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The General Manager
Competition and Consumer Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

10th July 2009

Re: Creeping Acquisitions - The Way Forward

Dear Sir/Madam,

I am pleased to enclose a submission paper in response to Treasury's discussion paper "Creeping Acquisitions - The Way Forward".

This submission has been prepared by a team of our economists based in Melbourne. If you have any questions regarding this submission, in the first instance please contact us at (3) 9935 2800.

Yours sincerely,

Simon Bishop

Partner

RBB Economics LLP

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RBB Comments on the Proposed Creeping Acquisitions Law in Australia

RBB Economics, 10 July 2009

1. Introduction and Executive Summary

This short paper, prepared by RBB Economics, responds to the second discussion paper released by the Australian Government on 6th May 2009, relating to the introduction of a creeping acquisitions law in Australia.[1] The motivation for such law is to close a perceived gap in Australian merger control; namely, that section 50 of the Trade Practice Act 1974 (TPA) may not be sufficient in dealing with creeping acquisitions. A creeping acquisition has been described as follows:

> *"The term 'creeping acquisition' generally refers to the practice of making a series of acquisitions over time that individually do not raise competitive concerns, usually because the changes in competitive rivalry from any individual acquisition are too small to be considered a substantial lessening of competition. However, when taken together, the acquisitions may have a significant competitive impact. (…) ['Creeping acquisition'] may also refer to a player with existing market power making a small acquisition, even though the small acquisition does not substantially lessen competition itself."*[2]

1 On 1st September 2008, the Australian Government released its first discussion paper related to the introduction of a creeping acquisitions law.

2 Report of the ACCC inquiry to the competitiveness of retail prices for standard groceries can be found with the following link. http://www.accc.gov.au/content/item.phtml?itemId=838251&nodeId=ada0fb93c16b68d5a78ac665943b688d&fn=Grocery%20inquiry%20report,%20overview.pdf

This short paper provides some comments on this issue and the questions raised in the second discussion paper from the perspective of economists advising in competition law proceedings.

Section 2 reviews the basic economic principles that underpin the competitive assessment of horizontal merger in order to provide a background to the following discussion. Section 3 examines whether the current merger legislation in Australia is sufficient in addressing concerns related to creeping acquisitions. We conclude that there is no meaningful gap in Australian merger control and therefore there is no substantive basis for extending the law to cover creeping acquisitions. Finally, Section 4 provides some comments on the regulatory models proposed in the second discussion paper relating to the introduction of a creeping acquisitions law in Australia.

In summary, we consider that it is *not* necessary to introduce a creeping acquisitions law in Australia for the simple reason that existing merger control in Australia is sufficient to capture all anticompetitive mergers; in other words, mergers deemed not to give rise to a substantial lessening of competition should be allowed to proceed. In consequence, the proposed amendment to the law carries a severe risk of over-intervention that is likely to have adverse effects for the Australian economy in general and therefore for Australian consumers.

2. Overview of the Economics of Horizontal Mergers[3]

A merger is said to be *horizontal* if the parties involved undertake directly competing activities. All horizontal mergers have the following effects; they reduce the number of firms active on the relevant market and therefore result in an increase in market concentration. Although specific horizontal mergers each raises their own particular competition issues, the structural changes brought about by horizontal mergers can result in a significant lessening of competition in two potential ways; either the merger gives rise to unilateral effects or the merger gives rise to coordinated effects.[4]

By eliminating the competitive constraint which currently exists between the merging parties, a horizontal merger may weaken to a significant degree the strength of the overall competitive constraints acting on one or both of the two parties. As a result, the prices charged by the merged entity may increase relative to their pre-merger level regardless of any competitive response of rival firms. A merger which has these characteristics is said to give rise to a situation of *unilateral effects.* Such price increases are known as *unilateral* price increases as they do not rely on the merged entity's remaining competitors adopting a particular mode of conduct.

