MERGER REGULATION:

A review of the draft merger guidelines administered by the Australian Competition and Consumer Commission

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Forming the Productivity Commission

The Federal Government, as part of its broader microeconomic reform agenda, is merging the Bureau of Industry Economics, the Economic Planning Advisory Commission and the Industry Commission to form the Productivity Commission. The three agencies are now co-located in the Treasury portfolio and amalgamation has begun on an administrative basis.

While appropriate arrangements are being finalised, the work program of each of the agencies will continue. The relevant legislation will be introduced soon. This report has been produced by the Industry Commission.

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PREFACE

Draft Merger Guidelines were issued for comment in November 1992 by the then Trade Practices Commission (TPC), now the Australian Competition and Consumer Commission (ACCC). These Draft Guidelines arose from the Government's decision, in line with the major recommendations of the 1991 Cooney Report on Mergers, Monopolies and Acquisitions, to amend the Trade Practices Act from January 1993 by introducing a new test for evaluating mergers. Mergers (or acquisitions) are now opposed — as they were between 1974 and 1977 — if they are found to have the effect of 'substantially lessening competition in a substantial market'. The previous test, which had applied since 1977, disallowed mergers if they 'created or enhanced a position of market dominance'.

The Draft Merger Guidelines outline the ACCC's proposed approach to administering and enforcing the competition test. The Draft Guidelines were intended to provide business with some pointers as to how the new arrangements would be applied, while at the same time permitting future revision of the Guidelines in the light of its own experiences with the new competition test, and taking into account comments received from interested parties, within both the private and public sectors. These Guidelines were supplemented in October 1993 by the release of a joint discussion paper with the New Zealand Commerce Commission concerning anti-competitive mergers involving 'failing firms' that would otherwise close down.

Now that over three years have elapsed since the Draft Merger Guidelines were released, and the ACCC created as part of the Government's desire to strengthen competition policies following the Hilmer report, it seems opportune for the ACCC to re-examine the Draft Guidelines, with a view to issuing revised final guidelines. Although such operational guidelines will always be open to interpretation and change, removing the 'draft' status would in itself help to reduce business uncertainty. The release of supplementary explanatory notes and other material on how the guidelines are being implemented, produced regularly by the ACCC, would also be helpful.

This paper reviews the Draft Merger Guidelines. It draws on the available evidence on market structures, competition and contestability, both internationally and within Australia, including experience gained by the Industry Commission (IC) from public inquiries. The IC has argued frequently that Australia's economic welfare is enhanced by policies aimed at making markets more open to competition, by removing import restrictions and regulatory barriers. At the same time, it is widely recognised that pro-competitive regulation needs to be administered so as to ensure that the regulatory costs do not exceed the benefits.

In 1993, initial comments on the Draft Merger Guidelines were published by the Office of Regulation Review which is established within the IC (ORR 1993). In November 1994, the Treasury released a discussion paper for public comment proposing a mandatory pre-merger notification scheme and invited public comment (1994). In a submission to Treasury in 1995, the ORR concluded that a mandatory notification scheme would impose an undue burden on the market for corporate control (ORR 1995c).

The IC and the ORR have also released several papers dealing with issues of competition policy directly relevant to the question of mergers. These include:

- *Competition and Retail Banking*, ORR, March 1995;
- *Competitive safeguards in telecommunications: a submission in response to 'Beyond the Duopoly'*, ORR, February 1995; and
- *What Future for Price Surveillance?*, IC, September 1994

In reviewing the ACCC's Draft Merger Guidelines, this paper draws on the previous work of both the IC and the ORR. It is hoped that the paper will assist the ACCC in its preparation of revised final merger guidelines.

EXECUTIVE SUMMARY

Mergers and acquisitions among firms are an important means of achieving a more efficient and productive economy. They not only allow attainment of economies of scale and scope, combining the resources and skills of smaller companies, but they also help to ensure a vigorous market for corporate control, which helps to sustain managerial competence. The policy problem posed by mergers and acquisitions is that some of them may also give rise to a concentration of market power, so that, despite any gains in productive efficiency, society is worse off because of excessive prices, reduced quality and other anti-competitive behaviour.

Mergers and acquisitions accordingly are regulated by many governments. In Australia, the relevant provisions fall within Part IV of the Trade Practices Act. Following legislative amendments in January 1993, a new competition test was introduced to prohibit mergers that are judged 'to substantially lessen competition in a substantial market in Australia', unless authorised by the Trade Practices Commission (TPC) — now the Australian Competition and Consumer Commission (ACCC) — as providing net public benefits.

The ACCC's task in administering the Act is very difficult, requiring judgements about when a proposed merger or acquisition is likely to 'substantially lessen' competition, and about whether the resulting adverse effects would be outweighed by public benefits. If the ACCC assesses too leniently the potential for anti-competitive behaviour, the community may end up paying higher prices than it should; if a too strict line is taken by the ACCC, efficiency and welfare-enhancing mergers may be prevented or impeded, and the market for corporate control weakened. Additional costs will also occur if uncertainty exists about which mergers are likely to be scrutinised. And merger regulators could end up impeding, rather than enhancing, competition.

In November 1992, the TPC issued Draft Merger Guidelines, setting out its approach to administering the new competition test. They include a five stage evaluation process for identifying mergers that would substantially lessen competition, applied sequentially and incorporating considerations listed in the legislation. The initial stages define the relevant market and determine whether the merger proposal meets the market share thresholds used by the ACCC. If not, the ACCC assesses in turn import competition, barriers to entry and any other relevant factors to ascertain whether there is sufficient competition at any one of these steps for it not to oppose the merger.

The Merger Guidelines are a useful vehicle for signalling to industry the circumstances in which mergers are likely to be scrutinised and challenged by the ACCC. Importantly, the Draft Guidelines include a 'safe harbour', involving thresholds for market concentration and market shares, below which mergers will not be subject to scrutiny. The Industry Commission (IC) strongly endorses this approach, which serves to reduce uncertainty and compliance costs, while allowing the ACCC to concentrate on those merger proposals that matter most for competition.

That said, it is opportune, now that the Draft Guidelines have been in use for over three years and the ACCC has been created as a key institution for implementing the national competition policy, to re-examine the Draft Guidelines prior to the ACCC issuing revised Final Guidelines.

While endorsing the broad direction of the Draft Guidelines, the IC considers there is scope to make changes which would reduce costs and uncertainty for industry, while meeting the ACCC's obligations under the Act.

The IC's assessment reflects its view that the emergence of a less regulated Australian economy, increasingly open to international competition, has enhanced the dynamism of market forces and significantly reduced the scope for firms to price above competitive levels for sustained periods. The IC also considers that, while any market power and its attendant costs will generally be eroded over time through new sources of competition (often associated with technological change), the economic benefits forgone when efficiency-enhancing mergers or acquisitions are prevented or deterred can be durable.

The IC's proposals are organised according to the steps in the ACCC's evaluation process, and are summarised in Box 1. They are intended to reduce the likelihood that the Draft Merger Guidelines are more restrictive on mergers than necessary to meet the Act's requirements. These, along with other suggestions aimed at improving the transparency of the Guidelines, would increase business certainty and lessen the risk of efficiency-enhancing mergers being deterred. Although the current legislation enables the ACCC to authorise efficiency-enhancing mergers that are anti-competitive provided they are judged by the ACCC to offer net public benefits, very few mergers undergo such 'authorisation'.

Box 1: **Summary of Industry Commission's main proposals**

- The IC suggests the ACCC examine the implications of raising the existing thresholds on market shares and concentration ratios for setting 'safe harbours', where mergers can proceed without ACCC scrutiny. In the IC's view, there would be merit in:
  - raising the threshold market share for an individual merged firm from the present 40 per cent to 50 per cent; and
  - replacing the threshold test in which the post-merger concentration ratio for *four* firms is 75 per cent or more (with the merged firm having at least 15 per cent of the market) with one in which the *three* firm concentration ratio is 75 per cent or more (with the merged firm having at least 20 per cent of the market).
- The IC proposes an additional 'safe harbour' rule such that where total *arms length* imports have accounted for at least 10 per cent of sales for three years, the merger will be free from scrutiny.
- Consideration should be given to increasing the estimated time period under the Draft Merger Guidelines for judging the effectiveness of the threat of entry from two to possibly five years.
- Key areas where the operations of the ACCC in relation to the Merger Guidelines could be re-considered and improved, and made more transparent, include:
  - the need to improve the treatment of market definition, including publishing case studies of mergers investigated to show how the market is delineated;
  - making publicly available more material on mergers considered by the ACCC including, for example, on how particular mergers relate to the enforcement thresholds and, for those cases subject to further examination, at which stage in the evaluation process they are considered no longer anti-competitive;
  - the identification and measurement of entry barriers, with greater emphasis given to the role of sunk costs;
  - the need to improve the scope and effectiveness of the authorisation process, including a better understanding of public benefits and more transparent guidelines and criteria that would also redress the existing imbalance against producers;
  - the use of enforceable undertakings, especially those affecting the future structure of the industry; and
  - the operation of the failing firm pro visions.

