Australian
Competition &
Consumer
Commission

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Introduction

The impact and coverage of the Trade Practices Act (the Act) and the Australian Competition and Consumer Commission (the Commission) has increased significantly over the past decade. The Commission now has an extensive regulatory role as well as a continued focus on anti-competitive behaviour and consumer protection.

As various sectors such as telecommunications, gas, electricity and transport are opened up to increased competitive pressures, the role of the Commission has expanded. As governments have embarked on major public assets sales, the Commission has undertaken analyses of the competitive impacts of such sales.

In my speech this morning I want to use a number of examples to illustrate Commission activities in the context of the theme of this conference, share buybacks and capital management. I will look at these matters from a regulatory context but also from the perspective of mergers and acquisitions analysis.

In the world of corporate finance, the financing of mergers and takeovers is a crucial issue. However, in its examination of mergers under section 50 of the Trade Practices Act, the method of financing is generally not of critical importance to the Commission. This is a generalisation of course and there may be circumstances where say the source of the financing for the takeover is of relevance to the Commission. This would particularly be the case where there was some link between the lender of the financing and the potential acquirer. This is a point I will come back to. But generally in the financing of an acquisition, the Commission is not concerned as to whether financing is via debt or equity or in which combinations.

The Market for Financing

One area in which the Commission does have a particular interest is with regard to markets for finance. Market definition is a critical element of merger analysis. An inappropriate definition of the market will lead to errors in evaluating the extent of competition in the market. Competition does not occur in a vacuum and the boundaries of the relevant market are a crucial feature of the analysis.

Over the past few years the Commission has looked very closely at bank lending in its examination of a number of bank mergers. In the Westpac acquisition of Challenge Bank in 1995, the Commission took the view that the banking market was best examined as a cluster of banking services which were delivered to their customers as a bundle.

The cluster approach argues that there is a cluster of banking functions such as deposits, loans and transactions. This approach argues that customers do not appear to exhibit sufficient price sensitivity over the bundle of banking products to enable suppliers of single or particular financial services to successfully attract customers.

A study undertaken by the Price Surveillance Authority (PSA) in 1995 supported this approach. The PSA study found that Australian financial institutions placed considerable importance on developing long term relationships with customers in an attempt to capture all the business of that customer. The PSA study also found that such a strategy allowed banks to disguise fees and charges via packaged product combinations and pricing strategies.

Under the cluster approach it is probably useful to separate products and services according to business scale. For example, while small bank business customers often require a range of bank products similar to those of the retail customers, they may also require additional and larger facilities in connection with lines of credit, overdrafts and loans. It would also be appropriate to delineate separate clusters of services for medium sized businesses and large corporate customers as well. While the boundaries between small, medium and large business sectors are not precise, in Australia firms seeking loans in excess of around $20 million would probably be included in the corporate banking sector.

In 1997 the Commission examined Westpac’s acquisition of the Bank of Melbourne. In this instance the Commission moved away from the cluster approach and identified specific product category groupings. Besides identifying six product categories for retail banking, the Commission also identified ‘corporate banking’ for large businesses as a further market. However, this market was not discussed in any detail due to the Bank of Melbourne‘s lack of presence in that market.

In its most recent bank merger investigation, the Commonwealth Bank's acquisition of Colonial, the Commission took the view that the banking needs and requirements of large corporations were entirely different from those of small and medium enterprises.

Large corporations have finance options available to them that are not necessarily available to small and medium sized enterprises. Large corporations can participate directly in financial markets in their own right. They are able to directly issue debt and equity.

Large corporations invariably have their own sophisticated internal treasury operations that may be an additional source of finance.

Banks have been at the cornerstone of financial intermediation in our economy, playing the absolutely critical role of facilitating exchange between savers and borrowers.

However, the 1997 Wallis report highlighted the evolving process of disintermediation, whereby large corporations have been able to bypass financial intermediaries and raise their own funds.

The result of disintermediation has been that bank loans have become a less important and ever diminishing source of finance for large corporation. Indeed, bank loans only account for around 15 per cent of corporate financing requirements.

According to the Wallis Report large firms, especially multi-national corporations, could increasingly raise funds directly in financial markets. The Wallis Report believed that this partly reflected improved information technology that permitted ultimate lenders to inform themselves about the characteristics of borrowers more easily and at lower cost, as well as the sheer size and multi-national presence of the world's largest corporations.

