Australian Competition & Consumer Commission

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS

# *EASING YOUR MERGER THROUGH THE TRADE PRACTICES ACT*

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## INTRODUCTION

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

This, however, has not always been the case in countries such as the USA and the UK, where for quite some time the relevant legislation lacked specific merger control. Essentially, such early legislation intended to deal with trade practices focused on conduct and sought to deal with that rather than limiting future problems by considering the implications for conduct of structural changes resulting from mergers.

The reason why mergers have been the focus of attention over the last twenty years or so arises from the conceptual approach to competition policy generally and to trade practices matters in particular. The intellectual framework used is the structure-conduct-performance paradigm. Essentially, the approach assumes that the structural features of a market provide a relatively stable environment within which conduct occurs. These structural features include the number of firms in the market and the degree of market concentration, the height of barriers to entry, product differentiation and vertical relationships, especially vertical integration.

Included in market conduct is behaviour relating to pricing, product strategy and advertising, research and innovation, investment and even legal tactics. Market performance is the evaluation of market conduct based on economic welfare. Economic welfare incorporates the economist's concept of efficiency but may also include such factors as equity and/or employment considerations.

In defining a market and providing criteria by which to delineate markets, the Trade Practices Tribunal in *Queensland Cooperative Milling Association (QCMA)* indicated that whether firms compete in a market is very much a function of the structure of the relevant market. The production and selling decisions of firms are constrained to a greater or lesser extent, according to the structural features of the market. For example, a firm may currently be the only major participant in a particular market and so appears able to restrict output and raise prices and hence profits. However, if barriers to entry are low, these increased profits will signal an opportunity to potential new entrants who upon entering the market and increasing supplies will cause the price to fall. Thus, our single seller will have a relatively short period during which it possesses market power.

The structure-conduct-performance paradigm thus sees a causal relationship from structure to conduct to performance. 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 not the result of anti competitive conduct; it is simply the outcome of rivalrous behaviour which is the competitive process in operation. Structural changes may result from new entry (a more competitive industry) or from exit (a more concentrated industry). Mergers may also 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, eg by gaining control of an essential raw material, a particularly favourable location etc.

Of course such a lessening of competition may not be the primary purpose of such a merger and this problem is considered further below. Indeed mergers may be motivated by a variety of factors which are not anti competitive in intent. Nevertheless, in the absence of a merger provision in the trade practices legislation if collusive conduct is a breach of the Act, then a merger might provide a means around this. While the chain of causation in relation to competition is seen to flow from structure to conduct to performance, it may also flow from conduct to structure. Thus, conduct such as an abuse of market power may cause the failure of new entrants or deter new entry.

Implicit in the discussion so far is the assumption that there is something undesirable about an environment in which there is less competition compared with one in which there is more competition.  Under normal circumstances, a competitive market structure will result in an efficient allocation of society's resources.  Economic efficiency refers to a situation where the economic system allocates resources in such a way as to produce the goods and services which consumers value most highly and are prepared to pay for, and it does so at the lowest possible cost in terms of resource use.  The aim of economic efficiency is to achieve the best use of society's resources from the perspective of society.  Like many other economic concepts, economic efficiency has various dimensions:

- Productive efficiency (also known as technical efficiency), refers to production which occurs at minimum unit cost, or for which inputs are minimised with respect to a given output;

- Allocative efficiency refers to a situation where resources are allocated to industries producing goods/services which are most highly valued by society; and

- Dynamic efficiency relates to the responsiveness of businesses to change in supply and/or demand conditions, ie innovation in terms of products, but also in terms of production technology.

Most basic analysis of monopoly commences from the assumption that the cost structure is the same under competitive and monopolistic conditions.  This is unlikely where economies of scale are significant.  A natural monopoly, while not achieving allocative efficiency, may be technically efficient because only with a large volume of sales can minimum unit costs be achieved.  Consequently, a number of small producers facing similar cost conditions will necessarily incur higher unit costs.  A similar situation might arise where owing to control of a patent, economies of scope or for some other reason, the monopolist faced a lower cost structure than a competitive firm for all levels of output.

Also difficult to evaluate is the implication of market structure for dynamic efficiency. On the one hand it is argued that competition is the stimulus for firms to innovate because this is the only way in which at least temporarily they are able to earn higher profits.  On the other hand, it has been argued that the monopolist has a greater incentive to innovate as it will retain for a long period the monopoly rents thus generated; in addition, it will have past monopoly rents available to fund research and development.

