result in a substantial lessening of competition in a market. In assessing privatisations, the Commission considers the existing interests of all bidders.

In the great majority of cases, bidders for privatised assets do not raise competition concerns and therefore do not raise problems under the Act. However, In the case of certain asset sales in the Victorian electricity sector the Commission did object to some bidding consortia. The Commission did so where it took the view that the interests of certain consortia parties would have raised potential competition concerns through horizontal linkages in the Victorian electricity generation sector.

In the case of the privatisation of Hazelwood power station, for example, the Commission raised its concerns with one bidding consortium. No further action was taken as the structure and composition of the consortium were changed during the course of the sale process in such a way that the Commission's initial concerns were no longer relevant to the bid. In another case involving the sale of Loy Yang A power station the Victorian Government sales group required bidders to give certain undertakings addressing the Commission's competition concerns about board representation and information flows.

In performing its assessment of any proposed acquisition, one of the matters which the Commission must take into account is the likelihood that the acquisition or merger would result in the acquirer being able to significantly and sustainably increase prices or profit margins.

Network industries can differ from others in that market power and the associated ability to increase prices is not always proportional to the amount of capacity controlled by any particular organisation. Market power can also arise through technical characteristics of, for example, electricity generators - for example, at peak periods gas or hydro generators with the ability to "ramp up" quickly may have greater market power than base load generators with larger capacity.

The Commission has also focussed on mergers and acquisitions within the electricity industry because of concerns arising from the fact that the sector is not subject to the competitive discipline of import competition and because of the lack of direct substitutes for electricity.

In its authorisation determination on the National Electricity Code, the Commission expressed concern over the structure of the market in a number of jurisdictions. The issue of market structure is not only crucial at the commencement of the National Electricity Market (NEM) but will be of on-going interest, particularly in respect of possible re-integration of firms participating in the NEM. Concerns also include possible mergers within each segment of the market, arrangements whereby NEM participants operate in upstream or downstream sectors (such as a generation company also operating a retailing business) and merger proposals between different energy suppliers (such as an electricity industry participant buying a gas industry participant).

Convergence

The issue of convergence is one that the Commission is likely to have to consider in assessing mergers and acquisitions in the utilities sector in the future. There have, for example, been recent reports in Australia of joint ventures and acquisitions involving telecommunications companies and energy distributors and retailers. The development of multi-utility service provider companies is a logical further step.

Convergence raises challenges to effective competition policy, in terms of possibilities for regulatory 'bypass' and for incumbents if the policy approach and the manner of regulation is uneven across the different industry sectors. It can also be argued that convergence holds the potential to create substantially-resourced business units holding market power. At the same time however, convergence may lead to industry growth and diversity and therefore lead to greater competition between products and greater choice of suppliers for customers. There are arguments for convergence in terms of economies in carrying out common functions eg integrated billing for energy; reduced consumer transaction costs. These benefits are likely to be maximised by having an integrated regulator which takes a consistent approach across industry sectors.

Reaggregation

Another issue that the Commission is likely to have to consider in the near future is that of reaggregation of utility companies. Consider for example, the possibility that in Victoria the five power generation companies seek to merge or to take over or to be taken over by the distribution companies. Of course there are some cross ownership restrictions built into Victorian law (until around 2002). If these mergers went ahead they could undo the pro-competitive effects of the Victorian divestiture of the former State Electricity Commission of Victoria. Likewise when deregulation gives rise to the replacement of state by national markets, firms often manoeuvre and merge in order to cope with the new situation. Again sometimes there are considerable efficiency gains, but at other times with considerable anti-competitive effects.

To take the energy industry as an example, there are several kinds of mergers which may arise for consideration in future. First, horizontal mergers within a state, eg. between power generators or distributors within one state located in the same state. Secondly, there may be vertical mergers between, for example generators and distributors in the state. Thirdly, there may be conglomerate mergers between different utilities, eg, between gas and electricity utilities, in the distribution and or retail field. Fourth, there may be interstate mergers combining some or all of the above elements.

