RBB's Comments on the Trade Practices Amendment (Material Lessening of Competition – Richmond Amendment) Bill 2009

RBB Economics, 21 December 2009

1 Introduction

This submission has been prepared in response to an invitation from the Secretary of the Senate Standing Committee on Economics to RBB Economics to make a submission to the Senate's inquiry into the Trade Practices Amendment (Material Lessening of Competition-Richmond Amendment) Bill 2009.

The Bill proposes two changes. First, it would prevent corporations from directly or indirectly merging, or acquiring an asset, which would result in 'material' lessening of competition in the relevant market. Second, it would prevent a corporation that already has a substantial share of a market from acquiring shares or an asset which would have the effect of lessening competition in the market.

RBB Economics believes that the Bill is unnecessary and that the existing 'substantial lessening of competition' test in Section 50 of the *Trade Practices Act 1974* is capable of identifying and preventing anti-competitive mergers in Australia. RBB Economics is also of the view that the proposed Bill – whose stated purpose is to strengthen Australia's anti-merger law – is likely to discourage or prevent *pro-competitive* mergers and acquisitions in Australia and therefore would have adverse consequences not only for Australian businesses but also for Australian consumers.

This submission provides two comments on this issue from the perspective of economists advising on competition law proceedings. Section 2 addresses the lessening of competition inherent in any horizontal merger and discusses the way that competition authorities might assess the extent to which such a lessening may be a concern. Section 3 then explores the role that information on market shares can play in merger assessment and looks in particular at some of the risks associated with preventing any mergers or acquisitions by a corporation that already has a substantial share of the market.

2 How Horizontal Mergers Affect Competition

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 horizontal mergers each raise their own particular competition issues, the structural changes brought about by horizontal mergers can result in a lessening of competition in two potential ways; either the merger gives rise to unilateral effects or the merger gives rise to coordinated effects.[1]

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 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.

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1 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".

2.1 By how much can competition be lessened?

The current test in section 50 of the *Trade Practices Act* is that corporations are prohibited from directly or indirectly acquiring shares or assets that would have the effect, or be likely to have the effect, of *substantially* lessening competition (SLC).

The Explanatory Memorandum to the Bill states that test in section 50 is 'set at too high a threshold and as a result a number of controversial mergers have been recently approved'. It goes on to state that a material lessening of competition test (MLC) would:[2]

> *"...lower the threshold for determining whether a merger or acquisition is anti-competitive and would allow the merger or acquisition to be tested by reference to whether it has a pronounced or noticeably adverse affect on competition, rather than on whether the merged entity would be able to exercise substantial market power post-merger, as is currently the case."*

Essentially the sponsors of the proposed amendment argue that the current regime permits anti-competitive mergers. In other words, that the ACCC is permitting mergers that lead to either unilateral or coordinated effects, namely price increases. There is no evidence to support this presumption.

From an economics perspective, however, the debate between a 'substantial' lessening of competition versus a 'material' lessening of competition is not the crucial issue. The more relevant question is how to identify whether a proposed merger will be pro-competitive - and welcomed by competition authorities – or anti-competitive – and which should be opposed by competition authorities.

The focus should, therefore, be on assessing how the merger alters the competitive constraints and on understanding the implications those changes have for the intensity of competition. This involves, *inter alia,* defining the relevant market according to the principles of the Hypothetical Monopolist Test, examining the competitive constraints provided by other competitors and, importantly, assessing the impact of the likely dynamic reactions of firms and customers.

Market definition is an important analytical 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</u>*

2 Trade Practices Amendment (Material Lessening of Competition – Richmond Amendment) Bill 2009. Explanatory Memorandum, 1.

> *Commission. The main purpose of market definition is to identify in a systematic way the competitive constraints that the undertakings….face." (emphasis added)*[3]

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.

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.[4] This approach is clearly laid out in the discussion of product markets in 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"*[5]

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

Although the definition of the relevant market plays an important role in the competitive assessment of mergers, it is important also to consider the competitive position of firms within the defined relevant market. This includes addressing such questions as the following: are some firms closer competitors to one another?; are rival firms able to expand in response to any putative price increase?; can rival firms alter their product offerings?; can new firms enter the market in response to any post-merger price increase?; what actions can customers take to undermine any attempt to increase price post-merger? Overall, this approach to assessing competition is both reasonable and, in practice, sensible.