## EXAMINING A MERGER PROPOSAL

Common features of most issues considered under Part IV of the *Trade Practices Act* are:

- the need to define the relevant market;

- assessment of the conduct/acquisition for competition, ie whether it is likely to result in a substantial lessening of competition.

A market may be defined as the interaction of buyers and sellers to determine the terms of sale. 'Market' is a multi dimensional concept. It relates to product, geographic area, function and time. The aim of market definition is to ascertain the relevant market shares of market participants, and the possible effects of the conduct on the market constituents.

The basic principles to be followed in defining a market for anti trust purposes are clearly spelt out both in decisions of the Trade Practices Tribunal (such as *QCMA*) and the Federal Court (such as *Singapore Airlines Ltd v Taprobane Tours Pty Ltd WA 1992*). The essential determinant of the market is substitutability. This concerns the extent to which demand and supply are responsive to a small but not insignificant and sustained price increase.

**PRODUCT MARKET**

In relation to the product market, the responsiveness of demand depends on:

- the technical characteristics of the products;
- consumer/user perceptions;
- the time period over which responsiveness is assessed;
- the relative importance of the item in the consumer's budget or in the user's production costs; and, where relevant
- the existence of arrangements such as long term contracts or take or pay provisions.

Responsiveness on the supply side also reflects technical considerations. It relates to the ability of a producer to increase its production of a commodity whose price has increased without undertaking significant new investment. Thus, for example, in the agricultural sector farmers generally produce a range of different products and alter the relative importance of these in response to market conditions. Similarly in manufacturing, where the same type of production facilities are used for different products, manufacturers may also respond to changing market conditions by altering their production mix.

## GEOGRAPHIC MARKET

Identification of the appropriate geographic market is also based on substitutability. This is influenced by:

- transport costs;
- the nature of the product; and
- the degree of inconvenience involved in obtaining supply from another source.

## FUNCTIONAL MARKET

A more difficult task may be delineating the relevant functional dimensions of the market. Within an industry there may be distinct functional levels eg manufacturing, wholesaling, retailing, and other forms of servicing. In some cases although there is a relevant functional dimension to the market, it is obvious and uncontroversial. This is likely where the issue under consideration clearly relates to only one activity eg production. In such instances the functional dimension is normally included in the product market definition eg the market is the market for the manufacture of widgets. Similarly where all relevant firms are vertically integrated, the functional dimension of the market will encompasses those functions over which the firms have integrated. In some instances, usually in the supply of services, production and distribution are inseparable eg the production and distribution of ready mixed concrete. Nevertheless, a firm involved in a Part IV matter may operate at several functional levels but this does not necessarily mean that the market definition will involve all such levels. In *TPC v Arnotts 1989*, Arnotts produced and distributed biscuits to wholesalers. However, distribution was not included in the market definition which related only to biscuit production; nevertheless, distribution was relevant to the assessment of market power. Problems arise where different firms in the relevant product market undertake a different range of functional activities. For example in relation to the sale of groceries, the national chains are vertically integrated across wholesaling and retailing but the independent grocery sector has separate operators at the wholesale and retail level. Clearly it is not appropriate to determine the relevant functional dimension on the basis of substitutability. It is generally not feasible to substitute one function eg manufacturing for another, eg retailing. Failure to recognise this has caused some unusual market definitions to be included in judgements and determinations.

## EFFECTS ON COMPETITION

The second step in assessing a merger proposal is to assess the implications for competition, that is to determine whether or not it will result in a substantial lessening of competition. Essentially, a substantial lessening of competition means the same as an increase in market power. Market power may be defined as the ability to raise price above the competitive level without such loss of custom that the firm is forced to lower its price again; that is, the firm has discretionary power to 'give less and charge more'. Thus, market power is the ability to make decisions unconstrained by competition from others. In a perfectly competitive market, individual firms lack market power, whereas a monopolist has substantial market power; between these extremes firms in imperfectly competitive markets have varying degrees of market power.

## MERGER FACTORS

Should the level of concentration in the particular market following the merger be of concern to the Commission, it is required by statute to look at various “merger factors” in order to determine whether the merger is likely to substantially lessen competition in that market. The most important of these from an international context is the level of import competition. If import competition, or the potential for import competition, is an effective check on the exercise of market power, it is unlikely that the Commission will intervene. In fact, the Commission has not opposed any mergers where comparable and competitive imports have held a sustained market share of ten per cent or more in the last five years, and as an indicative guideline is unlikely to do so.