Alternatively, a horizontal merger may lead to a reduction in the effectiveness of competition if the change in market structure creates a competitive environment which is more conducive for two or more firms to collectively adopt a mode of competitive behaviour that reduces the intensity of competition and thereby increase prices above the levels that would have prevailed

[3] Of course, merger control also covers vertical and conglomerate mergers. However, the proposed amendment to the law is to capture creeping acquisitions, which is essentially designed to address horizontal issues.

[4] Some commentators consider there to be a third category of potential competition harm; namely *non-unilateral effects*. According to Scheffman and Coleman (2003) "[n]on-unilateral" is broader than coordinated interaction. However, the examples put forward by Scheffman and Coleman, on a proper analysis, fall either into unilateral effects or coordinated effects. We do not therefore subscribe to this "third way".

but for the merger. A merger which has these characteristics is said to give rise to *coordinated effects*. Such price increases are termed *coordinated effects* since the price increase depends on a number of firms, and not just the merged entity, altering its behaviour.

There is a clear distinction to be drawn between unilateral effects and coordinated effects: the former is not predicated on one or more rival firms adopting a particular mode of competitive behavior, whilst the latter is. It is important not to confuse the possible responses of rival firms to a post-merger unilateral price increase as a coordinated effect. In many instances, a unilateral price increase by the merged entity will lead to the remaining competitors also increasing their prices. But that behaviour does not properly constitute coordinated effects since the initial price increase is optimal for the merged entity even if competing firms do not alter their competitive behaviour.

We consider the main economic issues arising in relation to both unilateral effects and coordinated effects.

2.1. Unilateral Effects

A horizontal merger will give rise to unilateral effects if and only if the merged entity would find it profitable post-merger to increase price (or restrict output) acting unilaterally; namely, independently of its competitors.[5] Any increase in price (or equivalently a restriction of output) is always associated with both benefits and costs. The profitability of restricting output will depend on these two countervailing factors. The benefits arise primarily from the increase in price.[6] The costs of price increases or equivalent output restrictions arise from the loss of the margins that would have been earned absent the loss in sales. The greater the margin earned on each sale, the greater the opportunity cost associated with a given price increase or output restriction, and the more likely that such a strategy is unprofitable.[7]

The standard approach to determining whether a horizontal merger is likely to give rise to unilateral effects involves an assessment of post-merger market shares. This traditional assessment of mergers implicitly measures the key factors discussed in the previous section. *Ceteris paribus*, the higher the merged firm's market share, the greater is the benefit on the installed customer base of a price increase or an output restriction.[8] Furthermore, market shares may provide a useful proxy for the strength of competitive constraints provided by each firm in the relevant market: i.e. the larger the market share of a merging party, the greater its pre-merger competitive constraint is assumed to be.

As a result, in general, the larger the post-merger market share of the merged entity, the more likely the merger is, *ceteris paribus*, to give rise to unilateral effects. In Europe, combined

[5] *Note here,* this is not to say that competitors will not respond to the merger. Typically, post-merger competitors will adjust their commercial behaviour. However, the profitability of the unilateral price increase does not require that competing firms react in a certain manner. This is unlike coordinated effects, where the profitability of the post-merger output restriction depends on the competitive behaviour of competing firms.

[6] If one is concerned with capacity as the relevant description of output, the benefit will also extend to deferred capital expenditure costs.

[7] This insight is analogous to that provided by critical loss analysis.

[8] Of course, the higher is the demand and supply elasticity in a given market, the less likely the firms are, even at a high market share, to find an attempted increase in price profitable.

market shares above 40 per cent were usually seen as providing a threshold below which no competition concerns were raised. However, it is understood that market shares can under- and overstate the competitive constraint that exists pre-merger between the merging parties. This can be the case where firms supply highly differentiated goods or services.[9] Where goods or services are highly differentiated, market shares do not always provide a good indicator of the likely competitive effects of a merger since some products are “closer” competitors than others. In assessing the likelihood of a horizontal merger giving rise to unilateral effects, it is therefore important to assess whether market shares over- or understate the magnitude of the competitive constraint between the merging parties.

