Creeping Acquisitions

Submission by ACIL Tasman to the Commonwealth Treasury

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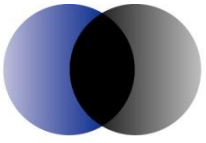

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1 Introduction

This submission has been prepared in response to the *Creeping Acquisitions – Discussion Paper* (Discussion Paper) (Commonwealth Treasury, 2008) released on 1 September 2008. The preparation of this submission has not been sponsored by any party. The views expressed in this submission are strictly those of the author.

The first of six principles of good regulatory process recommended in 2006 by the Regulation Taskforce was that:

> Governments should not act to address 'problems' until a case for action has been clearly established.
>
> This should include establishing the nature of the problem and why actions additional to existing measures are needed, recognising that not all 'problems' will justify (additional) government action. (Regulation Taskforce, 2006, p. 147)

The Regulation Taskforce argued that no regulation should be introduced unless the need for government action and the superiority of the preferred option had been transparently demonstrated (Regulation Taskforce, 2006, p. 148). A potential concern is that any new legislative provision to control creeping acquisitions may breach this first principle of good regulatory process.

While the ACCC has expressed support for the introduction of a general creeping acquisition law (Australian Competition and Consumer Commission, 2008), it is arguably the case that the exact nature of the anti-competitive detriment that such a law would be designed to address has so far been either poorly articulated or ill-defined. As such, it is submitted that there has been no anti-competitive detriment in relation to creeping acquisitions that has so far been sufficiently expounded as to warrant any corrective legislative action at the present time.

The structure of this submission is outlined as follows:

- The theoretical case for mergers law and the operation of mergers law in Australia
- Problems arising from an overemphasis on market concentration for the competition assessment of mergers
- The nature of possible anti-competitive detriments arising from creeping acquisitions
- Review of the proposed remedies to address creeping acquisitions
- Unintended consequences arising from an ill-conceived legislative provision to address creeping acquisitions.

2 Australian Mergers Law

William Kolasky and Andrew Dick, formerly of the antitrust division of the US Department of Justice, have defined allocative efficiency in the following terms:

> At the most general level, a market is said to achieve "allocative efficiency" when market processes lead society's resources to be allocated to their highest valued use among all competing uses. In the context of exchanges between consumers and producer, the value of a product in the hands of consumers is equalized "at the margin" to the value of the resources that were used to produce that product. This intuitive condition ensures that an economy maximizes the aggregate value of all of its resources by placing them in their highest valued uses.
>
> … In the long run competitive equilibrium, the market price is just equal to firms' incremental or marginal cost. Marginal cost reflects not only directly observable costs of production, distribution and marketing but also the relevant opportunities forgone when a resource is used for one purpose rather than for some other purpose. (Hence, the term "opportunity costs" used by economists.) From society's perspective, it represents the total cost of the resources consumed in producing, distributing, and marketing an additional unit of a particular commodity rather than employing those resources in their next best alternative use. Thus, when output is expanded to the point where price is just equal to marginal cost, the marginal value that consumers place on a good—which is the amount that they are willing to pay for the good—is just equal to the marginal value of the resources used in the good's production. (Kolasky & Dick, 2003, pp. 242-243)

The ACCC has stated that the theoretical case for competition laws has been traditionally founded on the need to protect allocative efficiency (Australian Competition and Consumer Commission, 2002, p. 226).

Price equalling marginal cost is the outcome achieved under the model of perfect competition which is used by economists to assess the welfare implications of real world market situations. On the other hand, a firm able to push its price above marginal cost is generally said to be exercising market power (Lerner, 1934).

American economist John Maurice Clark contended that the economic model of perfect competition was an inappropriate benchmark by which to assess real world outcomes because it "does not and cannot exist and has presumably never existed" (Clark, 1940, p. 241). Instead, Clark was the first to articulate the concept of workable competition.

In the Australian context, the definition of workable competition has generally been taken from the decision by the former Trade Practices Tribunal (TPT)[1] in the matter of *Re Queensland Cooperative Milling Association Ltd, Defiance Holdings Ltd (Proposed mergers with Barnes Milling Ltd)* (QCMA). In its decision in QCMA the TPT commented:

> As was said the United States Attorney-General's National Committee to Study the Antitrust Laws in its Report of 1955 (at p 3320): "The basic characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new potential entrants into a field, would keep this power in check by offering or threatening to offer effective inducements…." Or gain, as if often said in United States antitrust cases, the antithesis of competition is undue market power, in the sense of the power to raise price and exclude entry. That power may or may not be exercised. Rather, where there is significant market power the firm (or group of firms acting in concert) is sufficiently free from market pressures to "administer" its own production and selling policies at its discretion…
>
> In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price product service packages offered to consumers and customers. (*Re Queensland Co-operative Milling Association Ltd* (1976) 8 ALR 481, 515)

Recognising that perfect competition rarely if ever exists, the application of competition law in Australia has been directed towards preserving workable competition as enunciated by the TPT.

Mergers law is an attempt to preserve competitive market structures in order to guard against the accumulation and exercise of market power. The enactment of mergers law is predicated on the belief that market competition is the principal means for achieving an efficient allocation of scarce resources throughout society (Davey, 2003).

Australia's current mergers law for competition purposes is contained in section 50 of the *Trade Practices Act 1974* (TPA). In general terms, section 50 prohibits mergers or acquisitions which would have the effect or likely effect of substantially lessening competition in a substantial market for goods or services within Australia (SLC test).

The SLC test has a number of benefits over the previous dominance test that was used to regulate mergers on competition grounds in Australia from 1977

[1] The Trade Practices Tribunal was the predecessor of the Australian Competition Tribunal.

until 1992.[2] In the case of horizontal mergers, an SLC test enables consideration of two sorts of anti-competitive detriments that could arise:

- The exercise of unilateral market power where a single firm post-merger may have insufficient competitive constraints imposed upon it such that it can profitably raise prices.
- The exercise of coordinated market power, whereby a merger creates a market structure more conducive to coordinated conduct between firms, such as through either tacit or overt collusion.

The main difference between the SLC test and the dominance test is that an SLC test allows for consideration of both unilateral and coordinated market power whereas the previous dominance test only allowed for the consideration of unilateral market power.