Defining the 'market' is the key

Definition of the relevant market for the firms in question is fundamental to the application of the Draft Guidelines. This is rarely simple, but the market must be defined for a merger proposal before threshold limits can be applied. Depending upon how markets are defined, market power could be found to be pervasive or non-existent.

Most markets are characterised by differentiated products and geographical boundaries that often involve a time dimension because substitutes are developed continuously for many products. Markets affected by particular mergers are therefore usually imprecise, and their delineation normally requires judgements that can be made only on a case-by-case basis. Court decisions in Australia often have not clarified the situation. Some cases have added to the confusion by lacking economic logic.

Market boundaries are dictated, in principle, by substitution possibilities. The procedures in the Draft Guidelines for defining the market appear reasonable. They are aimed at delineating market boundaries that reflect those products that are considered substitutable in either consumption or production. The ACCC includes in the market 'all sources of closely substitutable products, in both product and geographic space, to which consumers would turn in the event that the merged firm attempted to exercise market power'.

The choice of the most appropriate market definition is often contentious. In the IC's view, broadly, rather than narrowly, defined markets are more likely in practice to be better indicators of effective competition. Narrow market definitions risk ruling out substitution possibilities which maintain a competitive discipline on the merged firm. Different products can also become substitutable over time as consumers modify their purchasing patterns in response to changing market conditions, including new sources of supply.

The IC encourages the ACCC to publish studies on mergers it has investigated to show how and why the market was delineated as it was, especially for more difficult cases. Greater transparency of the criteria used by the ACCC to define markets would also help to reduce business uncertainty.

The concentration threshold

High concentration ratios can be seen as a necessary, but not sufficient, condition for exercising market power. The Draft Guidelines specify that the ACCC will examine only proposed mergers which would result in the four largest firms supplying 75 per cent or more of the market (with the merged firm having at least 15 per cent), or the merged firm having a market share of 40 per cent or higher.

Mergers not triggering these ‘enforcement thresholds’ are in a ‘safe-harbour’ and will be unopposed by the ACCC, while other mergers will be examined further.

While such threshold limits can be applied objectively once the market is defined, determining the levels at which they should be set — along with defining the market — is not straightforward. Setting guidelines involving ‘enforcement thresholds’ or ‘safe harbours’ is consistent with the ACCC only investigating those mergers that are likely to substantially lessen competition — creating a strong likelihood that prices will be significantly higher after the merger. The thresholds therefore are an attempt by the ACCC to strike a balance between effectively enforcing the legislation, and wishing to avoid unwarranted examination of merger proposals. Such an approach enables the ACCC to better target resources to the main anti-competitive mergers.

Enforcement thresholds thus need to be set at levels where the likelihood of significant market power justifies further examination by the ACCC. Lower threshold limits may impose unnecessary costs on firms — by adding to uncertainty and compliance costs — and discourage the market for corporate control. This would hinder industry restructuring and undermine efficiency.

The number of merger and acquisition cases considered by the TPC/ACCC under the competition test suggests that the net could be cast too widely at present. While such cases almost doubled from 86 in 1992-93 to 151 in 1994-95, the number of mergers (openly) opposed by the TPC increased from 5 to only 8 in those years, equivalent to 5 per cent of total mergers considered in 1994-95. While the proportion of merger cases which required detailed investigation is small, most involved some investigation and analysis. It is unclear, however, how many cases were modified following discussions with the TPC, or indeed to what degree behaviour was altered without direct reference to the TPC at all.

While there are conflicting views, it is arguable that the current market thresholds for establishing a safe harbour are too restrictive. Some recent overseas evidence suggests that even relatively high market concentration may not be bad for consumers. These studies suggest that significant co-ordinated market power is unlikely where at least three firms exist in the market, and that above this number of firms the beneficial price effects from new entrants diminish rapidly. There is also some evidence to suggest that a firm rarely will be able to exercise substantial market power in its own right if it controls less than half of the market.

The applicability to Australia of some of this evidence may be debated; nevertheless, it does call into question whether the proposed ‘safe harbour’ criteria set in the Draft Guidelines are too restrictive. If so, some mergers will be discouraged, and more mergers than necessary will be examined against the other criteria used by the ACCC in deciding whether to oppose mergers likely to be anti-competitive. The Act requires the ACCC to analyse in depth only those cases in which there is a reasonable presumption that the merger may result in a substantial lessening of competition.

In the IC's view, there would be merit in examining the implications of raising the threshold market share of the merged firm from the present 40 per cent to 50 per cent. Also, the existing 4-firm concentration ratio of over 75 per cent could be replaced with a 3-firm concentration ratio of 75 per cent, with the maximum market share of the merged firms raised from 15 to 20 per cent. The ACCC could review its experiences (including those of the former PSA) against these suggested threshold limits so as to assess their impact on its ability to detect mergers that substantially lessen competition. The IC encourages the ACCC to publish analysis of the effects of market thresholds on market power in Australia.

More generally, it would be useful for the ACCC (without jeopardising necessary confidentiality) to publish material on how particular mergers relate to the enforcement thresholds and, for those cases subject to further examination, at which stage in the evaluation process they were considered no longer anti-competitive.

Import competition

The ACCC will not oppose mergers which satisfy the 'safe harbour' enforcement thresholds provided it is satisfied that the market would remain sufficiently competitive (the onus for demonstrating this being on the firms involved). Although the Draft Guidelines rightly regard import competition as important, they do not provide definitive guidance for determining what constitutes effective import competition for merger purposes. They envisage the need for a case-by-case assessment, using an indicative list of factors for determining whether actual (or potential) import competition is sufficient for the ACCC not to oppose the merger. Unlike the concentration thresholds, the Draft Guidelines provide no 'safe harbour' for firms exposed to import competition.

Competition from imports, or the threat of it, can be a powerful means of ensuring competitive outcomes, even where current imports are low. Imports are an important means of ensuring that relatively small markets like Australia remain competitive, and ensuring that mergers among domestic firms are not anti-competitive. Reductions in Australian tariffs to a maximum of 5 per cent by 1 July 1996 — excluding those on motor vehicles and textiles, clothing and footwear — and removal of quotas, mean that imports are now far less likely to be restricted sufficiently to enable merged firms to set anti-competitive prices.

With this in mind, the IC believes it would be beneficial if the ACCC were to set some benchmarks for determining when actual import competition was sufficient not to oppose the merger. The IC has argued previously that domestic firms would be unable to exercise market power where total *'arms length'* imports accounted for at least 10 per cent of sales over the past three years. Once 'arms length' imports reach this level, foreign suppliers would normally be sufficiently well established in the domestic market to be able to respond relatively quickly to market opportunities.

The IC therefore proposes that consideration be given to using this import share as another safe harbour rule, above which mergers will not be investigated by the ACCC, unless there is evidence of significant import restrictions, such as non-tariff barriers — including anti-dumping actions. (In such cases, the most effective means of achieving a competitive market may well be to dismantle the import restrictions rather than to oppose the merger.) Imports may, of course, exert sufficient competitive discipline in particular cases for the ACCC not to oppose a merger even at levels substantially below 10 per cent.

In cases where an industry is internationally efficient, whereby most of its output is exported and unrestricted imports are negligible, the level of natural protection in principle will determine the size of any post-merger price increase. Measuring the degree of natural protection afforded domestic producers through importation costs (freight etc) may therefore assist the ACCC to assess whether a merger would enable firms to raise prices substantially above competitive levels. Mergers are unlikely to warrant further investigation unless the level of natural protection in the industry is above (say) 10 per cent of the export price. The ACCC therefore may wish to review its recent enforcement decisions where unrestricted imports have been negligible to see whether the outcomes would have changed if such a cut-off based on natural protection had applied.

Barriers to entry

In determining the ease of market entry by firms, the Draft Guidelines refer to a number of factors that may prevent entry, including the existence of scale economies, the level of sunk investment (costs) and the degree of product differentiation. They adopt a broad view of what constitute entry barriers, and provide little guidance on how these are to be assessed. Since mergers with incumbents are commonly used by new entrants to overcome entry barriers, such as high sunk costs, care is needed to ensure that regulation does not in practice make markets less contestable and competitive by unnecessarily discouraging such mergers.

Determining whether entry barriers exist hinges conceptually on the level of ‘sunk costs’ that a new entrant must incur to enter the market. Since sunk costs cannot be recovered if the venture fails, they can constitute a significant barrier to entry because they place entrants at a cost disadvantage relative to incumbents, for whom the risks associated with any drop in post-entry prices are consequently lower. Although most markets with substantial scale economies will also involve large sunk costs, it is the sunk costs which are a barrier to new entrants, rather than the scale economies as such.

In the IC’s view, the coverage of entry barriers in the Draft Guidelines is too broad, and they lack sufficient transparency and predicability. Because of the essential role of sunk costs, greater efforts are needed to devise better guidelines for identifying when they are likely to preclude new entrants. It may be worthwhile for the ACCC to review the merits of using a pay-back method for evaluating sunk costs as used in the United States (but over a longer period) to help clarify entry conditions.