However, regardless of its level, the market share threshold is merely a filter and it ought not to be presumed that mergers exceeding the threshold necessarily give rise to competition concerns. It is now widely recognised that the scope for a merger to give rise to unilateral effects depends not just on market shares but also on other factors and in particular on the ease with which rival firms can expand output and the dynamic responses that those rivals might make (for example, through the repositioning of existing products) in response to attempts by the merged entity to increase price.

Some general factors that affect the likelihood of a merger giving rise to unilateral effects are as follows. It can be seen that it is important to extend the competitive assessment beyond a simple static analysis (i.e. one based primarily on current market shares and current competitors) to one that explicitly adopts a dynamic assessment (i.e. one that takes into account *inter alia* the scope for firms to expand output and/or to reposition their respective product offerings, including the introduction of new products).

- **Incumbents and their market shares**: the unilateral effects are generally more likely where few firms exist in the relevant market(s), the merger results in a combined entity with a large market share and there is no strong competitive fringe. Such concern becomes more vivid if the firms offer homogenous products.

- **Closeness of competition**: the merging firms may supply differentiated products, however lying within the relevant product market as there is sufficient degree of substitution between the products. In such merger, unilateral effects are more likely where the differentiated products offered by the merging firms compete closely, in particularly if each product represents the best alternative to the other for at least a substantial customer base.

- **Choice of alternative supplier**: unilateral effects are more likely where customers have little outside options other than the products offered by the merging firms. This could be due to the absence of alternative substitutes or the inability to switch facing with high switching cost.

- **Position of competitors to merging firms:** It is necessary to consider whether the competitors will be effective to prevent the merged entity from raising price, which depends in particular on the extent to which competitors' products are regarded by consumers as substitutes for the merging parties', whether there are any

[9] Goods and services can be highly differentiated in respect of product dimension (e.g. luxury and standard watches) and/or geography (e.g. firms located close by and firms located at some distance).

constraints on substitution and the ability of competitors to expand output or reposition their products to win business from the merged group.

- **Market dynamics**: there might be other elements in the market force that constraints the merged entity from raising price. For example, markets in which contracts are awarded through competitive tenders may be highly competitive, even if there are relatively few suppliers competing for the business.

- **New entry**: unilateral effect may arise if the merger is to eliminate the potential entrants to the relevant market(s). In particular, it is important to assess the entry barriers in the relevant market(s). Entrants that are likely to occur in a timely fashion and with sufficient magnitude in scope are more likely to counteract any anti-competitive effects resulting from the merger.

- **Buyer power**: The key issue to consider is whether the merged group's customers will be able to take steps which have the effect of preventing the merged entity from profitably raising its prices.

2.2. Coordinated Effects

A merger is said to give rise to coordinated effects concerns when the consequent change in market structure, including the reduction in the number of firms and the greater combined market share held by the merging party, better enables the merged firm and at least one of its remaining competitors to reach and sustain a tacit agreement not to compete effectively with one another and thereby raise prices. Such prices increases are termed ***co-ordinated effects*** because they result not from the actions of the merged entity alone but rather from the realisation amongst a number of firms i.e. the merged entity and at least one of its remaining competitors that the returns to competing less vigorously with one another are higher than competing vigorously.[10] In other words, co-ordinated effects rely on one or more of the remaining competitors *also restricting their output* when the merged entity restricts its output. This is in marked contrast to unilateral effects, where the post-merger price increase is profitable for the merged entity regardless of the responses of competing firms.

Coordination could take different forms. For example, firms may coordinate on prices i.e. reach explicit or implicit agreement to keep prices higher than otherwise would be in a competitive market; firms may also coordinate by dividing up the market among them.