The concept of coordinated market power comes from oligopoly theory. An oligopoly is a market structure characterised by a few sellers. There is no single determinate solution to the problem of oligopoly with many possible outcomes being postulated. The range of solutions runs the full gamut of possible outcomes from that reminiscent of perfect competition where price is equated to marginal cost to that of a monopoly.

A further advantage of the SLC test over the previous dominance test is that it allows sufficient flexibility for the consideration of a range of potential anti-competitive detriments related to vertical mergers without necessarily having to demonstrate dominance of a firm over a particular market.

Arguably, Australia's the current mergers law regime is consistent with best international practice (Davey, 2003, p. 26). The SLC test applied in Australia is fully consistent with the approach adopted by other English speaking countries. Section 50 of the TPA is based on section 7 of the US Clayton Act of 1914. Australia joins the United States, the United Kingdom[3], Canada[4], Zealand[5], and Ireland[6] in applying an SLC test. Other countries to adopt an SLC test include South Africa[7] and Singapore[8], while Japan applies a very

[2] The previous dominance test prohibited mergers that resulted in the acquirer dominating a market.

[3] Section 22, *Enterprise Act 2002*.

[4] Section 92, *Competition Act 1985*.

[5] Section 47, *Commerce Act 1986*.

[6] Section 20, *Competition Act 2002*.

[7] Section 16, *Competition Act 1998*.

[8] Section 54, *Competition Act* (Chapter 50B)

similar test[9]. Furthermore, the European Commission adopts a test that is very similar in its practical application to an SLC test.[10]

In weighing up the benefits of an SLC test in 2002, the UK Government opined that:

> Fundamentally, the Government believes that the SLC test is better adapted to merger control since it is both more directly grounded in economic theory and more flexible than the dominance test. (UK Government, 2002)

One potential problem with introducing a new legislative provision into the TPA to address creeping acquisitions is that the theoretical basis in support of such a provision may be either flimsy or non-existent.

[9] The Japanese Act on Prohibition of Private Monopolization and Maintenance of Fair Trade (Act No. 54 of 1947) prohibits acquisitions where it creates a business combination that may be substantially to restrain competition.

[10] European Union, Council Regulation No 139/2004 of 20 January 2004 states: [a] concentration which would significantly impede effective competition, in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market.

3 Problems with an Overemphasis on Market Concentration

Within the Discussion Paper there appears to an overemphasis placed upon the role of market concentration in determining market conduct. The Discussion Paper comments that:

> The Senate Economics Reference Committee in 2004 noted that 'as a matter of logic', creeping acquisitions in concentrated markets must over time substantially lessen competition. (Commonwealth Treasury, 2008, p. 5)[11]

Contained within the above comment is the proposition that a more concentrated market will inevitably result in a substantial lessening of competition. While market concentration can certainly provide guidance of which mergers are likely to raise competition concerns, it is certainly not the be all and end all of the matter. Market concentration is only one of a number of factors that should be relied upon in determining whether a merger is likely to result in any anti-competitive detriment.

Once a market definition has been settled upon, the most important role played by measuring the level of market concentration is as an indication as to which mergers are likely to raise competition concerns that require further investigation. According to William Baer, the former Director of the Bureau of Competition for the US Federal Trade Commission:

> … the market concentration today serves as a filter – screening out cases where the likelihood of competitive effect is low and focusing the analysis on the remainder. (Baer, 2005)

Professor David Round, the Director of the Centre for Regulation and Market Analysis at the University of South Australia, has warned:

> … concentration statistics or even market shares attributable to individual firms by themselves tell us nothing about the dynamics of competition within a relevant market. They present a snapshot only, and tell us neither how firms obtained those market shares, nor whether those shares are currently increasing or decreasing, and they certainly offer no guide as to what might happen as future market conditions change. (Round, 2006, p. 54)

Economic theory would suggest that the level of market concentration alone may not necessarily be the prime determinant for the actual state of competition in a market. Thus, a competition analysis focusing solely on

[11] This comment certainly captures the thinking and flavour of the Senate Economics Reference Committee 2004 report (The Senate Economics References Committee, 2004, p. 64) even if it may not be strictly accurate.

market concentration could be fundamentally flawed because it ignores other critical factors. These other factors include the height of barriers to entry and the extent of sunk costs incurred by new entrants.

As already referred to above, the range of possible outcomes in an oligopoly market structure runs the full gamut from that reminiscent of perfect competition to that of a monopoly. An oligopoly market structure need not necessarily result in an anti-competitive outcome, for as the Council of the European Union has observed:

> Many oligopolistic markets exhibit a healthy degree of competition. (The Council of the European Union, 2004)

Similarly, the independent review of the competition provisions of the Trade Practices Act chaired by Sir Daryl Dawson (Dawson report) opined that:

> A concentrated market may be highly competitive. (Dawson, Segal, & Rendall, 2003, p. 67)

Prominent industrial organisation economist Joseph Bain considered the force of potential competition as a regulator of price and output of comparable importance to that of actual competition and focused on the height of barriers to entry as the critical determinant of the price level (Bain, 1956). According to Bain, the extent of barriers to entry in an industry indicated the advantage that existing sellers enjoyed over potential entrant sellers that in turn reflected the capacity of existing sellers to raise their price over the competitive level without attracting new entry.[12]

Bain postulated that where entry into a market was easy or unimpeded was associated with the inability of firms to raise the price above the competitive level without attracting new entry. On the other hand, if the price persistently exceeded the competitive level without inducing entry, then Bain asserted that entry was somewhat impeded. The greater the discrepancy between the price and the competitive level price without inducing entry, the more difficult entry into the market was.

According to Bain, the height of barriers into a market was determined by three factors:

1. the absolute cost advantages enjoyed by established firms over potential new entrants
2. the extent of product differentiation advantages enjoyed by established firms

[12] Bain defined the competitive level of prices as the minimum attainable average cost of production, distribution, and selling for the good in question, such cost being measured to include a normal interest return on investment in the enterprise.

3. significant economies of large scale firms. (Bain, 1956, p. 14)

Bain postulated that barriers to entry would have the greatest impact in oligopolistic markets. In these markets, collective action would permit the deliberate elevation of prices to the extent allowed by barriers to entry. In addition, firms individually and collectively would calculate the effects of their policies in inducing or forestalling entry (Bain, 1956, p. 33).