An important factor in assessing ease of entry to an industry is how long it will take for new entry to occur. The Draft Guidelines regard effective entry as occurring within two years. The IC believes that this may be too short a period in many industries. Given the considerable time lags associated with most large investments, such a period may not give the market sufficient time to work. A period of five years, as used in the European Union, may be more appropriate.

Authorised mergers

Parties to a merger may apply to the ACCC for authorisation on the grounds that the merger provides public benefits that outweigh the merger’s detriment to competition. This is an important part of the legislation, since it provides the only opportunity for efficiency gains from mergers to be considered. However, it appears to the IC that the authorisation process may not be working as effectively as it should. Very few firms involved in takeovers or mergers seek authorisation. Whether this is an indication of the extent to which efficiency-enhancing mergers are deterred by the current arrangements, or an indication of the lack of efficiency enhancement in the mergers, is unclear.

The Draft Guidelines appear to discount benefits to producers through efficiency gains, unless the ACCC is satisfied that the firm will pass on to consumers the cost savings through lower prices. However, both consumer and producer interests are important in assessing national welfare. Mergers resulting in efficiency gains to producers would still increase national welfare, even without reduced prices to consumers (as required in the Guidelines), so long as consumer prices were not increased. The scope of the Guidelines should be expanded to take into account more effectively the efficiency effects of mergers.

The IC suggests that the Draft Guidelines surrounding the public benefit test be re-examined and clarified. They lack transparency and provide insufficient guidance on the criteria and rules used in assessing public benefits and detriments. Understanding the public benefit test is also made more complicated by the inclusion in the legislation several factors, such as the substitution of domestic production with imports, which are difficult to justify as public benefits.

‘Enforceable undertakings’

Another area where greater certainty is needed, in the IC’s view, concerns the ACCC’s negotiation of enforceable undertakings with the merger participants. Where the ACCC would otherwise oppose a merger, parties to the merger may submit written undertakings on matters of concern in order to obtain the ACCC’s agreement for the merger to proceed. Where these undertakings are breached, the ACCC may seek court orders directing compliance. Although separate guidelines were to have been prepared on enforceable undertakings, they have not yet been released by the ACCC. The IC believes that such guidelines should be issued by the ACCC as soon as possible, and be incorporated in the revised Final Merger Guidelines.

The IC is concerned about what appear to be the unlimited powers of the ACCC to make enforceable undertakings, and the need for firms to obtain its consent before such undertakings can be varied or withdrawn. A recent decision by the Trade Practices Tribunal (now the Australian Competition Tribunal) to review — and reject — such undertakings has added further uncertainty. It is important that the legal status of undertakings be clarified.

The enforceable undertakings accepted by the ACCC are usually structural in nature, often involving the divestiture of assets or market segments. Such undertakings may create business uncertainty among third parties, and they usually impose limitations on merger participants that do not apply to other firms in the industry. They also raise suspicions in some quarters that the ACCC may be ‘restructuring’ industries in ways that are inconsistent with market forces and ultimately not in the community’s best interests.

Allowing mergers to proceed on the basis of enforceable undertakings can impose large costs on the parties concerned. Firms may have little commercial choice but to agree in the end to the undertakings, or incur even more costly delays. The undertakings may nevertheless detract from national welfare. The

IC believes that the ACCC should reconsider its widespread use of undertakings. The ACCC should ensure that only the minimum, and least costly, undertakings necessary to overcome its competitive concerns with the merger are applied.

‘Failing firms’

The TPC augmented its Draft Merger Guidelines in October 1993 by issuing a joint discussion paper with the New Zealand Commerce Commission on the application of mergers involving failing companies. These Guidelines envisage that the ACCC is unlikely to oppose a merger proposal as anti-competitive if the target firm is likely to fail or is already in receivership, and there is no alternative purchaser willing to rescue the firm. This approach appears reasonable, since the acquisition of an otherwise failing firm is unlikely to have anti-competitive effects; the firm in any event would close down. However, in these situations, it is important that the ACCC identify failing firms in time to enable their unhindered merger with other firms.

The IC generally supports the failing firm approach for mergers as a means of enabling the necessary industry restructuring and rationalisation. However, in its view, the Draft Guidelines are incomplete. They fail to provide sufficient guidance and transparent criteria on what is a ‘failing firm’, and the conditions under which the ACCC would oppose such mergers. The IC’s comments on the shortcomings of the authorisation process are also relevant to mergers involving ‘failing firms’.

1 INTRODUCTION

From 21 January 1993, the *Trade Practices Act* has prohibited mergers and acquisitions that are likely 'to substantially lessen competition in a substantial market in Australia', unless authorised by the ACCC (formerly the TPC) as providing public benefits.[1] This new 'competition test' replaced the dominance criterion that had applied since 1977, whereby mergers and acquisitions that increased market concentration up to the point of duopoly were automatically allowed.[2]

It was thought that a competition rather than market dominance test was needed to control mergers and acquisitions that may result in the exercise of co-ordinated market power. According to the Chairman of the TPC:

> Dominance was predominantly concerned with evaluating the position of one firm in a market and how that was affected by the acquisition of a controlling interest in another firm. The substantial lessening of competition test considers a much broader range of firm conduct, including the likelihood of co-ordinated activity between firms, either lawful or unlawful, and the acquisition of minority interests in one firm by a competitor or vertically integrated firm. (Fels and Walker 1994, p. 98)

The new competition test has reduced the market threshold points at which market power may need to be regulated. This is an essential difference between the two merger tests. The dominance test had allowed concentration up to duopoly, even if significant barriers to entry existed. The two tests are closely related:

> ... the 'substantial lessening of competition' threshold calls for an examination of an effect on competition, while the 'dominance test' examines a degree of market power. However, these separate inquiries describe two faces of the same coin as economic theory provides that undue market power is the antithesis of competition. (Rich 1994, p. 125)

However, the competition test has enlarged greatly the factors that have to be considered when assessing the anti-competitive effects of mergers. No longer is the decision on whether to oppose a merger entirely dependent on market concentration shares. The move from a dominance to a competition test for

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1 Mergers judged to contravene the Act by 'substantially lessening competition' can be authorised by the ACCC where parties can show that the proposed merger provides public benefits.

2 Between 1974 and 1977, the *Act* prohibited mergers that were likely to substantially lessen competition in any market in Australia. See Round (1994) for a twenty year retrospective on the Trade Practices Act; Miller (1995) for an annotated version of the Act; and Brunt (1993, 1994) and Corones (1990, 1994a) for general discussions of Australian (and New Zealand) competition law and policy.

evaluating mergers has brought with it additional administrative difficulties. The dominance criterion was simpler to administer than the competition test, since analysis of the competitive effects of mergers largely requires a subjective evaluation by the ACCC of many factors affecting the future conduct of firms. On the other hand, the dominance test, once set, could be administered with much greater objectivity and certainty (Pasternack 1994). The IC, however, is not proposing any change from the criterion of substantially lessening competition.

1.1 The statutory merger factors

The merger and acquisition provisions fall within Part IV of the Act. The statutory competition test for mergers requires the ACCC to determine whether proposed mergers substantially lessen competition (s.50). In assessing the likelihood of such an outcome, the ACCC is required by the Act to have regard to various statutory merger factors. This merger evaluation process is not concerned with the efficiency-enhancing or other aspects of the merger, but only with its likely anti-competitive effects. Efficiency and other considerations are nonetheless relevant to the authorisation process — the ACCC may grant immunity from future prosecution by authorising anti-competitive mergers on public benefit grounds (s.88).

Merger evaluation by the ACCC, whereby it opposes anti-competitive mergers and, if necessary, institutes proceedings in the Federal Court against the merger parties, and authorisation by the ACCC on public benefit grounds are distinct processes under the Act. This distinction has been the essence of the statutory regime governing mergers in Australia since 1974, and was not changed by the recent amendments. Australia's unique 'dual adjudication system' in competition law, comprising a three-tiered institutional structure of court, commission and tribunal, requires:

> ... the courts [to] decide whether a practice lessens competition (per se or subject to some statutory specified competition test) and the *administrative bodies* [are] required to decide whether, exceptionally, a particular proposed practice would likely result in a benefit to the public that would outweigh any likely detrimental anti-competitive effects. In part the object of the procedure is to give the prospect of some certainty to the projects of business firms. But in part it is to shift some subject matter, especially efficiency considerations, out of the ordinary courts. This is especially important for merger law. (Brunt 1986, p. 265; 1993, p. 135)

The anti-competitive provisions of the Act charge the ACCC with the statutory duty of preventing mergers that are likely to substantially lessen competition. The statutory merger factors for evaluating the anti-competitive effects of proposed mergers are intended to guide the courts, the Australian Competition

Tribunal (formerly the Trade Practices Tribunal) and the ACCC to assess consistently the competitive effects of proposed mergers. The factors are:

- the actual and potential level of import competition;
- the height of barriers to entry;
- the level of concentration;
- the degree of countervailing power;
- the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins;
- the extent to which substitutes are, or likely to be, available;
- the dynamic characteristics of the market, including growth, innovation and product differentiation;
- the likelihood that the merger would result in the removal from the market of a vigorous and effective competitor; and
- the nature and extent of vertical integration in the market.