There are three conditions that must be satisfied for coordination to occur:

- The ability to reach an agreement of coordination;

- Coordination needs to be internally sustainable i.e. participating firms have no unilateral incentive to deviate from the agreement;

[10] Under a unilateral effects theory of harm, competing firms may also respond to the higher post-merger prices charged by the merged entity through increasing prices. But such responses do not represent an “accommodating” behaviour. Rather, the resulting higher prices are a consequence of unilateral profit maximisation, reflecting an increase in their respective residual demand.

- Coordinate needs to be externally sustainable i.e. competitions from third parties are unlikely to undermine the coordinative agreement.

In general, coordinated effects are more likely to occur in industries with oligopolistic setting, in particular where the incumbents supply homogenous products and exhibit symmetric cost structures. One often pays more attention to industries where there are evidences of pre-existing coordination in assessing coordinated effects from a merger. However, none of such conditions should be considered sufficient in concluding a likelihood of coordinated effects resulting from a merger.

3. A Creeping Acquisitions Law is Unnecessary

In this section, we discuss whether a creeping acquisitions law is necessary to the Australian merger control policy from an economic viewpoint and argue that it is not.

The key rationale behind the proposal of a creeping acquisitions law appears to be that mergers with small incremental market share could lead to anticompetitive outcomes and that such mergers would fall outside the current merger thresholds existing in Australian legislation. In short, the proposed creeping acquisitions legislation is predicated on a “gap” in existing merger control. We do not believe that such a gap exists.[11]

But it is not clear in what circumstance anticompetitive mergers would not be subject to proper scrutiny. Provided the relevant market is defined correctly (i.e. according to the principles of the hypothetical monopolist test)[12] and the market shares in that market are properly interpreted, then the current legislation is sufficient to capture all potentially anticompetitive mergers. This position is valid since market shares calculated on the basis of properly defined relevant market(s) provides a reasonable indication on the likelihood of anti-competitive concerns. If the increase of market share resulting from a merger falls below the concentration threshold, it implies that such merger is extremely unlikely to give rise to substantial lessening of competition in the relevant market(s).[13]

Hence, the perceived gap in Australian merger control is, in our opinion, illusionary. Provided the relevant market is defined correctly then all anticompetitive mergers already fall within the scope of existing legislation. The following provides a brief review of the principles of relevant market definition.

3.1. Market Definition Assessment

Relevant market definition provides a framework within which one examines the prevailing competitive constraints relevant to the assessment of the merger in question. Market definition

[11] In Europe, the debate over a potential gap in EC merger control centred on whether dominance as a substantive test was sufficient to cover all potential anticompetitive mergers. As a result, the substantive test was changed to a significant impediment to competition test, a test analogous to the substantial lessening of competition test employed in Australia.

[12] The hypothetical monopolist test is also known as the SSNIP test.

[13] In some industries characterised by supplying highly differentiated products, market shares can over- or understate the competitive constraints posed by firms. However, even in these cases, competition concerns are extremely unlikely to arise at low levels of concentration.

is a key step to identify competitive constraints on the supplier of a given product or service, although it does not represent an end of the overall merger assessment. This is the accepted view of competition authorities in the US, the EU and the UK, for example the EU market definition guidelines state:

> *"Market definition is a tool to identify and define the boundaries of competition between firms. <u>It serves to establish a framework within which competition policy is applied by the Commission</u>. The main purpose of market definition is to identify in a systematic way the competitive constraints that the undertakings….face." (emphasis added)*[14]

The key concept in market definition analysis is substitutability, both on the demand-side and on the supply-side. The willingness and ability of consumers to substitute one product for another or from suppliers in one geographic region to suppliers in another region is known as "demand-site" substitution. The willingness and ability of rival suppliers to switch into the production of new products using existing productive assets is known as "supply-side" substitution.