The theory of contestable markets, developed by American economists William Baumol, John Panzar, and Robert Willig (Baumol, Panzar, & Willig, 1982), is a reformulation of Bain's work on barriers to entry whereby oligopolistic behaviour can be explained by means of the constraint imposed by potential competition. Under this theory, an entry barrier has been defined as "anything that requires an expenditure by a new entrant into an industry, but that imposes no equivalent cost upon an incumbent" (Baumol & Willig, 1981, p. 408).

From this definition, a distinction is drawn between fixed costs and sunk costs. Fixed costs do not necessarily constitute a barrier to entry because they affect incumbents and entrants alike. However, any entry cost that is unrecoverable is a sunk cost. The need to sink costs into a new firm imposes a difference between the incremental cost and the incremental risk that are faced by an entrant and an incumbent (Baumol & Willig, 1981, p. 418). In the case of an incumbent, such funds have already been expended and they are already exposed to whatever risks the market entails (Baumol & Willig, 1981, p. 418). In contrast, the new firm must incur any entry costs on entering the market that incumbents don't bear.

Entry will occur in the event that the profits expected by a successful entrant outweigh the unrecoverable entry costs that will be lost in the case of failure (Baumol & Willig, 1981, p. 418). Hence, the need to sink costs can therefore constitute a barrier to entry.

In a market situation where there is an absence of barriers to entry, if incumbents offer profit-making opportunities to potential entrants then they leave themselves exposed to the possibility of hit and run entry, whereby new firms enter the market and gather up all the available profit and depart once the going gets tough. This is what has been dubbed a *contestable market*, and describes a market that is vulnerable to costlessly reversible entry.

Within a contestable oligopoly, Baumol observes that it can only immunise itself from the threat of hit and run entry by setting price equal to marginal cost (Baumol, 1982, p. 2). Hence, a perfectly contestable market delivers exactly the same outcome as that of a perfectly competitive market with no consequent loss of allocative efficiency. Baumol concludes that the oligopoly

equilibrium in a perfectly contestable market "yields a determinate set of prices and outputs that is not dependent upon assumptions about the nature of incumbent firm's expectation relating to entrants' behaviour and offers us a concrete and favourable conclusion on the welfare implications of contestable oligopoly" (Baumol, 1982, p. 12).

Since the seminal work of the 1982 Nobel Laureate for economics George Stigler (Stigler, 1964), oligopoly theory has been often viewed as the problems associated with enforcing a tacitly collusive agreement between market rivals. Rather than assuming the manner in which firms would behave, Stigler sought to identify what industry characteristics gave rise to collusion, as well as those that made it more difficult to achieve.

In his model, Stigler assumed that collusion takes the form of a joint determination of output and price by ostensibly independent firms. Once the form of collusion had been agreed upon, the critical issue was to ensure the stability of the collusive agreement. This became an issue of enforcement, as it was recognised that any member of the agreement could maximise their own individual profit by undercutting other members on the agreed price. To Stigler, enforcement of the agreement consisted of being able to detect significant deviations from the agreed-upon price. It was contended that price deviations would disappear once detected, as they would be matched by fellow conspirators if not subsequently withdrawn.

According to Stigler, an oligopolist would not consider making secret price cuts to buyers whose purchases fell below a certain size relative to their aggregate sales. From this, it was deduced that oligopolistic collusion would often be effective against small buyers even when it was ineffective against large buyers. A key finding from Stigler's model is that the aggregate gain in sales to a firm from secret price-cutting, thus its total incentive to cheat, is the sum of the gains from each rival firm, and is therefore increased roughly in proportion to the number of rival firms. In other words, the more rivals there are, the easier it is going to be to cheat on a collusive arrangement. Another important finding was that the incentive to cheat by secret price-cutting falls as the number of customers per seller increased. This reflected that the pay-off from cheating diminished in the event that buyers are relatively small in the size of their overall purchases. In addition, Stigler concluded that collusion was less feasible the less clear the basis on which it should proceed.

The most significant recent contribution to oligopoly theory has been the development of dynamic models taking a game-theoretic approach. According

to Professor Jonathan Baker[13], although repeated interaction can change the incentive structures faced by firms increasing the possibility for cooperative behaviour leading to tacit collusion, Stigler's insight that tacit collusion is not inevitable has still not been undermined (Baker, 1999, p. 185).

It is possible for a market to exhibit a high degree of concentration but still be workably competitive. For example, despite exhibiting a high degree of market concentration, the ACCC found that grocery retailing was workably competitive (Australian Competition and Consumer Commission, 2008, p. xiv).

One indicator of workable competition could be provided by the instability of market shares. Prominent American industrial organisation economist Richard E Caves and world renowned expert on competitive strategy and international competitiveness Michael Porter have commented in regard to market share instability that:

> It indicates conditions hostile to the effective recognition of mutual dependence among oligopolists, and hence favours an allocation of resources more nearly matching the competitive norm. (Caves & Porter, 1978, p. 310)

Prominent US antitrust jurist Richard Posner has argued that the primary focus of antimonopoly policy should be on the maintenance of competitive pricing, and not on particular numbers of competitors (Posner, 1970, p. 531).

An overemphasis on market structure may overlook whether market conduct is sufficient to deliver satisfactory outcomes in terms of competitive pricing and societal welfare. The risk with a policy approach that places an overemphasis on market structure is that it may come at the expense of preserving competitive pricing, thus undermining societal welfare.

[13] Professor at the American University's Washington College of Law and former Director of the Bureau of Economics at the US Federal Trade Commission.

4 Anti-Competitive Detriment of Creeping Acquisitions

There are potentially several sources of anti-competitive detriment arising from creeping acquisitions. Given the subject of creeping acquisitions has been raised most often in regard to the Australian grocery industry, this submission will use examples of potential anti-competitive detriment arising from the grocery industry for illustrative purposes. In regard to the grocery industry, anti-competitive detriment arising from creeping acquisition could have several possible sources:

- Adverse horizontal effects where the merged entity accumulates sufficient market power post-merger to profitably raise prices post-merger
- Adverse horizontal effects from increased vertical integration arising from raising rivals' costs
- Adverse vertical effects where the merged entity accumulates sufficient market power post-merger to exercise buyer power against suppliers.

Each of these potential sources of anti-competitive detriment will be considered in turn.

4.1 Adverse Horizontal Effects

In this instance, creeping acquisitions could result in a horizontal anti-competitive detriment due to either unilateral or coordinated effects.