1.2 The November 1992 Draft Guidelines

The Draft Guidelines outline the ACCC's approach to administering and enforcing the new competition test.[3] The Draft Guidelines incorporate the statutory 'merger factors' in a five-stage evaluation process aimed at providing 'bright green lights' for mergers which enter into certain so-called safe harbours or havens based on market concentration thresholds. The five stages are:

1. *define the market* — the Act applies only to mergers or acquisitions in a substantial market. The ACCC is interested therefore only in mergers or acquisitions that occur within a 'substantial market in Australia'. Delineation of the relevant market is also a necessary starting point for assessing the competitive effects of a proposed merger;
2. *calculate market shares and seller concentration ratios to be used as a 'green light' for entry into 'safe harbours'* — the ACCC investigates further a proposed merger only if it would result in the four largest firms supplying 75 per cent or more of the market (with the merged firm having at least 15 per cent of the market), or the merged firm having a market share of 40 per cent or higher;

[3] They replaced guidelines issued in 1986 on how the TPC administered the dominance test.

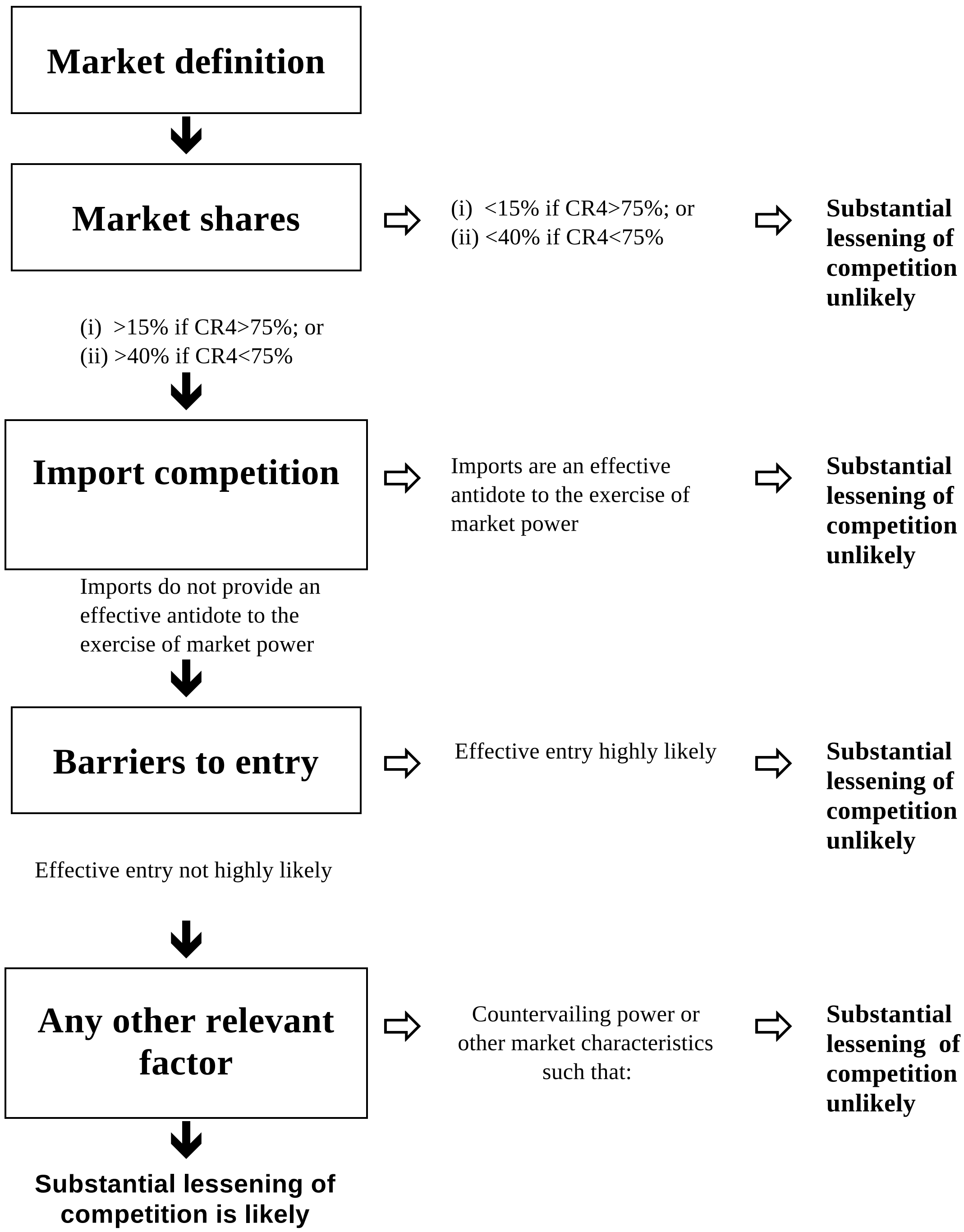
3. *review the effectiveness of import competition* — the ACCC will not further investigate mergers where competition from imports (either actual or potential) is judged to discipline effectively the prices of domestic firms;
4. *assess barriers to entry* — the ACCC will not object to mergers if new entry into the market is possible within two years, and on a scale sufficient to restrain the exercise of post-merger market power;
5. consider other relevant factors.

These five stages are intended to screen out those mergers considered not to have significant anti-competitive effects (Chart 1.1). Merger proposals entering a 'safe harbour' on the basis of market shares and concentration ratios will be given automatically the 'green light' to proceed. Others will be investigated further by the ACCC according to the evaluation process. Only those mergers 'failing' all evaluative stages will be opposed by the ACCC. It can agree not to oppose a merger proposal on the basis of enforceable undertakings entered into with the parties, or it may suggest that the parties apply for an authorisation on public benefit grounds[4]. Otherwise, the ACCC can attempt to prevent the merger by applying to the Federal Court for injunctions, divestiture orders and pecuniary penalties.

Although the Merger Guidelines have no legal status, they are intended to provide business with details of the approach to be taken by the ACCC in interpreting the 'merger factors' contained in the Act. By providing information on what mergers are reasonably likely to be challenged, and why, the Guidelines will reduce uncertainty, and firms will be able to avoid wasting time and resources on a merger proposal that has a high likelihood of being opposed by the ACCC.

4 As discussed in Chapter 5, less than one per cent of mergers considered by the ACCC proceed through the authorisation route. One of the two merger authorisation applications in 1993-94 was subsequently withdrawn; the other was unsuccessful (see TPC 1994). There was one application for merger authorisation in 1994-95.

Chart 1.1: **The ACCC's merger evaluation process**



Note: CR4 denotes four-firm concentration ratio.
Source: TPC (1992, p. 20).

In preparing its Draft Guidelines, the ACCC considered the experiences and merger guidelines issued in the USA and Canada where similar competition tests apply. The Guidelines attempt to draw a balance between providing clear signals to the market, while also retaining sufficient flexibility for the ACCC to exercise judgement in evaluating market information surrounding any particular merger. The Draft Guidelines were not intended to provide 'red lines' on which mergers would be likely to be opposed, but rather 'to provide a clearly defined approach to market definition and 'bright green lines' for mergers which fall within certain 'safe havens', based on concentration and market shares' (TPC nd, pp. 2-3). The intention was to strike a 'balance between providing clear signals to the market, while at the same time not over committing the Commission with a detailed set of guidelines that limit too severely the scope for future flexibility in the light of experience' (TPC nd, p. 2).

The Draft Guidelines, consistent with the Act, place the onus firmly on the merging parties to demonstrate that a merger breaching the concentration thresholds is not likely to substantially lessen competition. Although a final determination of issues is a matter for the court, the Draft Guidelines nevertheless provide:

> ... notice to the business community as to what factors the agency will be taking into account and how the various factors will be assessed. This will enable business to avoid wasting time and money on a merger proposal that is almost certain to be resisted by the agency and, in close calls, to enable parties to the merger to focus on the factors that will be critical in the agency's analysis. (Hay and Walker 1993, p.47)

1.3 The ACCC's pivotal role

Although disputes over mergers are a legal matter which ultimately can only be decided by the courts, most merger cases are resolved well before the court stage. Disputed decisions by the ACCC to oppose a merger proposal may be taken to the Federal Court of Australia. Decisions on merger authorisations may be taken to the Australian Competition Tribunal and, in certain cases, subsequently to the Federal Court of Australia. The ACCC, the Australian Competition Tribunal and the Federal Court, all play a central role in merger regulation in Australia.