These matters will fall to be assessed under section 50 of the Act. In assessing them, one background factor worth noting is that the ownership structure of the energy industry and some other deregulating industries has been greatly affected by public ownership arrangements over the years. The ownership pattern which might have emerged in a privatised market subject to competition laws was not present owing to the preference of most Governments for the public utilities to have both horizontal and often vertical integration. Clearly the deregulation of current public utilities brings advantages compared with the artificial integration established by Governments. For example, the Victorian disaggregation of the electricity industry would seem to represent an improvement over the pre-existing monopoly arrangements. However it is not especially likely that an initial disaggregation will yield the optimum ownership patterns in the industry. In free markets, reliance is placed on the workings of the capital markets to achieve more efficient ownership arrangements and on competition policy to make sure that those arrangements are not anti-competitive (unless they can be shown to be in the public interest). The present Victorian electricity market starts without the benefit of these processes unfolding over the years. It is quite likely that restructuring pressures will arise to create more efficient arrangements. The possible efficiency benefits of such mergers will need to be recognised and accepted under the Act. Equally however, it will be important to ensure that mergers are not simply anti-competitive and designed to undo the pro-competitive effects of deregulation.

These kinds of considerations apply to all mergers in sectors of the economy undergoing deregulation.

Globalisation and Global Mergers

Profound changes continue to occur in international trade and commerce, through rapid growth in international trade and increasing globalisation of commerce. These changes are driven by dramatic improvements in computer technology, communications and transportation. At the same time, there is a global trend towards reducing regulatory barriers to trade and commerce and increasing internationalisation of capital and financial markets. The Australian economy has reflected these changes, and in some areas Australia has been at the forefront, particularly in the area of reducing trade restrictions in the forms of tariffs and quotas.

In light of this changing global marketplace, the Commission is facing a number of challenges in its role as the statutory authority responsible for ensuring compliance with the Act and section 50 in particular. I will now address some of the specific issues that arise in relation to global mergers.

At any given moment in time there are a number of global mergers but not all of them have a direct impact on the Australian market. First, many, probably most global mergers do not have the effect of substantially lessening competition in any market in any country, just as most mergers in Australia do not substantially lessen competition (as evidenced, for example by the small number of Australian mergers opposed by the Commission).

Second, potentially anti-competitive global mergers are usually stopped (or modified) by regulators in North America, Europe and sometimes elsewhere.

Third, some global mergers may have little effect in Australian because the possible anti-competitive effects are mitigated by import competition. For example, the Commission would need to look at any major global motor vehicle manufacturer mergers but that sector does see significant imports into the Australian market. Other mergers may cause concerns overseas without causing any competition concerns in the Australian market.

When an overseas merger does cause competition concerns in Australia, the Commission has the power to act accordingly. For example, on 27 August 1992 the Commission instituted proceedings against The Gillette Company, and others in relation to the 1990 worldwide sale of the Wilkinson Sword wet shaving business by the Swedish Match Group of companies. As a part of that sale, The Gillette Company (a US company) acquired, in effect the non-European union based Wilkinson Sword wet shaving businesses worldwide. The Gillette Company also financed (and took an equity interest in) the management buy-out (through a company called Eemland) of the European Union based Wilkinson Sword wet shaving businesses.

In Australia, The Gillette Company accounted for about 50 per cent of all wet shaving products sold and Wilkinson Sword for about 17 per cent. The Commission was concerned that, in the event that the Gillette Company acquired control of the Australian Wilkinson Sword wet shaving business, it would dominate the Australian wet shaving market. In mid-June 1991, The Gillette Company advised the Commission that it had completed the acquisition of the Australian Wilkinson Sword wet shaving business through a series of offshore transactions involving New Zealand companies which had not carried on business in Australia. These New Zealand transactions were done in such a way that it appeared that they fell outside of the extra-territorial scope of the *TPA*.

The transactions were entered into without notice to, or being conditional on the approval of, the Commission. The Commission claimed that section 50 applied to the overseas transaction and the assignment of the trademarks to the foreign Gillette Company.

The Gillette Company vigorously opposed the Commission proceedings and challenged the jurisdiction of the Australian Trade Practices Act to an offshore transaction involving foreign companies in court. They were unsuccessful. In particular, the Court held that the Commission had established, prima facie, that The Gillette Company was subject to the Act and that, prima facie, section 50 applies to the Australian part of the worldwide transaction notwithstanding that the transaction was entered into overseas.

Subsequently, The Gillette Company approached the Commission and proposed settlement whereby, pursuant to an undertaking to be given by The Gillette Company to the Court, the Wilkinson Sword business in Australia will be licensed to and operated by a company fully independent of and unrelated to The Gillette Group of companies.

Possible Solutions to Competition Concerns

I would now like to cover some of the methods that may be used to address certain competition concerns. I must, however, stress that there is no set formula for every case and what is suitable in one case may not be suitable in another.

