Australian Financial Review Conference

CFO 2001 Summit

Mergers and Market Power

7 June 2001
Hilton Hotel, Sydney

Professor Allan Fels,

Chairman

Australian Competition and Consumer Commission

Introduction

The Australian Competition and Consumer Commission has persistent critics who claim that its implementation of the Trade Practices Act's merger policy is harming the economy. It is a policy, they argue, that it is driving company headquarters offshore and preventing the development of large Australian companies that can " punch above their weight" on the Australian market and beyond.

There are two immediate responses to the critics. First, the Commission is not anti-merger. Second, strong merger law is essential to the development of strong, internationally competitive Australian companies. I want to spend some time on both points.

In regard to anti-merger bias, the fact is that the Commission only opposes those mergers, which lead to a substantial lessening of competition. Very few have this effect.

In 1999-2000, the Commission reviewed 208 merger proposals and opposed four. The previous year it was 185 reviewed and seven opposed and the year before that 176 and five. It is hardly a tale of outright rejection or a vendetta against big business.

The virulence and persistence of the attacks raises the question of motive. Do the attackers want the unfettered right to establish monopolies so they can dominate the market and, by raising prices, earn greater profits? This may bring cheers from CEO's and some shareholders but not necessarily from consumers or other companies that buy inputs from the monopolies.

Australia is not alone in its interest in mergers. Governments worldwide have created strong laws to prevent the creation of cosy cartels. They have also empowered anti-trust agencies to enforce laws to protect consumers and small business from anti-competitive mergers. United States law can force dominant companies to divest to increase market competition and ban mergers that lessen competition. In Australia, with its much smaller business sector, a proposed merger that will lessen competition may proceed if there are offsetting public benefits.

If the critics were serious about promoting large internationally competitive Australian companies they would acknowledge the benefits of competition. Would Australia's big companies be internationally competitive if they had to secure their raw materials, such as coal and petrol, from a monopoly supplier? How would they fare if they had to export through a

monopoly transport company and raise finance from a monopoly bank? Would they be better off if they purchased their products from a monopoly retailer, "Colesworth"?

Big businesses benefit greatly from more competitive markets. Stronger domestic competition has lowered their costs and enabled them to compete internationally.

National Champions

It is claimed that if we don't change the merger provisions of section 50 of the Trade Practices Act Australian companies will be prevented from reaching a size big enough to compete in global markets. The so-called "national champion" argument.

My main response is that obstacles to export growth are not necessarily overcome by firms developing dominance in the domestic market. A certain size is not a prerequisite to export success, a fact often demonstrated by the overseas success of moderate-sized and even small Australian firms. Observers of the rural economy have noted the drive and initiative of rural cooperatives and individual farmers following the dismantling of statutory marketing schemes.

This is not to dispute the fact that large firms earn the bulk of export income. But the figures do show that exporting is not the exclusive preserve of big business and that small and medium sized firms can be and are very successful exporters.

Being Internationally Competitive

Domestic rivalry is the critical factor in export success. It is more important than rivalry with foreign competitors because strong domestic competitors put highly visible pressure on each other to improve. Domestic firms are under pressure to export so they can grow. There is also pressure to innovate. Research by Professor Michael Porter of Harvard University concluded that nearly every successful international firm comes from a highly competitive domestic market. He supports the view that the key to success in foreign markets is exposure to "blooding" in domestic markets.

Where local companies have faced significant import competition the Commission has not opposed mergers. Take the following example: Email's acquisition of Southcorp's whitegoods manufacturing facilities. In this case, the presence of imports was sufficient to alleviate any competition concerns.

Here is another. In November1993 the Commission did not oppose the acquisition by Amcor Ltd. of Associated Pulp and Paper Mills Ltd. despite making Amcor the only domestic manufacturer of paper (other than newsprint) and giving it ownership of four of the five largest paper merchants in Australia. After extensive inquiries, the Commission concluded that strong import competition at the manufacturing end of the market put substantial downward pressure on prices.