In practice, however, the role of the ACCC is pivotal since few parties to mergers litigate through the Federal Court if they are dissatisfied with the ACCC's response to the proposed merger, partly because of the typically high costs involved. Only four merger cases were fully argued before the Federal Court under the dominance test (Johns 1994; Smith 1994). [5] Moreover, no merger cases

5 See *AMH Pty Ltd v. Trade Practices Commission* (1989) ATPR 40-932; *Arnott's Ltd and Ors. v. Trade Practices Commission* (1990) ATPR 41-061; *Trade Practices Commission v. Ansett Transport Industries (Operations) Pty. Ltd. & Ors. (1978)* ARPR 40-071; and *Davids Holdings Pty Ltd v. Attorney-General of the Commonwealth* (1994) ATPR 41-304.

have gone to trial yet in the Federal Court under the new competition test (Taperall 1995), although a number of cases were argued and decided under the ‘substantial lessening of competition’ test contained in the Act between 1974 and 1977.[6]

As a number of leading experts have commented:

> After 20 years of analysis and decision making, the methodology for evaluating the effect of conduct on competition in Australia is becoming a little clearer. It may not have been entirely clear when the Act was first passed. It may still not be as clear as many people would hope. Despite the clarification given by the 1992 amendments, assessing the effects or likely effect of conduct on competition is a daunting and expensive exercise in evidence gathering for all concerned. (Corones 1994b, p. 264)
>
> [the major challenge remaining for Australian antitrust jurisprudence is] ... to develop operational tests, i.e. detailed standards of liability as to what constitutes ‘lessening of competition’ and ‘substantial market power’ for the different categories of conduct falling under the Act. (Brunt 1994, p. 63)
>
> [the introduction of the competition test for mergers will mean that] ... the law will take a decade to develop into some semblance of normality. (Pengilley 1992, p. 312)

According to the Chairman of the TPC/ACCC:

> Typically the parties to a merger will not proceed if the Commission objects. The parties can of course test the matter in court or seek an authorisation but for various reasons, often commercial rather than legal reasons, they do not. *The Commission is very conscious that any action it takes, for instance early advice opposing a merger or seeking interim orders, may in effect be a final determination.* There is considerable caution on the part of the Commission. This is a significant power and the Commission’s decision is not usually tested by formal processes. However, it has been in some cases. The Commission’s role in the courts has been very successful and its decisions usually vindicated. (Fels 1994, p. 12; emphasis added)

The ACCC thus has a major bearing on merger outcomes within Australia, and business has few alternatives available when seeking authoritative direction on merger policies. Firms will have little option but to rely heavily on and be guided by the Merger Guidelines in their dealings with the ACCC and in making commercial decisions on company restructuring via mergers and acquisitions. For these reasons, the Merger Guidelines should provide as definitive and transparent guidance as feasible in order to minimise business uncertainty. However, although this was a major objective of the publication of the Draft Merger Guidelines, they reflect a trade-off between a desire to provide greater information and a wish not to constrain merger enforcement unduly:

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6 See, for example, *QCMA and Defiance Holdings* (1976) ATPR 40-012; *Howard Smith Industries and Adelaide Steamship Industries* (1977) ATPR, 40-023; and *Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd* (1982) 64 FLR 238.

> While merger guidelines have an important role to play in informing the marketplace, they should not overly constrain the enforcement of merger law. The new test is a departure from that which applied for the previous 15 years. The Commission only has limited experience in the application of such a test, from 1974-77 when it was not restricted to substantial markets. It is impossible to predict every scenario which may arise and which may give rise to concern on competition grounds. While the market needs some clear indications and guidance, it is not reasonable to expect a 'street directory'. This will tend to overly restrict the Commission in applying a new piece of legislation. There needs to be scope for judgement of the complex market circumstances surrounding any particular merger. (Hay and Walker 1993, p. 40)

In providing its opinion on the possible effects of the proposed merger on competition, the ACCC may: (a) persuade the parties to modify the proposal in line with the Act, including the acceptance of written undertakings; (b) encourage the parties, where appropriate, to apply for authorisation for the merger to proceed on public benefit grounds; (c) convince the parties to abandon their proposal; or (d) institute court proceedings against the parties if the merger is pursued. Although firms are not required to notify the ACCC of intending mergers, parties to such potential mergers are encouraged to approach the ACCC for a preliminary assessment well in advance of the proposed merger. This usually will require a confidential submission by the parties to the ACCC on the proposed merger.

If parties do litigate on merger evaluations, the only concern of the Federal Court is determining whether the merger would result in a substantial lessening of competition. However, if the matter remains within the processes administered by the ACCC, the parties have the options of negotiating with the ACCC to obtain its approval, either through changing their merger proposals to meet the ACCC's anti-competitive objections, including agreeing to enforceable undertakings, or by obtaining authorisation for the anti-competitive merger to be permitted on the grounds of providing net public benefits.

Where the ACCC has not been approached, it undertakes its own market inquiries once it becomes aware of the proposed merger, and instigates discussions with the parties. The ACCC may take the case to the Federal Court seeking an interim injunction to prevent the merger while it carries out its investigations. Where a merger that is found to be in breach of the competition test has already been executed, the ACCC may seek through the Federal Court divestiture and/or the payment of penalties in appropriate cases. [7]

[7] Penalties may be up to $500 000 for an individual and $10 million for a corporation. To date the Commission has sought penalties in only one case.

1.4 A three year retrospective

More than three years have passed since the introduction of the competition test. Whether the new test becomes stricter on mergers than the previous market dominance test will depend on how it is interpreted eventually by the courts (see Taperall 1995). According to the Chairman of the ACCC, ‘the new test has not resulted in a sea change in policy’, and Australia’s regulatory experience has been that most mergers and acquisitions ‘do not raise competitive concerns’ (Fels and Walker 1994).

The number of mergers subject to TPC scrutiny has increased under the new test.[8] In 1993-94, the TPC considered 132 mergers — compared with 86 in the previous year — and formally objected to six. In 1994-95, the TPC considered 151 mergers and formally objected to eight (see Table 1.1).

It had been foreshadowed that the introduction of the competition test would increase the number of merger cases examined by the TPC. For example:

> In terms of likely impact, more mergers will be examined by the Trade Practices Commission; and more will be sent to authorisation. Some, relatively few mergers, in industries sheltered from international competition, will be stopped. But they will be very important mergers, strategically located within the economy. The new law will be vitally important for the functioning of the deregulated and privatised utilities — industries such as telecommunications, energy and transport. And there are other industries that had an easy ride through the dominance law — such as the media, aviation, areas of retailing — that will now come under closer scrutiny. (Brunt 1993, p. 192)

The TPC (1991a, p. 21) also anticipated at that time that the number of mergers it would have to consider under the substantial lessening of competition test would be likely to increase to 150 to 200 a year and, of that number, it expected only ‘some 25 to 30 would require detailed consideration’. This is a significantly higher proportion than under the dominance test, for which the TPC stated that out of the 120 to 150 mergers considered in each year, ‘some 10% require detailed investigation’ (1991a, p. 21).

8 The impact of the business cycle on merger and take-over activity of firms is unclear.

Table 1.1: **Recent mergers and acquisitions considered by the TPC**

Financial year	*Mergers and acquisitions considered*	*Authorisation applications*	*Court actions*	*Amended or not proceeded with*
1989/90	117	2	3	3
1990/91	120	2	1	2
1991/92	103	3	0	3
1992/93	86	1	3	5
1993/94	132	2	1	6
1994/95	151	1	2	8

Note: Although the competition test was applied from 21 January 1993 , mergers in 1992-93 were assessed mainly under the dominance test.
Sources: TPC, annual reports, various issues and private communications.

However, despite the number of mergers considered by the TPC increasing by more than half in 1993-94, the number of mergers opposed under the competition test (six) was only one more than in 1992-93 when the dominance test had mainly operated:

> The year was marked by a substantial increase in mergers referred to and/or considered by the [TPC]; 132 merger matters were considered or under investigation (compared to 86 in 1992-93). ... The new substantial lessening of competition test has widened the range of mergers which the [TPC] must consider and has led to more companies referring merger proposals to the [TPC] ... *Notwithstanding the change in the mergers test and the greater number of mergers considered, the [TPC] did not oppose substantively more mergers in 1993-94 than in 1992-93.* (TPC 1994, p. 36; emphasis added)

Moreover, it is the IC's understanding that the TPC/ACCC has objected to about 5 per cent of the 100 to 150 mergers formally investigated each year (since the introduction of the new test). In some cases, mergers which initially were objected to by the TPC/ACCC have been resolved by divesting and/or providing undertakings which addressed the competition concerns. Not every merger proposal leads to a full and detailed investigation by the ACCC of the specific facts and nuances. The IC understands that, although the extent to which merger proposals are investigated by the ACCC varies, only a small proportion of mergers are examined in detail. Nevertheless:

> While not all of these [the 132 merger proposals considered by the TPC in 1993-94] required detailed consideration, the majority required a degree of substantial investigation and analysis. (TPC 1994, p. 36)

The amount of time that the ACCC is devoting to investigations appears to be significantly greater under the competition test. According to the TPC, 'the vast majority of mergers' that it considered under the previous dominance test were ‘cleared’ within one week. (1991a, p. 22) Under the competition test, it was observed:

> Where the parties have approached the Commission in relation to a proposed merger, and depending on the complexity of the matter and whether or not market inquiries are required, the Commission may be able to give its views within 10 working days. However, substantial acquisitions where there is a degree of market place concern may take the order of four or five weeks. (Fels 1994, p. 5)

Moreover, the ACCC has indicated that in those few merger matters which raise very substantial issues with which it is likely to have a problem, it may take six to eight weeks to provide a response. In matters which do appear to breach the merger thresholds, the ACCC will usually be able to complete its market inquiries and consider the matter within one month. In cases where it is satisfied that merger thresholds are not breached, the ACCC can usually inform the parties that no action will be taken in 10 to 15 days.