Despite outlining several factors that impede competition, the ACCC found that grocery retailing in Australia is workably competitive (Australian Competition and Consumer Commission, 2008, p. xiv). At the very least, this suggests that the major supermarket chains (MSCs) in Woolworths and Coles do impose a competitive constraint on the conduct of one another. Under these circumstances, at the aggregate level there is unlikely to be any anti-competitive detriment in grocery retailing due to the exercise of unilateral market power.[14]

Given the comments of the ACCC and its Chairman, Mr Graeme Samuel, over a number of years, it would appear that there is little evidence supportive of the exercise of coordinated market power in grocery retailing between the MSCs in Australia. In 2004 when reflecting on a series of supermarket acquisitions by Coles, the ACCC commented:

[14] This does not preclude the possibility of the exercise of unilateral market power in a particular locality.

> … information provided to the ACCC and its own independent analysis suggests that Coles and Woolworths do compete vigorously against each other in the retail grocery sector. While the current program of acquisitions may negatively affect the competitiveness of the independent sector, the degree of competition between Coles and Woolworths indicates the acquisitions would not be likely to result in an increased likelihood of coordinated conduct. (Australian Competition and Consumer Commission, 2004, p. 51)

According to ACCC Chairman Graeme Samuel in 2006:

> "If I look at their [Coles and Woolworths] earnings before interest and tax margins, they are about 3 per cent. Interestingly, they have the lowest EBIT margins in the grocery sector in most of the developed world … They're big, they're powerful, they're dealing with suppliers, they're tough. Sometimes they're tough and we deal with it, but there's no law against tough bargaining. That's the nature of business.
>
> "Markets have a way of sorting themselves out. I know there are complaints about Coles and Woolies but they've just joined the ranks of the big banks which are barstards and the major oil companies that are running cartels. I mean, you've got clichés that have been there for a long time – because they're big they'll be subject to attack. What I guess encourages us is that the EBIT margins are so small that the competition appears to be very vigorous." (Ferguson, 2006, p. 36)

According to ACCC Chairman Graeme Samuel in 2008:

> I think there would be very few observers in the marketplace that would say to you, "Coles and Woolworths are not vigorously competing against each other." (ABC Television, 2008)

Even if any entity in grocery retailing, or any other market for that matter, were capable of exercising either unilateral or coordinated market power post-merger, it would appear that section 50 of the TPA is sufficiently robust to deal with this situation. The ACCC's *Merger Guidelines* states that the ACCC considers both horizontal unilateral and coordinated effects in its administration and enforcement of section 50 of the TPA (Australian Competition and Consumer Commission, 2008b).

In response to a recommendation from the Joint Select Committee on the Retailing Sector report, *Fair Market or Market Failure*, the then Government amended section 50 of the TPA to ensure that the geographic scope of the market did not inadvertently preclude the consideration of markets smaller than those operating on a state or national basis. In this case, section 50 was amended to ensure that the geographic scope of the market could include markets operating on either a national, state or regional basis.

In June this year, the ACCC demonstrated that the current operation of section 50 of the TPA does not preclude it from taking action to oppose the single acquisition of a supermarket site in a very narrowly defined geographic market space. On 25 June 2008 the ACCC announced that it would oppose the

acquisition of the Karabar Supabarn supermarket in Queanbeyan by Woolworths on the basis of its likely anti-competitive effect in the local retail supermarket market (Australian Competition and Consumer Commission, 2008a). On this occasion, the ACCC defined the geographic market as the Queanbeyan central business district and at Jerrabomberra.

The available evidence suggests that section 50 of the TPA is adequate to address any horizontal anti-competitive detriment arising from any merger.

4.2 Raising Rivals' Costs

Raising rivals' costs (RRC) is a form of anti-competitive exclusion whereby conduct by a predatory firm or firms places rival competitors at a cost disadvantage sufficient to allow the predatory firm or firms to exercise market power by raising prices (Krattenmaker & Salop, 1986, p. 214). Within the economics literature, RRC was first articulated by Professor Steven Salop of Georgetown University and Professor David Scheffman of Vanderbilt University (Salop & Scheffman, 1983). As a means of predatory conduct, Salop and Scheffman have identified a number of advantages of RRC, particularly as compared to predatory pricing conduct:

- It may induce a rival to exit the market
- It is far better to compete against a high cost competitor than a low cost competitor, and thus RRC can be a profitable strategy even if the target firm doesn't exit the industry
- A higher-cost rival quickly reduces output, allowing the predator to immediately raise price or market share
- There is no need to sacrifice profits in the short run for a speculative and indeterminate level of profits in the long run (such as the case with predatory pricing)
- There is no need for deep pockets or superior access to financial assets. (Salop & Scheffman, 1983, p. 267)

Professor Jonathan Baker has described exclusionary practices of RRC as creating an involuntary or coerced cartel (Baker, 1995).

In grocery retailing, there may be an anti-competitive detriment arising from creeping acquisitions due to the acquisition of numerous independent supermarket sites that put an independent wholesaler at a competitive disadvantage due to RRC. In this case, a series of acquisitions by the major grocery chains could lead to exclusionary effects by increasing the costs of doing business for an independent grocery chain through foreclosing on their access to a sufficient customer base, conduct that is referred to as customer foreclosure.

Professor Jeffrey Church of the University of Calgary has described customer foreclosure in the following terms:

> Customer foreclosure occurs when, post-merger, the downstream division of the integrated firm no longer sources supply from independent upstream firms. If this leads to a reduction in sales volume and that sales volume reduction leads to an increase in the average cost or marginal cost of upstream competitors, then, to the extent there is exit (from higher average costs) or reduced competitive vigor (from increased marginal costs) the competitive constraint these firms exert on the upstream division of the integrated firm will be reduced, leading to greater market power upstream and higher input prices. (Church, 2004, pp. 11-12)

The ACCC has previously outlined how creeping acquisitions could have a detrimental impact on the operations of independent wholesalers through several mechanisms:

- Due to a reduced customer base, an independent wholesaler will have fewer customers over which to spread the cost of its overheads for items such as warehouse, transport and administration.
- There may be a negative impact upon the terms of trade received by independent wholesalers, referred to as on-invoice costs. Suppliers achieve cost savings by delivering their products in whole truckloads or some other minimum order quantity. In order to encourage wholesalers to order quantities which are convenient to deliver, it is common practice for suppliers to offer quantity buy allowances or volume discounts.
- This problem can be overcome and the independent wholesaler retain the quantity buy allowance by ordering the same amounts less frequently. However, this cannot be achieved without incurring an additional cost burden in the form of higher average warehouse costs per sale.
- An important source of funds for independent wholesalers is discretionary monies, which are known as off-invoice benefits, consisting of such things as supplier rebates for achieving a certain pre-determined sales volume, sales growth, or promotional success targets. Any reduction in sales of a supplier's product is likely to have adverse consequences for off-invoice benefits. (Australian Competition and Consumer Commission, 2004, p. 28)

While in its recent grocery report the ACCC didn't explicitly raise the subject of RRC and customer foreclosure, the ACCC has previously used RRC and customer foreclosure to examine the competitive effects of a series of acquisitions of supermarket sites by Coles. In this instance, the ACCC concluded that:

> Despite the merits of applying RRC to analysis of such a program of acquisition in the grocery sector, in this instance the ACCC considers that the recent performance of the major independent wholesaler means that no substantial lessening of competition is likely to arise from Coles' acquisitions. Using RRC, the anti-competitive detriment arising from acquisitions by the national chains is predicated on a loss of volume for

> an independent wholesaler. However, current market analysis suggests that the major independent wholesaler has continued to increase its market share. (Australian Competition and Consumer Commission, 2004, p. 51)

The ACCC's *Merger Guidelines* makes reference to the anti-competitive detriment arising from foreclosure in vertical mergers arising from:

- limiting, or denying access by, upstream (non-integrated) rivals to a sufficient customer base; or
- raising the cost of access by upstream (non-integrated) rivals to a sufficient customer base. (Australian Competition and Consumer Commission, 2008b, p. 23)

On this basis, it would appear that the ACCC already makes specific provision for the anti-competitive effects of customer exclusion in their *Merger Guidelines*.

However, it should not be forgotten that increased vertical integration can have positive effects on allocative efficiency through the elimination of double marginalisation. Double marginalisation, which was identified by American economist Joseph Spengler, occurs wherever there is any market power exercised at successive vertical stages of production (Spengler, 1950). If market power is exercised at successive vertical stages of production, for example at the grocery wholesale level and the retail level, then the wholesaler will mark up the product in order to make a profit and the retailer will then take the wholesale price and mark it up again. This double mark up on the product leads to lower total sales and lower total profit than if the wholesaler and retailer were vertically integrated. Thus, vertical integration can counter the effects of double marginalisation and thereby improve allocative efficiency. In regard to the benefits arising from vertical integration, Spengler observed:

> Horizontal integration may, and frequently does, make for higher prices and a less satisfactory allocation of resources than does pure or workable competition. Vertical integration, on the contrary, does not, as such, serve to reduce competition and may, if the economy is already ridden by deviations from competition, operate to intensify competition. (Spengler, 1950, p. 347)

Improvements in allocative efficiency arising from the elimination of double marginalisation would need to be balanced up against the prospect of any anti-competitive detriment arising from RRC through customer exclusion in a merger increasing the level of vertical integration.

If the anti-competitive detriment raised by creeping acquisitions is RRC through customer foreclosure, then given the ACCC's previous consideration of this matter as well as its current *Merger Guidelines*, it would suggest that this potential anti-competitive detriment can already be adequately addressed through the existing provisions of section 50 of the TPA.

4.3 Buyer Power

Another possible concern with creeping acquisitions is that it may provide purchasers of intermediate goods with buyer power that could result in an anti-competitive detriment. Professor Roger Noll of Stanford University has defined buyer power in the following terms:

> …"buyer power" refers to the circumstance in which the demand side of a market is sufficiently concentrated that buyers can exercise market power over sellers. A buyer has market power if the buyer can force sellers to reduce price below the level that would emerge in a competitive market. (Noll, 2005, p. 589)

A monopsony is a market structure in which there is only a single buyer, known as a monopsonist, that faces many sellers. A monopsony is analogous to a monopoly. Whereas a monopolist seeks to reduce production so that it can profitably raise the price of a good, a monopsonist seeks to reduce its purchases of an intermediate good so that it can profitably reduce its purchasing price. If a monopsonist succeeds in reducing the amount of an intermediate good produced then there will be a reduction in allocative efficiency in that society would prefer that more of the intermediate good be produced but this is prevented through the exercise of buyer power.

With a monopsonist of an intermediate good able to exercise buyer power, consumers of the final end product do not receive any benefit from the lower price extracted for the intermediate good by the monopsonist (Blair & Harrison, 1991). Instead, the lower price for the intermediate good extracted by the monopsonist will be retained as profit.

If the monopsonist is selling their final end good into a competitive market, then the price of the good will be determined by the market. In this situation, while the exercise of buyer power reduces allocative efficiency for producers of the intermediate good it has no effect on welfare for consumers of the final end product (Dobson, Waterson, & Chu, 1998, p. 27). However, if the monopsonist also exercises market power in the market for the final end good then consumer welfare will be adversely affected through higher prices.

Australian markets for the supply of inputs to the grocery industry could not be characterised as a monopsony, but could be described as an oligopsony where relatively few buyers face numerous sellers of intermediate goods. Australian markets for the supply of inputs to the grocery industry could also often be characterised as being oligopolistic. Where the market for the supply of an intermediate goods is relatively concentrated on both the selling and the buying side, the welfare implications are not so clear cut (Dobson, Waterson, & Chu, 1998, p. 5). According to a research paper published by the UK Office of Fair Trading:

> If buyer power can be exerted against imperfectly competitive suppliers without increasing the buyers' own selling power, then the exercise of buyer power *may* be socially beneficial. (Dobson, Waterson, & Chu, 1998, p. 5)

Similarly, the ACCC has recently commented in its grocery inquiry report:

> … the broader impact of buyer power on economic welfare is still not yet settled in the economic literature. In particular, it is not yet clear if buyer power results in a gain or a loss to consumers. However, if lower supply prices are passed through to consumers in the form of lower retail prices, then this will generally result in a gain to consumer welfare. (Australian Competition and Consumer Commission, 2008, p. 387)

Several prominent competition law jurists have argued that the exercise of buyer power should be subject to the some level of sanction comparable with the exercise of market power on the selling side of the market:

> Antitrust policymakers and, to some extent, antitrust scholars have never fully incorporated the symmetry of markets into their analysis. They have focused almost exclusively on the behaviour of sellers. Yet the simple truth is that there is a buyer for every seller, and anti-competitive conduct by buyers can cause adverse economic consequences similar to those caused by anti-competitive conduct by sellers. (Blair & Harrison, 1991, p. 339)
>
> The argument for prohibiting monopsony practices, but not the corresponding monopoly practices, has no theoretical or empirical foundation in economics. (Noll, 2005, p. 591)

Even if creeping acquisitions results in the accumulation and exercise of buyer power that results in an anti-competitive detriment, there is nothing to preclude consideration of buyer power in the competition analysis of mergers for their compliance with section 50 of the TPA. Subsection 50(3) contains a list of non-exhaustive matters that must be taken into account to determine whether a merger or acquisition is likely to result in a substantial lessening of competition in breach of section 50. While subsection 50(3) does not make reference to the consideration of buyer power, it does not preclude other matters from being taken into consideration. Hence, there is nothing to prevent the consideration of buyer power by either by the ACCC, the Australian Competition Tribunal, or the Federal Court in the consideration of a merger and its compliance with section 50 of the TPA.

In its recent inquiry into grocery retailing, the ACCC has considered the exercise of buyer power by the MSCs and concluded that there was little evidence available to substantiate claims made that it resulted in any anti-competitive detriment:

> The inquiry was provided with little evidence to substantiate anecdotal allegations of buyer power being exercised in an anti-competitive or unconscionable manner rather than simply to drive a bargain that was harder than the supplier would have preferred. (Australian Competition and Consumer Commission, 2008, p. 407)

> In relation to fresh produce, there is no credible evidence that MSCs (or anyone else) can manipulate wholesale prices to suppress prices below competitive levels. (Australian Competition and Consumer Commission, 2008, p. 407)
>
> Farm gate prices are determined by the supply and demand conditions prevailing in the relevant market, rather than by buyer power. In many instances, farm gate prices are heavily influenced by supply and demand in world markets. (Australian Competition and Consumer Commission, 2008, p. 407)

While the ACCC recognised that buyer power did exist in the Australian grocery sector, it came to the conclusion that its exercise did not result in any anti-competitive detriment:

> Coles, Woolworths and Metcash have significant buyer power in relation to many packaged grocery products because many suppliers effectively have little option other than to deal with these buyers. Competition between retailers is, however, sufficient to ensure that Coles and Woolworths cannot simply retain all of the benefits of the lower wholesale prices they extract—at least some of the benefits flow to consumers in the form of lower retail prices. (Australian Competition and Consumer Commission, 2008, p. xv)
>
> The buyer power of Coles, Woolworths and Metcash may adversely affect individual competitors. However, the role of the ACCC is to consider competition, not individual competitors. There is no significant evidence to suggest that innovation or competition at the supplier level has been damaged. Further, consumers can benefit from buyer power in the form of lower prices. (Australian Competition and Consumer Commission, 2008, p. xxiii)

Even if buyer power results in an anti-competitive detriment likely to cause a substantial lessening of competition, there is nothing preventing its consideration in regard to the application of section 50 of the TPA. Under these circumstances, it would appear that section 50 is capable of dealing with the accumulation and exercise of buyer power arising from creeping acquisitions.

4.4 Conclusions on Anti-competitive Detriments

It would appear that there has so far been no anti-competitive detriment identified relating to creeping acquisitions that cannot be adequately addressed through the existing section 50 of the TPA. The existing provision appears to be sufficiently flexible and robust to deal with any possible anti-competitive detriment at the present time. This view is also consistent with the conclusion previously reached by the Dawson report:

> … the Committee is of the view that section 50 in its present form is adequate to enable the ACCC to consider creeping acquisitions in so far as they raise questions of competition. (Dawson, Segal, & Rendall, 2003, p. 67)

While it is still possible that there may be other scenarios where creeping acquisitions result in an anti-competitive detriment that cannot be dealt appropriately with through section 50, they have so far not been identified nor articulated. This suggests that the case for amending section 50 of the TPA to address creeping acquisition has not yet been satisfactorily made.

5 Review of Proposed Remedies for Creeping Acquisitions

In the Discussion Paper, two proposed remedies are suggested to address the problem of creeping acquisitions:

- An aggregation model where a corporation would be prohibited from making an acquisition if, when combined with acquisitions made by the corporation within a specified period, the acquisition would be likely to substantially lessen competition in a market
- The introduction of an additional substantial market power test.

Both of these two proposed remedies will be reviewed in turn.

5.1 Aggregation Model

The proposed aggregation model would seek to prohibit the latest acquisition in a series of creeping acquisitions and would apply to a combination of acquisitions made by a corporation within a specified period (Commonwealth Treasury, 2008, pp. 5-6).

In order to determine where one in a series of creeping acquisitions is likely to result in an anti-competitive detriment leading to a substantial lessening of competition, it would appear that a 'tipping point' would need to be identified.[15]

There appear to be two main issues regarding the application of an aggregation model:

- Identification of the tipping point where the substantial lessening of competition actually occurs
- Enforcement of section 50 of the TPA for a potential substantial lessening of competition.

Identification of a tipping point would most likely involve a considerable amount of intricate competition analysis on the part of the competition regulator, the ACCC. It is difficult to envisage how the introduction of an aggregation model would make this complex task any simpler or easier.

Furthermore, when a tipping point has actually been reached and identified, it would appear that there is nothing to prevent this situation from being adequately addressed through the existing section 50. For all practical intents

[15] A tipping point is a level at which the momentum for change becomes unstoppable (Walsh, 2007).

and purposes, it would appear that the addition of an aggregation model to section 50 would make no substantive change to the existing provision in guarding against the prospect of a substantial lessening of competition.

In conclusion, it appears that there is nothing particularly special nor unique about the aggregation model that would result in any better outcomes than compared with the existing section 50.