Amcor argued that it needed the acquisition to achieve economies of scale. But later, it appeared to negate its own argument by splitting into two companies; Amcor took the packaging manufacturing assets, PaperlinX the paper assets.

When PaperlinX proposed the acquisition of the fine paper firm, Spicers, it was considered likely to lessen competition in this market. However, PaperlinX overcame the Commission's concerns by undertakings that included the divestiture of two paper merchant businesses, Edwards Dunlop and Commonwealth Paper. A major factor in the Commission's decision was the actual and potential level of paper imports directly reaching a market to customers.

Often a merger is allowed to proceed if undertakings are given. Without them the Commission will act to stop the merger. In May last year the Commission decided not to oppose the acquisition of Colonial Limited by the Commonwealth Bank subject to significant undertakings to minimise any decline in competition.

It is possible to satisfy merger ambitions by applicants amending the original proposal. Take the merger between British American Tobacco's Australian subsidiary WD and HO Wills and Rothmans. With only three cigarette manufacturers in Australia (the other being Philip Morris) and imports accounting for less than one per cent of the market, the initial Commission reaction was "no".

The two companies responded by selling 17 % of their combined brands to Imperial Tobacco, which became a strong competitor on the Australian market. The merger went ahead with no resort to the courts and increased market competition.

Whatever the claims of by big business, even where a merger is found to anti-competitive, the merger provisions of the Act are not an obstacle to firms achieving a size that will bring the

economies of scale needed to be internationally competitive. The key is that there must be public benefits that can be tested under the authorisation provisions.

Under the Trade Practices Act, public benefits are specified as including a significant increase in the real value of exports and significant import substitution. The Commission must also take into account all matters relating to the international competitiveness of Australian industry. They include whether a proposed merger would have an adverse impact on the ability of smaller companies to expand or develop export markets.

I believe the Commission can clearly demonstrate that the Trade Practices Act is not a barrier to company growth. However, this has not stopped the Business Council of Australia trying to water down merger law at every opportunity. The latest tactic is to claim that Australia will develop a branch office economy as firms shift head offices off shore.

Moving Offshore

It's inevitable that with globalisation gathering pace that more Australia companies will move offshore. However, the company names supplied to the media by BCA sources, as likely to decamp for overseas have had few problems with the Commission. They include BHP that acquired New Zealand Steel and recently merged with Billiton without objection from the Commission, AMP that acquired GIO, NAB that acquired MLC. Brambles and Lend Lease have never had a merger blocked. Pioneer is also mentioned but it never put any proposal to the Commission to acquire CSR, despite the issue being raised several years before the Hanson acquisition.

Preventing mergers, it is claimed, will force companies to re-locate overseas. There is no evidence that companies have been forced overseas because the Commission knocked back their mergers.

There are a variety of reasons why firms go offshore and merger policy is at the bottom of the list. A major reason for decamping is taxation policy, others are the need to get closer to customers and easier market entry.

It has been claimed that many company chiefs, who would like to merge, will not come forward because they fear an inevitable knockback. The figures on mergers I mentioned earlier put paid to this. With a rejection rate of less than five per cent, arguments that companies will not come

forward are clearly wrong. The CEOs of large firms are not shrinking violets. If they are interested in a merger they will quickly sound out the Commission in one way or another.

The Big Business Agenda

In general, the big business's agenda over the years has been to weaken and water down the merger law at every opportunity. Some CEOs want a soft merger law others want no law even if this means an economy made up of monopolies that cannot compete internationally. However, the big business agenda receives little support from small business.

The impact of anti-competitive mergers and joint ventures can be profound causing a loss of consumer welfare and an adverse impact on the costs of affected industries. It should be remembered that once industry structures are in place, they are difficult to alter and may lead to higher prices, lower quality, poor service and a dearth of innovation.

A merger can create supply bottlenecks for smaller companies and may restrict market entry or access to crucial facilities. Third parties must have access to supplies at a competitive price.

Merger Guidelines

Australia's CEOs would be aware that the Merger Guidelines streamline the process of informal consideration to reduce costs and the regulatory burden. They do not bind the Commission but indicate what it considers important in decision making.