The Wallis Report found back in 1997 that the trend towards disintermediation in Australian financial markets had been relatively weak to that date, and that the banks continued to be an important source of corporate credit.

Bank lending is still an important source of corporate finance but the direct issue of debt in Australian financial markets is becoming much more prevalent.

If this trend continues then bank loans will become a less significant source of finance for large corporations in the future.

Australian Stock Exchange / Sydney Futures Exchange

Another merger with significant financial sector implications I would like to speak about was the proposed merger between the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE).

In August 1999, the Commission expressed the view that the Australian Stock Exchange's bid for the Sydney Futures Exchange would be likely to substantially lessen competition and breach section 50 of the Trade Practices Act. On the same day, the Australian Stock Exchange announced that it would not seek authorisation of its proposal and withdrew the proposal.

During its investigation of the Australian Stock Exchange's proposal, the Commission undertook extensive market inquiries. It canvassed the views of a wide range of participants, including brokers and investors. The Commission found that there was a mixed reception to the merger proposal in the market, including negative reactions and concerns about anti-competitive effects.

The Commission had concerns that the merger would decrease the innovation in financial services markets and delay, if not prevent, more competitive pricing of financial services products from the combined Australian Stock Exchange and Sydney Futures Exchange. The Commission's overall findings were that:

In the absence of the merger, the Australian Stock Exchange and Sydney Futures Exchange were likely to compete strongly in the future. This was especially the case for new products. With new financial instruments being continually devised and, with the market expanding rapidly, the scope for competition between the Australian Stock Exchange and Sydney Futures Exchange was likely to increase substantially, especially with foreshadowed changes to the Corporations Law . Proposed regulatory changes would enable each exchange to offer the full range of exchange trading services for financial instruments without any distinction between shares and futures.

If the merger had proceeded, the result would have been the creation of one dominant exchange in all exchange traded financial instruments.

Given that the merger was essentially a merger between the only two currently significant firms in the market, at face value this would have likely lead to a substantial lessening of competition. The Commission then had to consider if these concerns would be overcome by the possible entry of a strong competitor, within a reasonable time, which would supply services competitive to those of a merged Australian Stock Exchange/ Sydney Futures Exchange. The Australian Stock Exchange was not able to address those concerns.

On the information then available, the Commission was not satisfied that barriers to entry were insubstantial. There were significant costs in establishing trading, clearing and settling facilities that could not be recouped on exit from the industry. The Australian Stock Exchange and Sydney Futures Exchange controlled the clearing and settling facilities. There were substantial costs involved in establishing alternative settling and clearing systems.

Another barrier was the need for a new entrant to achieve sufficient liquidity. This refers essentially to the volume of trading which directly influences the ease with which customers may buy or sell a product on the exchange, and is a measure of the depth and breadth of trading.

The Australian Stock Exchange's submissions did not contain material which persuaded the Commission that substantial foreign competition in the market for the exchanges' services appeared likely within the foreseeable future. Foreign exchanges were not able to compete effectively in the domestic market due to differing national laws regulating entry, market integrity and investor protection.

Brokers and institutional investors appeared unlikely to set up a competing exchange. These groups had little incentive to establish rival trading mechanisms given their primary focus on broking and investment. Broking groups and their employees are major owners of the Australian Stock Exchange and would have had little incentive to compete with an organisation in which they possessed equity.

The merger proposal may have been defensive in order to hinder the competitive effects of dynamic factors such as regulatory change, technology, and innovation that may otherwise had been realised in the future. The Commission recognised that there were significant new and dynamic changes occurring in financial markets but was concerned that the merger proposal may prevent these developments and stifle potential competition if they had a detrimental impact on the dominant position of the Australian Stock Exchange.

If the ASX had lodged an application for authorisation, the Commission would have had an initial period of 30 days in which to consider the application.

Within the context of an authorisation application, the ASX could have presented relevant arguments relating to greater public benefits generated through increased globalisation, but they declined to go down this route.

I should note that the Financial Services Reform Bill 2001 is currently before the Federal Parliament. This legislation makes up another important element of the Government's response to the recommendations of the Wallis report.

This Bill aims to increase competition in financial markets in Australia by lowering the barriers to entry and encouraging new participants to operate competing markets and facilities.

The legislation will end the current distinction between securities exchanges and futures exchanges by introducing a single licensing regime for 'financial markets'.