3.1.1. Market Definition Framework

The conventional approach undertaken in order to define relevant economic markets is the Hypothetical Monopolist test (HMT) or the SSNIP test, which is used to establish the smallest product group and geographical area in which a hypothetical monopolist, controlling that group/ area could increase competitive prices by a small but significant amount, and profitably sustain these prices.[15] An example where this approach is clearly laid out is in product market definition section of the US merger guidelines:

> *"A market is defined as a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future producer or seller of those products in that area likely would impose at least a "small but significant and non-transitory" increase in price, assuming the terms of sale of all other products are held constant. A relevant market is a group of products and a geographic area that is no bigger than necessary to satisfy this test"*[16]

The overall process of defining relevant product and geographic markets is integral to analysing the competitive effects of any merger.

3.2. The ACCC Approach

The ACCC applies the Hypothetical Monopolist Test (HMT) framework for defining relevant markets in its assessment of mergers. This framework is not only in line with international best practice, but is also consistent with standard economic principles.

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14 "Commission Notice on the definition of relevant market for the purposes of Community competition law", Official Journal C 372, 09/12/1997, paragraph 2.

15 Typically the degree of price increase which is tested is 5 to 10% (this is the right contest where to use the common definition of a SSNIP) and it is assumed that prices of all other goods remain constant.

16 "1992 Horizontal Merger Guidelines [with April 8, 1997, revisions to section 4 on efficiencies]", Federal Trade Commission, section 1.0, paragraph 3

Moreover, the approach undertaken by the ACCC in its assessment on market definition appears to be generally fact driven and carefully considered on an individual case basis. The concepts of demand-side and supply-side substitutability is applied within the framework of the HMT test. As an illustration, we refer to its assessments of geographic market(s) in some recent acquisitions proposed by Woolworth.

In the Woolworth's acquisition of 11 Action Stores and Development Sites (2005), the ACCC defines a local market as follows:

> *"The relevant geographic market for each store to be acquired varies depending on the geographic and demographic characteristics of the area in which it is located. Broadly, the ACCC included all large supermarkets within 5km of the stores proposed to be acquired in the relevant market. However, allowance was made for geographic factors (including the presence of barriers such as rivers) and transportation factors, such as road design and capacity, in determining the precise boundaries of the relevant markets. "*[17]

Thus, in the proposed acquisition of Karabar Supermarket by Woolworth in 2008, the ACCC reached the conclusion that the local retail supermarket includes the supermarkets both in the Queanbeyan CBD and at Jerrabomberra. In this case, the ACCC took into account the likelihood that a greater range, better quality and lower price of the products post-merger would attract customers from further away (thereby expanding the geographic scope of the market). In addition, potential road developments (reducing distance hurdles) were considered (also leading to an expansion of the geographic market).[18]

Overall, the framework of market definition adopted by the ACCC is conceptually sound. Provide that framework is adhered to, the resulting definitions of relevant markets provide the appropriate focus for the competitive assessment of the merger, taking into account the factors outlined in Section 2 above.

4. Comments on Proposed Regulatory Models

Having concluded that a creeping acquisitions law is not necessary, we now provide some comments on the proposed regulatory models in the second creeping acquisition discussion paper. In short, we believe that the proposed models are likely to cause significant adverse effects to competition and ultimately be detrimental to consumers.

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[17] The ACCC competitive assessment report can be found with the following link. http://www.accc.gov.au/content/item.phtml?itemId=751210&nodeId=eba33dd6d804d9334bf62b4a57010ea9&fn=Woolworths%20Ltd's%20proposed%20acquisition%20of%2022%20Foodland%20Associated%20Ltd%20supermarkets%20-%2019%20October%202005%20-%20grocery.pdf

[18] The ACCC competitive assessment report can be found with the following link. http://www.accc.gov.au/content/item.phtml?itemId=837371&nodeId=ffcc21565c5a797e1f0741b361340ed7&fn=Woolworths%20Ltd—proposed%20acquisition%20of%20Karabar%20supermarket—11%20July%202008.pdf

4.1. Proposed SMP Model Approach

In the second discussion paper on the introduction of a creeping acquisitions law, published by the Government on 7th May 2009, two models were proposed to address the creeping acquisition concerns.