In examining proposals the Commission assesses market concentration ratios and will examine the matter further if the combined market of the four largest firms is greater than 75 per cent and the merged firm will supply at least 15 per cent of the relevant market. Alternatively, if the merged firm will supply 40 per cent or more the Commission will give the merger further consideration.

The potential, or real, import competition is considered an important factor because of the globalisation of markets. If import competition is an effective check on the exercise of market power, it is unlikely the Commission will intervene in a merger. It has not rejected any merger where imports, independent of the merged parties, have been sustained at more than 10 per cent of the market.

Barriers to market entry are examined. If there are no significant barriers, incumbent firms are likely to be constrained by the threat of entry and behave as if the market is competitive. A concentrated market often indicates high barriers to new entrants.

We also look at "other factors" including whether the merged firm will face countervailing power in the market, whether the merger will remove a vigorous and effective competitor or whether the merger is pro or anti -competition.

The Qantas-Impulse Merger

A recent and extremely difficult merger. The Commission concluded in the first instance, that the merger would be likely to lessen competition in the airline industry.

However, it became apparent to the Commission that a likely outcome, should the proposal be rejected out of hand, would see Impulse going into receivership. Given the structure of the industry and its regulatory framework, particularly the slot allocation mechanism, it is highly likely this would have lead to a more anti-competitive outcome ie the slots would have gone to Ansett or Qantas.

Our concerns were lessened in light of the court enforceable undertakings by Qantas to overcome anti-competitive elements of the deal. Qantas guaranteed slots to new and emerging airlines, helping to overcome a major barriers to entry and growth. Guarantees were also given in regard to services and restrictions on fare increases for routes where both airlines were the only ones that competed.

The Franklins Agreement

This was also a difficult matter given Franklins decision to exit the market due to unsustainable losses. The Commission has obtained the best outcome possible under the circumstances, boosting the market share of independent grocery retailers, while also facilitating the entry of two new competitive players in the eastern Australian supermarket industry.

As you know, Woolworths will acquire far fewer stores than they originally sought with independents offered two-thirds of the total sales value of Franklin stores. Foodland and Pick’N’pay are getting a significant number.

The Commission was concerned that Franklins was close to an uncontrolled collapse that would have seen more stores go to the major chains leaving fewer for independents. I believe the outcome is good for the industry and consumers. We have announced the detailed outcome today.

Woolworths can only use the "No Frills" brand name and Franklins trade names for a transitional period and must divest a number of its own stores to address local concerns about competition.

Energy Reform

Another area where reform has been a major challenge for governments, regulators, industry and customers is the Energy sector. The business community has a major interest in seeing the effects of these reforms.

Public authorities have been restructured, re-branded and in some cases, privatised. Commercialised generators, retailers and traders conduct business in spot and contract markets and promote their services online. New investors are entering the market from overseas as well as other Australian industries. Monopoly networks are regulated and separated from the competitive businesses to provide non-discriminatory access for third parties.

The key development has been the creation of the National Electricity Market (NEM) which joined for the first time the separate electricity markets in Queensland, NSW, ACT, Victoria and South Australia.

This market has introduced new ways of trading wholesale and retail electricity. At the same time, customers have progressively earned the right to choose suppliers and services with the idea they could negotiate new deals based on prices and conditions driven by competition.

Such reforms are not unique to Australia: industry restructuring and competitive electricity markets are increasingly a global trend, with the aim of delivering power more efficiently through competition. The result is intended to be an industry where commercial incentives drive management decisions and new investment, an industry that contributes more effectively to our economic growth and improves the well being of consumers.

Have these reforms delivered on their promises? Indications are that industrial and commercial customers benefited in the initial years from lower prices, especially in NSW and Victoria where electricity constantly traded close to the generators' marginal fuel cost. As a result, these

customers experienced reductions of 20 to 30 per cent in charges. There were winners and losers too amongst the generators and retailers, with some well-publicised court disputes over contracts and prices.