Further, a suitably qualified market will be able to trade in any financial product, meaning that securities and futures contracts can be traded on the same exchange in Australia.

To quote from the explanatory memorandum of the Bill: "The primary problem in relation to Australian markets is the lack of competition in this sector".

The explanatory memorandum then goes on to highlight the fact that there are only two approved securities exchanges operating in Australia – the ASX and the Stock Exchange of Newcastle - and while there were previously two approved futures exchanges, there is now just one – the SFE, after the demise of the Australian Derivatives Exchange.

Had the Commission allowed the ASX / SFE merger to proceed, it could have potentially stifled an important aspect of the Government's response to the Wallis report.

The Commission has been involved in several matters recently in which financial and capital issues were important. Two of the more high profile matters were the Franklins sell down and the Qantas acquisition of Impulse.

I would like to speak briefly about both.

Late last year Franklins, through its owner, Dairy Farm International, approached the Commission indicating its intention to exit from its involvement in food and grocery retailing in Australia. The Commission was provided with confidential information on the financial state of the Franklins' business and considered its future in light of that information. This included statements from the owners, supported by financial documentation, that the losses they were incurring were unsupportable and that the decision had been made not to invest further in the Australian enterprise. The information provided backing for the Dairy Farm's contention that it would exit and sell its operations regardless of the Commission's views on the managed sell down.

That is, if the Commission saw a managed sell down as anti competitive in light of s50, then the company would exit through other means.

To enable this exit, Franklins proposed a managed sell down of its stores, warehouses, distribution facilities and other related assets to various parties. An integral part of the proposal was the participation of a major chain. Franklins wanted the Commission to provide its opinion on whether the proposals put forward by it would contravene section 50 of the *Trade Practices Act.*

The parties argued that a managed sell down involving one of the major chains was necessary to under-write the process, providing certainty to suppliers and ensuring the maintenance of the individual Franklins' businesses. Should the wider industry and consumers begin to doubt the ability of Franklins to maintain its operations many of the suppliers would likely reduce or eliminate services while customers would migrate to Franklins' competitors. A managed exit as proposed, therefore, would ensure that damage to competition that may occur with Franklins announced withdrawal was minimised.

In addition to considering the consequences of a managed sell down, the Commission considered the possible consequences of an un-managed sell down by Franklins. It concluded that the likely effect on competition would be far more severe than any outcome arising from an agreed managed exit. In particular, the Commission was of the view that significantly less stores would have been able to be acquired by independents, as a substantially higher number would have gone to the major chains.

In May 2001 the Commission announced that it had reached in-principle agreement with Dairy Farm for the sale of stores in the Franklins supermarket chain. In June 2001 the Commission announced that it had accepted section 87B Undertakings from Dairy Farm, Franklins and Woolworths in relation to the package for the sale of Franklins stores. The Undertakings deal with issues including utilisation of the brands owned by Franklins, the number of stores to be acquired by various purchasers, a requirement for Woolworths to divest a number of stores and non-interference by Woolworths in the process to sell stores to independent operators.

The managed exit plan will result in Franklins' stores being offered and/or sold as follows:

- 67 stores in New South Wales, Victoria, Queensland and South Australia to Woolworths;
- 35 stores in New South Wales and northern New South Wales to Action;
- 51 to 60 stores in New South Wales to Pick ‘n Pay, a South African company; and
- 112 stores in New South Wales, Victoria, Queensland and South Australia through the Joint Independent Divestiture Alliance (JIDA) between Franklins and Metcash Trading Limited Australasia (“Metcash”) to various independent operators.

The sale of stores to all independent retailers, other than FAL and Pick ‘n Pay, will be conducted through the Joint Independent Divestiture Alliance (JIDA) between Metcash and Dairy Farm. The JIDA process is the process for the sale of JIDA stores as set out in an agreement between Franklins and Metcash. JIDA stores are directly offered for sale to independent operators, not being Coles or Woolworths.

While not required, the Commission did assess the ability of the two independent operators, FAL and Pick ‘n Pay, to finance their respective acquisitions. Although an in depth analysis was not conducted the Commission spoke with all parties to ensure the operators’ bona fide’s. This was seen to be important due to the large number of stores being acquired and their role in the managed sell down.

At a micro level the Commission is involved in ensuring that Franklins complies with the Undertakings it has given the Commission in relation to the managed sell down. Included in the Undertakings is a commitment by Franklins to do everything reasonable within its power during the period of the JIDA process to effect the transfer of JIDA stores to Independent Operators. In monitoring Franklins' compliance with its Undertakings, the Commission will audit the sale process, including financial matters where applicable.