Where a merger raises competition concerns on the demand side of a market, exports can play a similar role in constraining market power of buyers to the role played by imports in constraining the market power of suppliers. If the merged firm buys goods or services from producers in an export industry it will not be able to depress domestic prices below competitive levels if this would result in supply switching to export markets. Thus the Commission is open to arguments that, where there are sustained and significant exports (or the potential for such exports), a merger would be unlikely to substantially lessen competition in the market for the purchase of the goods or services.

When undertaking its merger review process, the Commission will consider, amongst other things, the dynamic characteristics of a market, including growth and innovation. A merger might involve combining technologies, or research and development, and this can in turn affect the dynamics of the market by enhancing the ability of a firm to compete internationally. Efficiencies may be gained from product innovation that have the effect of creating a competitive constraint on the unilateral conduct of a firm in a market, or of undermining the conditions for coordinated conduct. Exposure to international competition can have significant implications for the dynamics of a market. For instance, regulatory changes such as tariff reductions or the removal of import quotas can enhance the competitive constraint that imports provide in a market.

***FOCUSSING ON INPUTS INTO EXPORTING INDUSTRIES***

The importance of imports (and exports) as an effective constraint on the exercise of market power has underpinned a change of focus in the approach of the

Commission to mergers and acquisitions.   As exposure of the traded sector to the disciplines of international competition has reduced the Commission's concern at the level of domestic concentration in that sector, the focus for merger policy is increasingly in the non-traded sector where the Commission is concerned with ensuring that there is effective competition, particularly in the public utility and infrastructure industries.  Merger regulation, particularly in the trade-sheltered public utility and infrastructure industries, is critically important to ensure the trade-exposed sector of the economy has competitive input markets, so as to be able to compete effectively both domestically and internationally.  In doing so, the Commission can ensure, as far as possible, that input costs to exporters are minimised.

***EFFICIENCIES***

During its analysis of the competitive effects of a merger, the Commission will also consider the issue of efficiencies, which many firms set out to achieve in order to become more internationally competitive.  Essentially, where efficiencies impact on the competitive process and make a merger more likely to be pro-competitive, there is unlikely to be any conflict with s 50.

Traditionally when firms argue that a merger may lead to greater efficiency, this has been regarded as most relevant to a public benefit analysis carried out in respect of applications for authorisation of mergers under Part VII of the TP Act.  The Commission's *Merger Guidelines* now expressly recognise that in some circumstances a merger that results in cost and/or dynamic efficiency gains may contribute to improved competition and that this may be taken into account at the stage of considering whether or not a merger is likely to breach s 50.

Allowing mergers which substantially lessen competition will result in a decrease in international competitiveness.  In light of the ever increasing internationalisation of world markets, efficient industries in Australia are necessary to ensure that each sector of our industry performs at its maximum capacity. Globalisation has encouraged Australian firms to increase their efficiency in production, distribution and management; and has encouraged innovation. It should be recognised that, like imports, internationalisation of markets can impose constraints on the behaviour of an exporter in its domestic market(s). For example, Australian firms trading with the subsidiaries of multi-national companies in Australia and overseas are unlikely to be able to raise domestic prices following a merger while charging lower prices overseas. Consequently, efficiency gains resulting from a merger aimed to increase international participation may be relevant in assessing the consequences of the merger under section 50 of the Act. With declining tariffs, it is more difficult to prevent arbitrage in tradeable products and so the efficiency improvements required to enter international markets are also likely to flow through to domestic consumers (this will not usually be the case where a company enters the international market by establishing a separate offshore operation).

## AUTHORISATION

Where there is likely to be a conflict with s 50, authorisation should be considered by parties to a merger or acquisition. For instance, although there may be cost or dynamic efficiency gains, a merger may also reduce competitive pressures which may cause allocative efficiency to suffer. In such a case, the authorisation process and its public benefit test provides a mechanism under which these conflicting claims can be offset. Put more broadly, the authorisation process provides a mechanism by which various “trade-offs” that arise in the context of merger analysis can be determined. For example, while a relatively large size may be necessary to achieve economies of scale, it may also lead to a concentration in market power domestically, the exercise of which can lead to losses in efficiency and a reduction in consumer welfare.