So the larger customers gained from the early rounds of deregulation. Will similar benefits be available to smaller businesses and households when they enter the competitive market? Or will the market be less competitive, more concentrated and over-protected by governments?

A major concern I have is whether or not governments have the will to carry reforms through so that all customers (including small businesses and households) can share in the rewards.

Development of a unified, rationalised market is also at stake. Ten years ago Australian governments recognised some states had surplus capacity and slowing demand, whereas others had growing demand and supply shortages. The reforms intended that these excess resources would be shared, and not wastefully duplicated. There is to my mind some danger that this goal will not be achieved or, if achieved, will accomplish too little, too late.

Will consumers see lower prices?

Lower prices and customer choice were observable benefits of the new market, but these happened more in some states than in others. Also, these price falls resulted from introducing reform in an industry in NSW and Victoria with excess generating capacity. Individual generators faced the risk of their output not being dispatched, whilst as retailers were keen to increase market share. This combination of incentives yielded unexpectedly low prices and slim retail margins. While the newly contestable customers reaped the rewards, this was at the expense of the industry's profitability.

However, as demand has increased, the gap between supply and demand has contracted and prices have risen. Already, in states such as South Australia, high prices have been the order of the day. Queensland prices have fallen, but only after a volatile, peaky start to their market, which was symptomatic of system constraints.

I fear that a narrowing gap between supply and demand means that some of the early, easily won benefits will evaporate. For reform to deliver sustainable long-term benefits, the market must stay competitive. Higher prices should be revealing opportunities for new investment in generation and interconnection. After all, this was one of the fundamental aims of reform.

Interconnection and generation projects in Queensland – which is likely to shift from supply shortages to excess capacity over the coming years – suggest these signals are working.

But this will take time. The NEM will not instantaneously erase the history and past practices in what was a centrally planned industry in each state. For instance, South Australia still relies on a base-load interconnect in a region with chronic peak load problems. Hopefully, new investments such as Pelican Point, Ladbroke Grove and the Port Pirie magnesium smelter will support new gas supplies and consequently new entry in electricity generation. That still doesn't explain why major investment in interconnection did not occur earlier, as with the proposed South Australian / New South Wales Interconnector (SANI project) some years ago.

A danger I foresee is that industry owners will lose patience with reform. Proposals to re-amalgamate generators, arrangements to boost sale prices on privatisation and anti-competitive pricing practices may well solve the industry's short-term profitability problems. They will not encourage a competitive industry and they will not deliver long term benefits to electricity consumers.

Further disaggregation, new entry and new investment in generation should be occurring in an environment where there is viable competition between fuel types (coal, gas, hydro, renewable) and technologies. The market and the networks should provide clear signals as to the best place and best time to invest. Ideally, alternative projects (new and refurbished generation, interconnection, co-generation or demand side projects) should compete for network access on an equal basis that reflects an appropriate sharing of costs and benefits.

As California has proven, stop-gap and compromise measures, that take no account of market incentives will be ineffective and can be disastrous. Further disaggregation and more competition must be a high priority. Without this structural reform, any review and rewriting of the electricity market rules will be inadequate and, ultimately, meaningless.

Static reform = Too much interference

So why are these concerns still with us, six years after reform commenced? I believe that continuing intervention by governments – who still own most of the assets - overshadows the continued delivery of reform benefits to all customers. Governments become very sensitive about the sale (or revenue) value of these assets and about the impact of regulatory decisions affecting them. It is no surprise that governments (as owners and shareholders) take issue more often with

regulators, than the electricity businesses or customers themselves. Government treasuries and energy departments often filter the views of these businesses before they are publicly known.

State treasuries still rely on the energy sector for a large slice of their revenues and budget outlays. Governments also have reasons for retaining control over how prices are set for different customer groups or different regions. Sometimes these cross-subsidies yield public benefits. In other cases this is not so clear cut, and often the arrangements are not transparent.

Until governments adopt a more hands-off approach to the outcomes of reform, there will be this ongoing conflict between their roles as asset owners, as tax collectors, as managers of an economy which needs to operated competitively and efficiently and as the elected representatives of voters and customers.