Management Buy Outs

One other area where the Commission has undertaken extensive analysis of companies' financing is in the area of management buy outs.

In certain circumstances the Commission may approve an acquisition subject to the merging parties divesting certain assets. For example, late last year the Commission approved the acquisition of the private hospitals of Australian Health Care by Mayne Nickless subject to the divestiture of a number of hospitals. The Commission also agreed not to oppose the acquisition of Spicers by PaperLinx subject to the divestiture of certain paper merchanting businesses including Edwards Dunlop.

In these circumstances the Commission has sought divestiture to ensure that the merged entity does not have a market share sufficient to substantially lessen competition. Thus it is necessary to ensure that the businesses which are sold, are sold to entities unrelated to the merged firm.

Generally this is not a difficult issue. Competitors of the merged entity are often willing to acquire divested assets. However, sometimes the merged parties propose to divest assets via a management buy out. The Commission has no particular opposition to management buy outs of assets required to be divested as part of a merger deal, provided that the management buy out leads to an independent entity unrelated to the merged firm.

It is these circumstances where the nature of the financing becomes of relevance to the Commission. In the first instance the Commission would seek to be satisfied that the divested firm will be sufficiently capitalised by its new owners so that it will be a viable competitor to the merged entity. Secondly the Commission will seek to ensure that the management buy out is financed by funding sources unrelated to the merged entity selling the assets. The Commission has concerns in circumstances where the financing for sold down assets is via loans or other financing from the merged firm required to sell the assets.

It is essential that in circumstances where merger approval requires divestiture, that such divestiture creates an entity independent of the merged firm.

The Failing Firm

There is another circumstance where the Commission would pay close attention to a firm's financing. That is where a firm being acquired via a merger or takeover is a 'failing firm'. It is sometimes argued that the target firm's assets would exit the industry in the absence of a takeover. The Commission would need to be convinced that the firm cannot be successfully reorganised and there is no other viable buyer whose acquisition of the firm would not raise competition concerns.

If a target firm in a proposed acquisition is considered to be failing, the Commission will consider the likely effect of the acquisition on competition compared to the effect of the target's assets exiting the market altogether. Unlike the US, Australia does not have a formal 'failing firm defence'. The Commission will, however, consider the arguments associated with failing firm in the context of the s50 merger evaluation.

The Commission does not automatically consider investment ratings as a good indication of a failing firm in the trade practices sense. Investment ratings simply reflect an assessment of credit risk, and may, for example, cover multiple operations and markets and could simply reflect poor management.

If the firm goes under, other companies in the market will compete for the failing firm's customer base which would be divided up on the basis of market forces. On the other hand, the acquisition of the failing firm would tend to deliver those customers to the acquiring firm.

The Commission considered the failing firm argument in its recent determination on the acquisition of Impulse by Qantas. Impulse claimed that it was a failing firm and would become insolvent on 14 May 2001. The Commission independently evaluated this claim by engaging independent auditors to assess the financial viability of Impulse. The report confirmed Impulse's claim that it was indeed a failing firm with the withdrawal of support by investors preventing the company from remaining viable.

The Commission determined that the company was suffering from a capital drain with little likelihood of alternative investors coming forward. In addition, the company also demonstrated severe cash flow problems, which indicated no future consequent to the investor community's withdrawal of support.

In addition to its audit the Commission staff assessed the business plan and financial statements and also interviewed Impulse's investors to determine the possibility of additional funding.

The likely failure of Impulse and the lack of alternative buyers led the Commission to consider the impact of two alternatives on longer term competitiveness in domestic aviation. These alternatives were to allow Impulse to go into receivership or allow Qantas to acquire the company.

Given the alternatives, after extensive evaluation the Commission concluded that while the acquisition would lessen competition, the competition concerns could be better addressed by allowing the acquisition to proceed accompanied by undertakings designed to improve the competitive position of firms currently constrained in their ability to expand and any potential new entrants. Under the other alternative, that is a receivership for Impulse, a less competitive outcome was likely.

In conclusion, as a general rule the Commission does not take a great deal of interest in the financing methodology associated with mergers and acquisitions. The relative weighting say of debt and equity is not of prime concern to the competition regulator. Only in special circumstances would the Commission be concerned with the source of the financing.