Tonking (1995, p. 3) considers that four to five weeks is a ‘most conservative estimate’ of the duration of a detailed merger evaluation by the TPC/ACCC.

The increased number of cases being considered by the TPC/ACCC under the competition test without any commensurate rise in the number of merger cases opposed raises the question of whether the Draft Merger Guidelines are casting a wider net than necessary to catch those mergers that are substantially anti-competitive. The Act does not require all anti-competitive mergers to be examined by the ACCC, only those that are likely to substantially lessen competition. This is recognised implicitly in the Draft Guidelines which allow a ‘safe harbour’ for mergers according to enforcement thresholds based on concentration and market shares. Determining how widely to cast the net is not easy, but it should involve the investigation by the ACCC of no more mergers than justified to meet the anti-competitive requirements of the legislation.

This paper develops proposals that the ACCC may wish to consider in reviewing its Draft Merger Guidelines. Section 2 considers when an investigation should be launched; Section 3 examines the role played by international competition; Section 4 discusses market entry conditions; and Section 5 reviews authorized mergers, enforceable undertakings and mergers involving ‘failing firms’.

2 WHEN TO INVESTIGATE

The Trade Practices Act regulates mergers and acquisitions that are likely to have the effect of ‘substantially lessening competition in a substantial market in Australia’ (s.50). In considering a proposed merger, the Draft Guidelines state that the TPC/ACCC will firstly look at answering the following three questions:

(a) what is the market?

(b) is the market substantial?

(c) will the merger be likely to substantially lessen competition?

Case law offers little guidance on the meaning of ‘substantial’ in both of these contexts, other than to confirm that the term is ambiguous, and to highlight the importance of the context in which it is used. Brunt has said that:

> In the end it must surely be a matter of judgment as to whether the likely lessening of competition is of sufficient importance in the context of the policy of the legislation for the merger to be enjoined or for other remedial action to be taken. (1993, p. 193)

As noted, merger decisions by the ACCC may become, in effect, a final determination. The Draft Merger Guidelines represent the ACCC’s efforts to devise acceptable and effective operational rules which enable it to meet its statutory duty of enforcing the trade practices legislation. These Guidelines should minimise the administration and compliance costs of firms, including any costs to do with business uncertainty, consistent with the requirements of the legislation. This necessarily involves some fine judgements on the cost of a merger law enforcement policy that undertakes precautionary investigations at the margin, relative to one that, when in doubt, is non-interventionist. Neither approach is free of error.

Ideally, the ACCC’s overall approach to merger evaluation and authorisation would be concerned with minimising the economic costs of:

- allowing undetected anti-competitive mergers to proceed;
- preventing efficiency-enhancing mergers — either anti-competitive mergers offering net public benefits which are deterred from seeking authorisation permitted under the merger legislation, or mergers which would not be anti-competitive but which are discouraged by the merger regulatory system; and
- administration and compliance.

The problem in drafting the Merger Guidelines to interpret and implement the legislation is that efforts to minimise the chances of not detecting anti-competitive mergers, also raise the risk of discouraging efficiency-enhancing mergers, and increasing administrative and compliance costs. The Act proscribes mergers where the acquisition has or is likely to have the effect of substantially lessening competition in a substantial market for goods and services. The application of the Act requires judgement, and the statutory merger factors on which the ACCC has based its Merger Guidelines reflect such judgements.

Drawing the line between what is effective competition and anti-competitive outcomes is usually, in practice, a difficult process since market conditions tend to be changing continually:

> Competition is a process rather than a situation. Dynamic processes of substitution are at work. Technological change in products and processes, whether small or large, is ongoing and there are changing tastes and shifting demographic and locational factors to which business firms respond. Profits and losses move the system: it is the hope of supernormal profits and some respite from the 'perennial gale' that motivates firms' endeavours to discover and supply the kinds of goods and services their customers want and to strive for cost-efficiency. Such a vision tells us that effective competition is fully compatible with the existence of strictly 'limited monopolies' resting upon some short run advantage or upon distinctive characteristics of product (including location). Where there is effective competition, it is the on-going substitution process that ensures that any achievement of market power will be transitory. (Brunt 1990, p. 96)

The legislation reflects a view that the economic costs of allowing major anti-competitive mergers may be large. But the economic costs of deterring important efficiency-enhancing mergers, especially where scale economies are important, can also be large:

> ... the efficiency-enhancing character of many mergers goes beyond simple economies of scale to exploit financial economies, economies of scope, and the complementarity of the unique resources in the particular firms involved. A merger may involve firms with well-developed distribution networks in different geographical areas or market segments, or firms with alternative research paths whose joint pursuit could lower risk. It may bring together firms with complementary product lines that could be manufactured, distributed, or marketed more efficiently in conjunction with one another. The internal growth of a single firm may never reproduce that configuration of resources, or it may take many years for a firm to accomplish unilaterally what it could have accomplished instantly by means of a merger. (Ginsberg 1991, p. 27)

Thus, parties to the blocked merger may not grow separately to realise the scale economies and other efficiency benefits that the merger would have made possible much earlier. Moreover, mergers and acquisitions often result in significant improvements in the way companies are structured and managed. For example, where existing managers are under-performing, a new management team may be needed to re-vitalise operations, product lines and distribution and marketing networks:

> An active 'market for corporate control' can ensure that management acts to maximise shareholder wealth through responding to market demand and efficiently managing the

> firm's resources ... However, the most likely source of superior management is another firm operating in the same market. This raises another potential conflict for merger policy. (Fels and Walker 1994, p. 97)

A vigorous market for corporate control is thus an important constraint on managerial slack. Eckbo has said that:

> Mergers and acquisitions are essentially a mechanism by which firms can quickly enter or exit an industry. Instead of wasting resources duplicating the production technologies already existing in an industry, the new entrant can focus on reallocating existing resources to a higher-valued use. The existence of a market for corporate control effectively puts a ceiling on the degree of inefficiency that can develop within an industry. (1991, p. 140)

Since the legislators have decided to prohibit mergers that substantially lessen competition, unless authorised on public benefit grounds, the focus of this paper is not on the economic benefits of preventing such mergers, but rather on ensuring that the costs of these regulatory arrangements are minimised given the Act's objectives. Precisely where the trade-off lies between containing the economic costs of anti-competitive mergers and not deterring efficiency-enhancing mergers which would be allowed by the legislation is difficult to determine conceptually and empirically.

However, gains from preventing anti-competitive mergers may, at least at the margin, be offset by losses to economic efficiency if the merger arrangements discouraged efficiency-enhancing mergers. For example, based on a business survey it conducted, the Bureau of Industry Economics (1995) found that aspects of competition policies in Australia had been the most important government factor motivating direct investment abroad over the period 1987 to 1994.

Similar views were expressed by several participants to the IC's current inquiry into Firms Locating Offshore[9]:

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[9] For example, Pioneer stated that '... its ability to expand in Australia is seriously restricted by the Trade Practices Act, which is currently administered to make it virtually impossible for a large company like Pioneer to increase its market share significantly. Such restraint also inhibits Pioneer from achieving world competitiveness and optimum efficiency and costs in Australia ... If the number of major Australian building materials companies were reduced from three to two (by merger or takeover) the global competitiveness of the remaining two companies would be substantially improved. The building materials industry in Australia would be considerably more efficient and lower cost, to the benefit of the Australian economy' (IC 1996, p.239).

The Metal Trades Industry Association (MTIA) also said 'Part IV of the Trade Practices Act, by its concentrated focus on prohibiting conduct that is likely to substantially lessen competition on the domestic front, runs the very real risk of becoming an impediment to the necessary aggregation of Australian capability in order to become a viable force not only in our domestic market but also in world markets' (IC 1996, pp. 239-40).

> During its round of visits, the Commission heard from a number of major offshore investors — in finance, construction materials and other areas of manufacturing — that they had little alternative to offshore investment if they wanted to grow, as the new Trade Practices regulation effectively precluded domestic expansion through mergers and acquisitions. They saw this as unnecessarily impairing the efficiency of the Australian industry. (IC 1996, p. 239)
>
> These concerns were also reflected in the Commission's survey results, in which a significant proportion of respondents identified merger regulation as the most important Australian government influence on their decision to locate abroad. (IC 1996. p. 240)

A major concern raised in that inquiry was that the merger requirements of the Act were being interpreted too narrowly. Concerns were expressed that successful efficiency-enhancing mergers achieved in the past would be either impossible, or much more difficult, under the current regulatory arrangements [10]. More specifically, the banking sector expressed concerns that the ACCC was defining the market for their services too narrowly (see Box 2.2).