First, the second discussion paper proposes a Substantial Market Power (SMP) model, which would prohibit mergers and acquisitions that enhance a corporation's existing substantial market power. The suggested wording reads as follows:

> *"(1) A corporation that has a substantial degree of power in a market must not directly or indirectly:*
>
> a. *acquire shares in the capital of a body corporate; or*
>
> b. *acquire any assets of a person;*
>
> *if the acquisition would have the effect, or be likely to have the effect, of enhancing that corporation's substantial market power in that market."* [19]

Second, the paper proposes an alternative approach, which triggers the application of a creeping acquisitions law to a given firm, for a set period of time and under a set of restrained circumstances only. Under this proposal, the Minister would have the power to unilaterally "declare" a corporation or a product/service sector to be under the application of the creeping acquisition law, if he had concerns about potential and/or actual competition harm from creeping acquisitions, or acquisitions by corporations with substantial market power.[20] The same restrictions would apply to the firm in this alternative approach than the ones described for the revised SMP model above.[21]

4.2. RBB Comments on the Revised SMP Model

In our view, an adoption of the proposed SMP model carries serious risks for the Australian economy and Australian consumers by preventing pro-competitive mergers. More specifically, our main concerns with regards to the proposed SMP model are twofold:

- First, the SMP model relies on the determination of pre-merger significant market power, which is not a straightforward task in practice;
- Second, to a large extent, the proposed SMP model introduces a presumption that all mergers engaged in by large firms necessarily significantly lessen competition. Such presumption is not supported by standard economics.

We will briefly discuss these two aspects in turn below.

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[19] Compared to the original SMP model, the revised model aims to deal directly with the "enhancement" of market power, which seeks to complement, rather than undermine, the existing substantial lessening of competition test in s 50 of the TPA.

[20] Alternatively, it is proposed that the Minister could make a declaration after receiving an application from the ACCC.

[21] The second discussion paper also suggested that the models would operate in addition to the existing mergers and acquisitions test in s 50 of the TPA.

4.2.1. The SMP Model Requires Clear Definition of "Substantial Market Power"

The assessment based on the SMP model relies on the determination of substantial market power. More specifically, if one of the merging parties is held to exhibit pre-merger substantial market power in the relevant market(s), the proposed merger will be deemed anti-competitive.

An adoption of such model calls for clear guidelines on how to define and assess whether a firm possesses substantial market power. Without clear guidance, such model will create significant uncertainty in practice and is likely to discourage pro-competitive mergers with consequent adverse effects for Australian consumers.

Assessing pre-merger substantial market power is fraught with a number of additional complexities that standard merger control does not face. Perhaps most importantly, defining relevant markets to assess pre-merger competition is potentially affected by the *cellophane fallacy*. This raises a number of issues in interpreting observed market data and as such introduces a degree of uncertainty over whether a firm truly possesses pre-merger significant market power or is subject to effective competition.[22] Put simple, a number of firms, potentially a large number, will not know whether they would be deemed to possess significant market power.

4.2.2. The Principle of the SMP Introduces a Presumption that is *NOT* Supported by Economic Theory

Even if substantial market power could be easily and clearly defined in theory and in practice, the proposed SMP model raises another important issue. The proposed SMP model introduces a presumption that any increase in the market share of a firm held to possess pre-merger substantial market power necessarily gives rise to a substantial lessening of competition regardless of the market position of the firm being acquired. But there is no support in standard economics for such a presumption. As a result, the proposed creeping acquisitions legislation would deter pro-competitive mergers, with consequent adverse effects for the Australian economy and ultimately for Australian consumers.

[22] For a comprehensive discussion of the cellophane fallacy and its implications for market definition in practice, see Baker and Bishop (2001) "*The role of market definition in monopoly and dominance inquiries"* - Study for the UK Office of Fair Trading.