Thus, mergers and acquisitions can offer the prospect of enhancing the international competitiveness of an Australian industry but at the same time threaten to reduce competition on the domestic front. 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 cross-subsidise its export price. Ultimately, Australian consumers and industry may be forced to pay a higher price in order to underpin the merging entity's export sales.

The Commission will consider any such trade-offs on a case by case basis. As mentioned, this trade-off is recognised, to a certain extent, in the authorisation provisions of the TP Act. Authorisation is a public process by which the Commission grants immunity, on public benefit grounds, for mergers that might otherwise contravene the TP Act. In those few cases where the Commission challenges a merger as anti-competitive, Part VII of the TP Act enables the Commission to authorise mergers where they would be likely to result in such a benefit to the public that the acquisition should be allowed to take place. Parties may choose to apply for authorisation by the Commission without submitting their proposal for scrutiny under s 50.

### *INTERNATIONAL COMPETITIVENESS AS A PUBLIC BENEFIT*

Parliament has specifically provided in s 90(9A) of the TP Act that a significant increase in the real value of exports and a significant substitution of domestic products for imported goods must be regarded by the Commission as a public benefit for the purposes of determining applications for authorisation of mergers and acquisitions. Further, all other relevant matters that relate to the international competitiveness of any Australian industry must be taken into account. The legislation makes explicit what has been implicit in the Commission's practice for many years. Therefore, in circumstances where the Commission considers that a proposed merger may breach s 50 but the proposal appears to have redeeming features, such as producing efficiencies that assist an Australian company to compete in markets overseas, then the Commission will suggest to the parties that they seek authorisation for the proposed merger.  This will ensure that the process for assessing any net public benefits is exposed to public scrutiny.  The Commission will use its resources to facilitate speedy consideration of such applications.

The authorisation process, as a mechanism that incorporates efficiency considerations, and the ability of the Commission to assess efficiencies that impact on the competitiveness of a market under s 50, make Australian treatment of efficiencies in mergers among the most progressive in the world.  Evidence before the 1996 Federal Trade Commission Hearings on *Competition Policy in the New High-Tech, Global Marketplace* referred to the Australian incorporation of efficiency considerations in respect of mergers as being more progressive than the United States and the European Union.

It should be noted that many of the objectives of mergers may be achieved through other mechanisms which may also fall for examination by the Commission, such as registration of an export agreement with the Commission (pursuant to s 51(2)(g) of the Act), or formation of an consortium or joint venture in respect of export operations.  This is not the place to discuss administrative treatment of these arrangements, except to say that the Commission’s administration of them reflects a similar appreciation of the needs of Australian firms to compete in a more internationally competitive environment.  The Commission’s concern with these arrangements is that they may provide an opportunity for firms to engage in conduct that has the purpose or likely effect of substantially lessening competition in a market in Australia.  Thus firms should ensure that the operations of export consortia do not impact adversely on the competitiveness of the domestic market, or that, in respect of those that are subject to an authorisation application, there is a net public benefit to such arrangements.

## THE INTERNATIONAL FRAMEWORK

The Commission will also take account of the international framework that surrounds any merger or acquisition.  This may mean taking account of arguments that Australian firms are competitively disadvantaged in external markets, tariff and non-tariff barriers in export markets, other impediments to export enhancement (eg. intellectual property, R & D, taxation, labelling issues etc), and whether the merging firms have historically sought to expand exports by investing in operations in an export market rather than exporting there.  Firms might do this for a number of reasons - there may be a greater availability of capital, or better access to superior technology, resources or customers.  A firm may also find that an overseas joint venture partnership may be of more benefit to that firm's international competitiveness than a domestic partner.  For instance, the overseas partner may provide greater access to distribution channels and have greater market knowledge.

## CONCLUSION

Easing your merger through the Commission is a matter of ensuring that there is no substantial anti competitive effect.  Section 50 only prohibits mergers which are likely to substantially lessen competition.  And the Commission looks at all the factors I referred to earlier in coming to its view about the effect of a merger on competition.

The administration of mergers also envisages, by way of the system of authorisation that particular mergers may result in such public benefit as to outweigh anti competitive detriment.  Moreover, the 1993 amendments to the Trade Practices Act made express reference to contribution of  exports and/or import substitution and to the general achievement of international competitiveness as benefits.

The Commission also has the tools to be flexible enough to arrive at solutions rather than merely seeking to block a merger where undertakings may be provided to address the anti competitive concerns.