2.1 Market definition

Defining the relevant market is fundamental to any merger assessment. It is a statutory requirement, since the Act refers specifically to conduct occurring in relation to a particular market. Moreover, delineation of the market represents an essential first step in assessing the competitive effects of a proposed merger, and whether the merger is likely to yield market power. The Guidelines recognise this by stating:

> An appropriate definition of the market is the critical underpinning for the evaluation of 'substantial lessening of competition' and the calculation of concentration ratios. (TPC 1992, p. 23)
>
> In identifying the relevant market, it must be borne in mind that the object is to discover the degree of the defendant's market power. Defining the market and evaluating the degree of power in that market are part of the same process, and it is for the sake of simplicity of analysis that the two are separated. (Mason C.J. and Wilson J., *Queensland Wire* case at 50,008; quoted in TPC 1992, p. 23)

Market definition generally has been the first step taken by the TPC/ACCC, the Tribunal and the courts in assessing mergers. Although 'the degree of precision in market definition may be tailored to the task at hand' (TPC nd, p. 13), and some courts have expressed concern that excessive resources have been devoted to this issue, the competitive effects of a proposed merger can only be assessed once the relevant market has been defined. Determining the market, no matter

[10] Information presented at the inquiry indicated, for example, that past mergers in the tyre business — essential to achieve efficient scale — would most probably be no longer possible.

how imprecisely, is necessary to set the outer boundaries beyond which a firm's market power is unrestrained by the action of others, and hence to evaluate whether competition is lessened substantially:

> Hence, market definition, if it is to be an aid to analysis, has to place in the relevant market those products and services and firms whose presence and actions can serve as a constraint on the policies of the alleged monopolist. (Fisher 1979, p. 13)

The purpose of defining the market is to draw a line around those firms that are sufficiently in competition that a price increase by one seller would cause enough consumers to switch to the other seller(s) for the price rise to be unprofitable — that is, the smallest group of firms that can raise prices significantly. According to the Draft Guidelines:

> Conceptually, the process of market definition can be viewed as establishing that area of product, functional and geographic space within which a hypothetical current and future (that is, not subject to the threat of entry) profit-maximising monopolist would impose a small but significant and non-transitory price increase from the competitive price level. (TPC 1992, p. 24)

In defining the relevant market by the 'area of close competition or rivalry among firms', the ACCC 'is concerned to establish the potential sources of competitive, that is close, substitutes for the products of the merging parties' available to consumers (TPC 1992, pp. 22-23). Identification of which products are close substitutes for the merged firms' product is clearly important in delineating the relevant market. As well as high cross-elasticities of demand, the ACCC will also consider whether there is a sufficiently high degree of product substitution in supply, and the geographic dimension of the relevant market, to ensure that 'the market includes all sources of supply to which the consumer can viably turn in the event of the merged firm imposing a significant price increase' (see Box 2.1). Merging firms will adjust their prices and products until competition makes further changes unprofitable. In principle:

> A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them. Within the bounds of a market there is substitution - substitution between one product and another, and between one source of supply and another, in response to changing prices ...
>
> ... in determining the outer boundaries of the market we ask a quite simple but fundamental question: if the firm were to 'give less and charge more' would there be, to put the matter colloquially, much of a reaction. (*Re Queensland Co-operative Milling Association* (1976) ATPR 40-012 (*Queensland Milling* case) at 17,247; reproduced in TPC 1992, p. 24)

Box 2.1: **Market definition**

The process of market definition contained in the Draft Merger Guidelines requires.... 'all sources of close substitutes for the merged firm's products [to be] included in the definition of the market. The process of establishing the market boundaries starts with the product(s) and geographic area of supply covered by the merged firm. It is then extended in its product and geographic dimensions to include all those sources, and existing potential sources, of close substitutes which would otherwise make it non profit-maximising for the hypothetical monopolist to impose a small but significant and non-transitory price increase'. (TPC 1992, p. 24)

The ACCC believes that the market must include all sources of substitute products, and that such an analytical framework is appropriate 'within which to make the necessary judgements in analysing the quantitative data and information it will have to rely on. In particular, the question of price competition is seen to be critical; if a product does not place any effective constraint on the price which the merged firm could charge for its product, the two products will not be considered to be in the same market'. (TPC 1992, p. 25)

However, the definition of market used in the Draft Guidelines as 'the smallest group of firms that [moving together] can raise prices significantly' intersects with the ACCC's definition of market power whereby a merger is said to be anti-competitive if the merged firms can raise their prices significantly. Together, these definitions could be taken to imply that a merger can only be anti-competitive if it involves all the firms in the market, or else involves tacit collusion or co-ordination of prices. The relevant consideration is how a merger would affect the behaviour of the firms in the market, not parties to the merger. Thus, for example, if they follow the leadership of the merged firm or implicitly collude with them, then the merger can be anti-competitive even if it does not involve all the firms in the market as defined.

Markets are multi-dimensional, having product, space, function and time dimensions. These must be reflected adequately in the delineation of the market. Moreover, the matter is often further complicated in practice by the relationship between these dimensions:

> A market has product, space, function and time dimensions. Between what set of products can customers and suppliers switch? Within what geographic space? Is the focus to be on the selling function or the buying function ...? finally, how much time is needed for customers and suppliers to make their adjustments in response to economic incentives?
>
> An important practical consideration is that these dimensions may not be independent. Thus, for example, geographic substitution may be alternative to, or complementary with, product substitution. And the interdependence may be enhanced the longer the time period. (Brunt 1990, p. 102)

While the Draft Merger Guidelines specifically mention product and geographical market dimensions, no direct reference is made to the time dimension. This is important, since it is through time and the dynamics of competition, involving the development of new substitute and alternative products, that any short-term market power is often effectively eroded. Yet it is this dynamic characteristic of markets that is the most difficult to 'measure'. (It is picked up by the Draft Merger Guidelines at the barrier to entry stage.)

2.1.1 How should markets be defined?

How the market is defined can have a major bearing on whether the proposed merger is opposed[11]. Drawing the boundaries around a market requires judgements on the limits of substitutability, since substitution is the defining feature of a market. In delineating the relevant market, one is attempting to determine the outer boundaries around which the pricing behaviour of firms is restrained by competitive pressures from firms (both actual and potential) producing substitutable products.

Plausible differences in market definition can lead to strongly contrasting views about the degree of market power. Depending on how market definition is handled, suspicions of market power can be endemic or irrelevant. It requires only a little 'creativity' to define a market in such a way that almost any industry is concentrated, or on the other hand, highly competitive:

> Market definitions are such notoriously elastic constructs that any one person disposed to worry about monopoly will not want for sources of concern, and anyone with a contrary inclination will sleep easily.
>
> Depending on how one looks at things, monopoly is either endemic or irrelevant in the economy. If markets are defined tightly enough (say, cotton shirts with crocodile emblems), almost every firm is a monopolist. If markets are defined broadly, (say, all clothing sold anywhere in the world), no firm comes close to having a monopoly. (Easterbrook 1981, p. 25)

The problems of market definition are closely related to the ability to distinguish in practice between differentiated products. Since markets generally comprise many differentiated products, it is often difficult to determine the extent to which products are substitutable. Indeed, creating and marketing differentiated products is one of the most powerful means by which suppliers compete in markets [12]. Manufacturers are trying continually to market products sufficiently differentiated from other goods in the hope that they will be able to exercise some, even if only transitory, degree of market power. It is these outcomes that make markets dynamic and competitively efficient.

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[11] It can also determine whether the merger proposal is unopposed by virtue of falling within the 'safe harbour' enforcement thresholds established by the ACCC.

[12] The area of intense competition is usually at the margin where small changes (as little as one per cent) in market share can have a major impact on the firm's profitability and survival prospects.

Where strong product differentiation exists, appropriate definition of the market is fundamental to ensuring that market shares retain their meaning as thresholds for market power. One response to strong product differentiation is to define markets more narrowly. Another response is to use sub-markets to capture the notion that there are markets in which some products are better substitutes for each other than for other products. Corones considers, however, that a 'sub-market is a market' — sub-markets are just markets which happen to have some discontinuity in substitution possibilities or other special features (1990, p. 56).

Generally speaking, broad, rather than narrow, definitions of markets would appear to be most appropriate for ensuring that all effective substitution possibilities are included. However, Australian courts, while generally endorsing the need first to delineate the market, have tended to accept, at least until recently, narrow, and at times confusing, market definitions. They have handled market definition in cases where strong product differentiation was an issue with varying degrees of consistency and success. In an early and unfortunate precedent, for example, the court considered the relevant market was for Datsun motor cars[13]. In the *Arnott's* case, it was held that the appropriate definition was the market for biscuits, rather than the general snack-foods market [14]. Similarly, the banking sector has been critical of the definition of its market used by the ACCC (see Box 2.2).

[13] *Top Performance Motors Pty Ltd v. Ira Burk (Queensland) Pty Ltd* (1975) ATPR 40-004. See also *Aut 6 Pty Ltd v. Wellington Place Pty Ltd* (1993) FCR 164 and *Attorney General of the Commonwealth v. Davids Holdings Pty Limited & Anor* (1993) ATPR 41-226.

[14] *Arnott's Ltd and Ors. v. Trade Practices Commission* (1990) ATPR 41-061.