Authorisation

One of the most powerful tools available to a company that risks breaching section 50 is to seek an authorisation. Australia, unlike many other countries provides for the possibility of granting an authorisation which permits a party to be in breach of the Act in the event that there are public benefits to offset the competition concerns. Since 1993, the Act has explicitly stated that export generation, import replacement or contributions to the international competitiveness of the Australian economy are public benefits.

Clearly the framework of the *TPA* is not an obstacle to allowing Australian firms to merge to achieve the scale necessary for international competitiveness providing there is a sufficient public benefit. There are in fact many cases where authorisations have been permitted. Over half of authorisations have in fact been successful. A number of them have related to cases

where the merger would cause a substantial reduction in competition in Australia but would bring international type benefits. The Commission's publication on 'Exports and the Trade Practices Act*'* provides a number of case studies including the DuPont/Ticor merger authorisation (1996) which illustrates the Commission's approach to international issues in an authorisation application. The publication identifies the kinds of arguments which the Commission considers most relevant to claims for mergers that will enable Australian firms to take part in world markets, even where the effects may be anti-competitive in the home market. There are of course instances in which the trade off of loss of competition in the home market versus benefits to Australia from a firm playing a role in world markets is unfavourable in terms of the public interest and in some cases mergers create monopolies or 'home champions' in the home market. They are not necessarily firms well prepared to compete in world markets as Professor Michael Porter's study, The Competitive Advantage of Nations demonstrated. "Exports and the Trade Practices Act" also lists a number of other mergers where the Commission has taken into account the global nature of markets and the competition constraint imports place on Australian industry, for example, Dow Chemical/Huntsman Chemical, Chemcor/Hoeschst Plastics, ICI Australia/Auseon.)

Undertakings

Section 87B has become a very important part of the Act. However it has attracted greatest attention in relation to its use in merger situations even though in fact the Commission is very sparing in its use of undertakings to resolve merger questions.

The recent cigarette merger provides a good example. The Commission formed the view that British American Tobacco Plc's proposed world wide merger with Rothmans International was likely to substantially lessen competition. The merger would have given the merged group a 62% share of the Australian cigarettes market. The Commission's view reflected its concern about the likely impact of the increase in market concentration and the merged group's control of major Australian cigarette brands, in a market where import competition is negligible and barriers to entry are substantial. The potential for import competition to increase is limited by barriers to establishing retail distribution links independently of incumbent suppliers, the existing trading arrangements between manufacturers and retailers that would restrict the opportunities for new entrants to gain brand visibility, brand recognition and brand loyalty among smokers, and restrictions on advertising that limit opportunities to build brand images. They parties sought reasons for the Commission's decision and then suggested a divestiture proposal to address concerns about the effect on Australian competition of the proposed world-wide merger. After much consideration and negotiation the Commission accepted a court-enforceable undertaking for divestiture of cigarette and roll-your-own tobacco brands to Imperial Tobacco Group PLC and the merger went ahead.

The Commission did not see itself as engaging in social engineering in this case. The parties had sought to merge and in doing so to engineer an outcome in which the Australian cigarettes market would be much less competitive than in the past. The Commission needed to be satisfied that the undertakings balanced or neutralised the anti-competitive effects. Whether this is called engineering or not is a semantic matter. The fact is that the Act clearly contemplates that undertakings will be used in these situations. The benefit is that mergers can go ahead and realise many of their benefits.

The question of whether undertakings should be negotiated publicly is sometimes raised. The Commission's preference is that undertakings should normally be made known publicly before being accepted so that there is a full opportunity of assessing their likely effects on, the market

place, aided by players currently involved in the market place. These is, however, opposition by firms which want to make undertakings confidentially.

There are some circumstances in which the Commission may accede to such requests. These include cases where the Commission is reasonably well informed about the industry's history and circumstances as it was in the dairy industry where it has considered a range of mergers in recent years. There are two merger proposals which it was highly unlikely would have been able to proceed had the Commission not agreed to undertakings given in private. These were the National Foods case and the eventually aborted Wesfarmers attempt to acquire ICI's Australian assets. The Commission is very hesitant indeed about agreeing to undertakings that are given privately but it does not rule them out totally.

Conclusion

Experience in the years since 1974 with the mergers provisions of the Act provides a degree of certainty in terms of the process. Through its 1996 Merger Guidelines, the Commission has sought to identify `safe harbours' for potential merger partners, as well as to highlight the structural features of a market which may result in difficulties.

In conclusion, I would like to reiterate that the merger laws and the Commission's administration of them are consistent with enabling Australian firms to realise greater international competitiveness. Thank you for your attention today. Are there any issues or questions that people would like to raise?