5.2 Substantial Market Power Test

It is intended that a substantial market power test would supplement the SLC test in section 50 of the TPA. The Discussion Paper has described the practical application of the substantial market power test in the following terms:

> Practically, a proposed acquisition could pass the current substantial lessening of competition test in section 50, but not a substantial market power test, where:
>
> - the acquirer facing no significant competitive constraint, and so is likely to have substantial market power; and
> - the merged firm facing no significant competitive constraint but the impact of the proposed acquisition on competition would be less than 'substantial'. (Commonwealth Treasury, 2008, p. 6)

One observation with the substantial market power test is that if the provision has been specifically designed with the intention of addressing the perceived dominance of the MSCs in grocery retailing, then based on the above description contained in the Discussion Paper, it would appear to do little to prevent continued ongoing supermarket acquisitions by either Woolworths or Coles on an aggregate basis. This is because both Woolworths and Coles face at least one significant competitive constraint in each other.

Based on the description of the practical application of the substantial market power test contained in the Discussion Paper, it is difficult to envisage a situation where the test could actually be applied, and furthermore, in the unlikely event that such a situation did arise, whether its use would actually improve market outcomes.

For all intents and purposes, the market situation being described in the Discussion Paper as relevant for the practical application of the substantial market power test is virtually a monopoly where a firm already possesses unfettered and unconstrained market power to choose its own of level of profits by giving less and charging more. This would usually imply that the target firm is not price competitive and/or its output is so miniscule as to have virtually no impact in the event it was acquired by the firm exercising substantial market power. In this situation, it not necessarily clear that the

blocking of a merger necessarily improves market outcomes. Such mergers could remove firms from the market that are not productively efficient[16] or eliminate double marginalisation, which in turn could improve allocative and productive efficiency. In these situations, the substantial market power test would merely serve to protect the diversity of ownership for the sake of diversity itself possibly to the detriment of society.

A potential risk with the substantial market power test is if the actual threshold set is lower than indicated by the practical application of the test described in the Discussion Power. The description of the phrase 'substantial market power' contained in the Discussion Paper would suggest that there may be far greater scope to apply the substantial market power test than has been suggested by the description of the practical application of the substantial market power test. According to the Discussion Paper:

> Broadly, the phrase 'substantial market power' would mean a significant, but not absolute, freedom from competitive restraint, the extent of which would be considered in light of the factors set out in subsection 50(3) and the ability to raise prices above competitive levels.

Under the description of substantial market power contained in the Discussion Paper, it is theoretically possible for the MSCs to be brought within the scope of the substantial market power test. According to the ACCC grocery inquiry report:

- Grocery retailing is workably competitive, but there are a number of factors that currently limited the level of price competition, including: …
- the limited incentives for Coles and Woolworths to compete aggressively on price
- limited price competition that Coles and Woolworths face from the independent sector. (Australian Competition and Consumer Commission, 2008, p. xiv)

The above statement by the ACCC would suggest that Coles and Woolworths may possess the ability to raise prices above the competitive level, thus potentially bringing them within the scope of the substantial market power test. However, this conclusion is completely at odds with the likely outcome arrived at using the practical application of the substantial market power test also described in the Discussion Paper.

[16] Productive efficiency exists when all goods are produced at the minimum possible total cost so that there is no possible rearrangement or alternative organization of resources (such as labour, raw materials, and machinery) that could increase the output of one product without necessarily forcing a reduction in output for at least one other product (Kolasky & Dick, 2003, p. 244).

If the interpretation of the substantial market power test is not entirely clear from the Discussion Paper, then it is difficult to envisage how this task will be any simpler for the courts to determine. The economic and legal literature has provided several different definitions of market power which could provide considerable scope for ambiguity in its interpretation by the courts. One commonly used definition in economics is that provided by US economist Abe Lerner which is the ability of a firm to push its price above marginal cost (Lerner, 1934). However, the problem with the Lerner definition of market power is that it is often difficult to measure marginal cost in the real world.

Another definition of market power comes from prominent US antitrust jurists Carl Kaysen and Donald Turner:

> A firm possesses market power when it can behave persistently in a manner different from the behaviour that a competitive market would enforce on a firm facing otherwise similar cost and demand conditions. (Kaysen & Turner, 1959, p. 75)

This definition has been used by the ACCC (Australian Competition and Consumer Commmission, 2002, p. 64) and in a prominent Australian legal judgement[17]. Another definition of market power provided by prominent US antitrust jurists William Landes and Richard Posner is "the ability of a firm to raise price above the competitive level without losing so many sales so rapidly that the price increase is unprofitable and must be rescinded" (Landes & Posner, 1981, p. 937).

If the threshold for the activation of the substantial market power test were set too low, then the amended section 50 could create considerable uncertainty. Furthermore, a low threshold would prevent much beneficial merger activity that results in absolutely no substantial lessening of competition. The Discussion Paper refers to several benefits that could be achieved through mergers including improvements in allocative, productive and dynamic efficiency[18] (Commonwealth Treasury, 2008, p. 1). Under these circumstances, the substantial market power test could be used inadvertently to thwart much desirable conduct to the detriment of societal welfare.

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[17] Cited with approval by Dawson J in *Queensland Wire Industries Proprietary Limited v The Broken Hill Proprietary Company Ltd and Anor* (1989) 167 CLR 177 at 200

[18] Dynamic efficiency arises from market processes that encourage innovation to lower costs and develop new and improved products. Whereas allocative and productive efficiency can be viewed as static criteria—holding society's technological know-how constant—a more dynamic view of efficiency examines the conditions under which technological know-how and the set of feasible products optimally can be expanded over time through means such as learning by doing, research and development, and entrepreneurial creativity. (Kolasky & Dick, 2003, p. 247)

5.3 Conclusion on Proposed Remedies for Creeping Acquisitions

It would appear that the proposed aggregation model would not make any substantive difference to that already served by the current section 50 of the TPA. Similarly, if the substantial market power test is based on the description of its practical application contained in the Discussion Paper, then it would serve little practical purpose given that it would probably only be applied in an extremely limited number of cases.

On the other hand, based on the definition of substantial market power contained in the Discussion Paper, the threshold for the application of the substantial market power test could set considerably lower. This could create considerable uncertainty as well as potentially thwarts much beneficial merger activity.

6 Unintended Consequences from a New Legislative Provision

Given the absence so far of a sufficiently robust argument in support of a new legislative provision to guard against the anti-competitive detriment arising from creeping acquisitions, there is a significant risk that any new law could have perverse and unintended consequences.

According to the ACCC:

> The object of the [Trade Practices] Act is not to protect individual competitors from vigorous competition. Competition, by its very nature, will involve damage to some competitors and the success of other competitors. (Australian Competition and Consumer Commission, 2008, p. 7)

The Government needs to be extremely careful that by seeking to address the issue of creeping acquisitions, it is not seeking to protect individual competitors at the expense of the competitive process.