In our view, therefore, this approach, which is broadly consistent with that currently undertaken by the ACCC, is sufficient to identify and oppose anti-competitive mergers while allowing pro-competitive mergers to proceed. Such an approach is, therefore, preferable to lowering the test

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

4 Typically the degree of price increase which is tested is 5 to 10% and it is assumed that prices of all other goods remain constant.

5 "1992 Horizontal Merger Guidelines [with April 8, 1997, revisions to section 4 on efficiencies]", Federal Trade Commission, section 1.0, paragraph 3

in section 50 from a “substantial” lessening of competition to a “material” lessening of competition.

3 The Appropriate Role of Market Shares

The second change proposed by the Bill would be to prevent a corporation that already has a substantial share of a market from acquiring shares or an asset which would have the effect of lessening competition in the market.

This change – aimed at preventing ‘creeping acquisitions’ by introducing a ‘cap’ on corporations with a substantial share of the market – would require clear guidelines on how to define and assess whether a firm possesses such a share of the market. Without clear guidance, the change will create significant uncertainty and is likely to discourage pro-competitive mergers with consequent adverse effects for Australian consumers.

Even if a ‘substantial share of the market’ could be easily and clearly defined in theory and in practice, the proposed cap introduces a presumption that any increase in the market share of that firm necessarily gives rise to a lessening of competition that should concern the ACCC. Such a concern would arise regardless of the market position of the firm being acquired. There is no support in standard economics for such a presumption. As a result, the proposed legislation would deter pro-competitive mergers, with consequent adverse effects for the Australian economy and ultimately for Australian consumers.

In our view, market shares are merely a filter and it ought not to be presumed that mergers exceeding a particular level give rise to competition concerns. These competition concerns will generally arise if the merged entity has the ability to increase prices (or reduce quality) to the detriment of consumers. Market shares, on their own, cannot help competition authorities and policy makers to assess the likelihood of such concerns arising. High levels of concentration need not preclude a market from operating effectively.

Economic analysis can be used to help to determine when a high or substantial market share might lead to a poor competitive outcome. A decision to raise price (and therefore restrict output) involves both benefits and costs to the firms involved and a proper assessment of unilateral effects involves an examination, most likely an empirical assessment, of this trade-off. For example, do the benefits from restricting output outweigh the costs associated with that restriction?

And even where post-merger market shares are high, a merger may not give rise to unilateral effects for a number of reasons. Competitors already active in the market may respond to any output restriction so as to mitigate and possibly eliminate any benefit to the merged entity from restricting output. In particular, existing competitors can respond either by expanding or re-positioning their product offerings. It is also possible for potential competitors to respond to any output restriction by entering the market. Moreover, there may also be scope for customers to undermine the benefits of output restrictions by exercising buyer power. Buyer power refers to the ability of customers to take actions to alter the structure of the market upstream by sponsoring either expansion by existing firms or by sponsoring the entry of new firms.

Moreover, it is increasingly accepted 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.[6] 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 risky to rely so heavily on market shares and important to assess whether market shares overstate or understate the magnitude of the competitive constraint between the merging parties.

4 Conclusion

RBB Economics believes that the proposed Bill is unnecessary. Competition Law in Australia (and elsewhere) should be aimed at preventing *anti-competitive* mergers and should not impede *pro-competitive* mergers. Pro-competitive mergers benefit companies by allowing them to enjoy cost savings by taking advantage of efficiencies. They also benefit consumers by reducing the prices they pay for goods and services. Pro-competitive mergers are also an important way that firms can grow and access funds.

Our view is that there are real risks to the economy if one creates a presumption against any merger, as that will inadvertently capture pro-competitive mergers. Instead, the better approach is to focus on defining the relevant market correctly and to examine the prevailing competitive constraints relevant to the assessment of the merger in question.

In addition, a market share ‘cap’, of the type proposed by the Bill is also unnecessary. It introduces the unsupported presumption that any increase in the market share of a firm necessarily gives rise to a lessening of competition that should concern the ACCC regardless of the market position of the firm being acquired. It also places too much reliance on market shares, which can understate or overstate the competitive constraint that exists pre-merger between the merging parties.

6 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).