Extending Commission Powers

Court action by the Commission can produce judgements that extend its powers under the Trade Practices Act and this is particularly true with section 46. This section prohibits a company with a substantial degree of market power from using it to damage a competitor. One main weapon is predatory pricing, that is, selling below cost until the weaker competitor is driven out of business. Consumers may cheer the initial drop in prices but they do not last.

There have been several landmark cases where the Court has recognised that predatory pricing can constitute a misuse of market power and therefore unlawful under section 46. The Court's interpretation of predatory pricing is stronger than that of the US and Europe. There predatory pricing only becomes unlawful where a business charges supra-competitive prices to recoup losses once rivals are eliminated. In Australia a later recoupment of losses in the market in question is not necessarily essential to contravene section 46. This is the verdict of the recent Boral case.

Last February the Court declared unanimously that Boral Besser Masonry Ltd's pricing below cost breached section 46. The Commission took action alleging that Boral had slashed prices below manufacturing cost to drive the smaller C&M Bricks out of the concrete products market. Justice Finklestein went further declaring that "psychological pressure" had accompanied predatory pricing. Boral had not only sold below cost but publicised the fact that it was

increasing manufacturing capacity. It was signalling to its rivals that it was willing to wage the price war for some time and could bear the losses.

Another important Court decision concerns Melway Publishing Pty.Ltd's refusal to supply Robert Hicks Pty Ltd with its Melbourne street directory for distribution, arguing that it had a long-established, exclusive distribution system in place. While the High Court said that Melway had not breached section 46 the important point is that the Court appears to have accepted the ACCC submission that it is sufficient to establish that the existence of market power made it easier for the firm to act in a prohibited manner. This lowers the threshold for breaching the Act.

The decisions are a warning to companies tempted to use their muscle to crush their competitors that section 46 is as vital in the quest for competitive economy as are other sections of the Act dealing with cartels and company mergers.

ACCC Resources

It should be noted that in recognition of the Commission's continuing and expanding role the Federal Government had significantly increased the resources available to the Commission.

In the recent Federal Budget the Commission received a 27% increase in funding to a total of $73.4 million in 2001-2002. Additionally, the Federal Government has created a litigation reserve fund of initially $10 million building to around $20 million over time, to assist the Commission in meeting the costs of large cases and court activity. This will strengthen our capacity to deal with major litigation.

The funding granted by the Government enables the Commission to maintain its high standard of service delivery and to meet emerging priorities such as e-commerce and rural and regional issues. The additional resources will also allow the Commission to effectively meet the increasing international challenges including:

- the impact of globalisation;
- the increased complexity of markets and technological change, and;
- major regulatory activity.

The funding will also allow the Commission the flexibility to reallocate resources with changes in its operating environment.

Our consumer role will be enhanced by this additional funding. Can I remind you that the Trade Practices Act specifies that it is our role to "enhance the welfare of Australians through the promotion of competition and fair trading and the provision of consumer protection". The consumer, whether a household or small business consumer, is rarely in the forefront of the minds of those proposing mergers. What may be foremost is market domination, which can mean charging higher prices to consumers and paying less to suppliers.

The Commission's relationship with big business is at times tense because it is there for the benefit of consumers. However, the business community stands to lose from an uncompetitive economy.

The anti-competitive conduct provisions of the Trade Practices Act, including the merger provisions, are an attempt to enact economics as law. For this reason, interpretation of the Act is always going to be somewhat controversial and the Commission's decisions on some mergers will attract criticism and debate.

What should be remembered is that the Commission is the administrator and enforcer of an Act of Parliament introduced to protect the public against anti-competitive forces. The Courts are the final arbiters on whether breaches of the Act have occurred. Further, the Commission's authorisation decisions can be appealed to the Australian Corporation Tribunal.

There are ample safeguards for businesses that disagree with the Commission. They can appeal to the courts and the Australian Competition Tribunal. In court, the onus is on the Commission to prove its case if a business wishes to proceed with a merger considered anti-competitive by the Commission.