The following subsections focus on two potential pitfalls arising from an ill-considered legislative provision targeting creeping acquisitions.

6.1 The US Robinson-Patman Act

The US Robinson-Patman Act was enacted in 1936 in the aftermath of the Great Depression following the emergence of large, successful grocery-store chains. Protection of small retail business interests was the primary driving force behind the enactment of the Robinson-Patman Act, which was introduced by the US Congress following pressure from independent grocers and drug store lobbies amidst concerns over the buying power wielded by large retailers (Dobson, Waterson, & Chu, 1998, p. 28). Prominent US antitrust jurist Robert Bork has described the genesis of the Robinson-Patman Act in the following terms:

> Enacted in 1936, the statute was a child of the depression, as was so much pernicious economic regulation. Robinson-Patman shared with much of that other regulation … the premise that free markets were rife with unfair and anti-competitive practices which threatened competition, small business, and consumers. Price discrimination was thought to be such a practice, in large measure because of the chain store movement… The chains purchased in volume and often took over certain distributive functions from suppliers, thus creating cost savings that were reflected in an ability to buy for less. Superior efficiency is not popular with those who must compete against it, and it never seems well understood by lawmakers. In any case, the cry went up that the chains were prospering unfairly as recipients of low prices; anti-chain store legislation in various forms was adopted in many states, and at the national level the

> result was a statute drafted by counsel for a wholesale grocers association, the Robinson-Patman Act. (Bork, 1993, pp. 382-383)

According to Professor Jeffrey Church of the University of Calgary and Professor Roger Ware of Queen's University:

> The [Robinson-Patman] Act has been universally condemned by economists for focusing on the protection of competitors rather than on competition, and for condemning *price differences* rather than making any attempt to identify true price discrimination… (Church & Ware, 2000, p. 177)

The risk of enacting an ill-considered legislative provision to address creeping acquisitions is that Australia could be enacting its own version of the Robinson-Patman Act. Any legislative provision focusing on the protection of specific competitors rather than the competitive process could work towards undermining the objective of the TPA to enhance the welfare of Australians through competition.

The Dawson report has warned that a focus on preserving numbers of competitors rather than competition was more suitably the policy domain of industry policy rather than competition policy:

> … while a genuine competitive environment exists, the preservation of the number of competitors in a market is more a matter for industry policy than for competition policy. A concentrated market may be highly competitive. Whilst there may be a desire to preserve the number of competitors in a competitive market, it will ordinarily be for policy reasons other than the promotion of competition. Part IV of the [Trade Practices] Act is concerned with the promotion of competition rather than industry policy. (Dawson, Segal, & Rendall, 2003, pp. 67-68)

6.2 The Market for Corporate Control

The ACCC has previously observed that the threat of takeover imposes an important discipline on the performance of company managers:

> Apart from the stock market, there are no objective standards of managerial efficiency. Only takeovers offer some assurance of competitive efficiency among corporate managers. The threat of takeover imposes a competitive discipline on managers to perform, otherwise their companies will be vulnerable to takeover. (Australian Competition and Consumer Commmission, 2002, p. 134)

In a similar vein to the ACCC, the Commonwealth Government Minister for Small Business, Independent Contractors and the Services Economy, the Hon. Craig Emerson MP, has recently warned about the possible detrimental consequences of unnecessarily restrictive mergers laws:

> … great care needs to be taken to ensure that competition laws and practice do not, in fact, stifle competition by protecting inefficient businesses from mergers and takeovers by more efficient operators. Inefficient, poorly-run businesses should be

> subject to takeovers or mergers by or with efficient, well-run businesses, as long as the resulting entity behaves competitively against other rivals. Two business rivals in an industry might be constantly at each other's throats to the benefit of consumers while five businesses might collude against consumers through price fixing. It is not the share of businesses in a market that matters but whether those businesses are behaving competitively. (Emerson, 2008)

The comments by both the ACCC and Minister Emerson appear to draw on the pioneering work of Professor Emeritus Henry Manne formerly of George Mason University Law School. In writing on the subject of mergers and the market for corporate control, Manne contended that "[o]nly the take-over scheme provides some assurance of competitive efficiency amongst corporate managers" (Manne, 1965, p. 113). In assessing the competition law implications of a merger, Manne argued that these needed to weighed up against the benefits of a merger from the viewpoint of the market for corporate control. Amongst the advantages of a market corporate control, Manne identified the following:

> … a lessening of wasteful bankruptcy proceedings, more efficient management of corporations, the protection afforded non-controlling corporate investors, increased mobility of capital, and generally a more efficient allocation of resources. (Manne, 1965, p. 119)

Another unintended consequences arising from the enactment of an ill-considered provision to address creeping acquisitions is the possible stifling of the market for corporate control.

7 Conclusions

It would appear that there has so far been no anti-competitive detriment identified relating to creeping acquisitions that cannot be adequately addressed through the existing section 50. While it is possible that there may be other scenarios where creeping acquisitions result in an anti-competitive detriment that cannot be dealt with through section 50, they have so far not been identified nor articulated. This suggests that the case for amending section 50 of the TPA to address creeping acquisitions has not yet been satisfactorily made. Thus, a potential concern is that any new legislative provision directed towards creeping acquisitions may breach the first principle of good regulatory process recommended by the Regulation Taskforce in that Governments should not act to address 'problems' until a case for action has been clearly established. Under these circumstances there is a significant risk that any new law could have perverse and unintended consequences.

There is concern that the Government's policy approach in dealing with creeping acquisitions is placing an overemphasis on market structure to the detriment of actual market conduct. The risk with this approach is that it may come at the expense of preserving competitive pricing, thus undermining societal welfare. If the Government's policy objective is to maintain diversity of competitors, then industry policy would appear to offer a more appropriate policy response to the issue of creeping acquisitions.

The proposed aggregation model would appear not to make any substantive difference to the existing law. Similarly, if the substantial market power test is based on the description of its practical application contained in the Discussion Paper, then it would serve little practical purpose given that it would probably only be applied in an extremely limited number of cases. The risk with the substantial market power test is in the event that the threshold is set too low. This could create considerable uncertainty as well potentially thwart much desirable conduct that may in turn undermine societal welfare.

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