Box 2.2: **Defining the market for banking services**

The future restructuring of the financial sector will be affected by the ACCC's policy towards mergers involving the major banks. Judgements as to the likely effects on competition of such mergers rests heavily on how the market for banking, and more broadly financial, services are defined. Any such definition of the market would need to take into account adequately the substantial technological changes that have occurred in the type and mode of delivery of banking services, as well as the recent provision of these services by major non-bank financial intermediaries. It has been claimed:

> A merger of any of the major banks in Australia would apparently be automatically deemed by the [ACCC] to substantially lessen competition. Why, given the clear evidence that banks are not the sole providers of banking and financial services, would it automatically be assumed that a reduction in the number of banks of any size would be anti-competitive ... Its a global game now ... the regulators have got to start to think about what technology is doing. (Argus 1996, p. 31)

The matter of market definition for banking services was raised in the IC's inquiry into Firms Locating Offshore, where the Commission concluded that such changes justify a reassessment by the ACCC of the markets in which banks now operate (IC 1996, p. 243):

> Some participants from the banking sector cited the TPC's reasoning in relation to the Westpac takeover of Challenge Bank in Western Australia as implying:
>
> - a distinct market for services offered by banks — when banks see themselves in competition with a range of non-bank financial institutions; and
> - a market defined by state borders — when banks see their markets as national and, in some activities, international in scope.
>
> While banks clearly retain a high profile in the community, it is also true that technological change has transformed the financial sector and heightened the substitution possibilities within and across regional boundaries. As the Deputy Governor of the Reserve Bank has observed:
>
> > Technological innovations are rendering obsolete judgements about market competitiveness which are based on numbers of branches in a particular geographic area, or even existing market shares for deposits or loans. This is because the new delivery systems are making regional markets more readily contestable by institutions — whether banks or others — without a strong physical presence in those areas (Thompson 1996, p.6).

Such narrow definitions constrain the substitution possibilities within markets. These decisions are in sharp contrast to the wide market definition recently adopted by Justice Burchett in the *Super League* decision. In this Federal Court case, the concept of a narrow market definition was rejected totally and the widest possible definition applied for determining the limits of competition in the relevant market. This case highlights the wide range of views of legal interpretations that exist in defining the market, and illustrates how contentious and crucial to merger regulation is the question of market definition. The decision in this case, which is on appeal to the full Federal Court, applied a very broad market definition in line with the Trade Practices Tribunal decision in *Application by Tooth & Co Ltd: Application by Tooheys Ltd* (1979):

> Competition may proceed not just through the substitution of one product for another in use (substitution in demand) but also through the substitution of one source of supply for another in production or distribution (substitution in supply). <u>The market should comprehend the maximum range of business activities</u> and the widest geographic area which, if given a sufficient economic incentive, buyers can switch to a substantial extent from one source of supply to another and sellers can switch to a substantial extent from one production plan to another. In an economist's language, both cross-elasticity of demand and cross-elasticity of supply are relevant. (*Application by Tooth & Co Ltd: Application by Tooheys Ltd* (1979) ATPR 40-113 at 18,916; referred to by Justice Burchett (his underlining) in *Super League* case, p. 57)

Justice Burchett also stated in the *Super League* case:

> ... the identification of too narrow or too broad a market will completely distort the picture gained of the competitive forces at work ... (p. 57)
>
> A market, I have suggested, is to be identified as the frame within which the picture of competitive forces may be clearly seen. Since too narrow a frame will exclude part of the action to be observed; it is essential that the market be sufficiently broadly delineated; ... (p. 58)

Moreover, Justice Burchett interpreted the meaning of the amendment to s.4E in 1977 to include in the legislation the words 'or otherwise competitive with' to infer a legislative intention to:

> ... specify a wider rather than a narrower market. There is good reason for this, since too narrow a delineation of the market will exaggerate the power of a relatively large firm in it, ... The Act would then be turned into an instrument for strangling competition rather than enhancing it. (p. 58)

2.1.2 Need for broader definitions

The Draft Merger Guidelines provide an indicative list of factors to which the ACCC will have regard when establishing the relevant product and geographical dimensions of the market. These include the end use of the product and potential substitutes; costs of switching between current product and potential substitutes;

the perishability of the product; as well as the transportation costs and customer's convenience of gaining access to alternative sources of supply (TPC 1992, p. 25-26).

However, none of these factors provides definitive guidance, and in practice the ACCC is able to reserve its judgement on market definition until it receives full details from the parties of the merger proposal. Thus, firms are required to prepare and submit their merger proposal to the ACCC without detailed knowledge of how their market will be defined by the ACCC.

Not surprisingly, issues surrounding the appropriate market definition to use in assessing mergers and acquisitions probably have caused more concerns than any other single factor. It is the fulcrum on which all further analysis, including application of market enforcement thresholds, depends. Moreover, business uncertainty appears to have been increased by what many see as degrees of inconsistency in the application of market definitions between industries and sectors, including as to whether national or state boundaries to competition are relevant.[15] Market definition is one important area where greater efforts are needed to improve the Draft Merger Guidelines. In the IC's view, broadly defined markets are more likely in practice to be better indicators of effective competition than are narrowly defined markets.[16]

Given the crucial role market definition plays in the application of the legislation and Draft Merger Guidelines enunciated by the ACCC, the IC believes that the ACCC should make more transparent the criteria used in delineating the relevant market. In this context, the ACCC should consider publishing case studies of recent mergers to illustrate how it arrives at a market definition, particularly in industries characterised by strong product differentiation. For example, the National Economic Research Associates' (NERA 1993) paper on market definition in competition policy for the Office of Fair Trading in the UK included case studies of recent mergers involving product differentiation. Officials of the

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[15] In many cases, the ACCC, and previously the TPC, has defined the relevant markets to be set by state, rather than national, boundaries. For example, the TPC rejected a merger between pharmaceutical groups FH Faulding & Co and QDL in 1994 on the grounds that it would lessen competition in Queensland. Similarly, the TPC has indicated support for the need to maintain significant state regional banks (Box 2.2). However, in its recent decision authorising the Davids Holdings-QIW merger without undertakings, the ACCC accepted a national market for grocery products.

[16] Markets which are too narrowly defined, or the rigid application of sub-markets, although they may be especially useful in registering the short-run effects of change, may be misleading if used uncritically to assess the long-run competitive effects (*Queensland Milling* case).

Antitrust Division of the US Department of Justice also publish widely on market definition, and include case studies of recent mergers. [17]

2.2 What is a substantial market?

The Act applies only to mergers in ‘substantial markets’. However, the Draft Guidelines, and the courts, provide little assistance in determining whether a particular market is significant enough to be covered by the Act. According to the TPC/ACCC, ‘... a market is substantial where a substantial lessening of competition is likely to have *significant and pervasive welfare consequences for the regional or national economy*. This is turn depends on the relevant location of the adjacent product and geographical markets and the input-output relationships in the economy’ (TPC nd, p. 12).

2.3 ‘Substantial lessening of competition’

The Draft Guidelines interpret a substantial lessening of competition as equating to a substantial increase in market power. Price rises are seen as the observable feature of a substantial lessening of competition. While recognising that market power may be exercised through non-price aspects of performance, such as quality, variety and innovation, the Guidelines focus on the price effects of anti-competitive mergers which are ‘more readily measurable’ (TPC nd, p. 8).

A substantial increase in market power occurs where there is a sufficient likelihood that the merger would raise prices. In line with the market definition, the criterion used in the Draft Guidelines to determine what constitutes a substantial price rise is the significant and non-transitory price increase of a hypothetical profit-maximising monopolist (SSNIP) above the competitive level.[18] As a guide, a 5 to 10 per cent price rise would be considered substantial. This approach, adopted in the Guidelines, is seen by the ACCC as offering a suitable and workable framework for assessing qualitative market information.

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[17] See, for example, Ordover and Baker (1992), Ordover and Willig (1993), Joskow, Werden and Johnson (1994), Werden (1993), Werden and Rozanski (1994), Werden and Williams (1989), Willig (1991a, 1992), and White (1987).

[18] According to the Background Paper for the Draft Merger Guidelines, the ‘competitive price is considered to be the appropriate base price for analytical purposes and this view is incorporated in the guidelines. However, there is the substantial practical difficulty of identifying what the hypothetical competitive price might be. Consequently, for practical purposes, the current price will often be taken to be the competitive price, unless there is some clear evidence that an alternative price is appropriate’ (TPC nd, p. 15).

In order to evaluate whether a merger is likely to have the effect of substantially lessening competition, the ACCC uses a five-stage evaluation process (see Chart 1.1). This process is intended to eliminate the majority of mergers from further investigation by applying market share thresholds, with other mergers being evaluated against other factors, including the effectiveness of import competition and ease of entry, which are progressively more complex and subjective. The ACCC sees such an evaluative structure as reducing its demands on the business community by reducing the degree of complexity as well as the amount of information and time needed to assess the merger's anti-competitive effects. As the TPC explains:

> In evaluating whether a merger is likely to have the effect of substantially lessening competition, the [TPC] will adopt a five stage evaluation process. ... The majority of mergers can be eliminated from the need for further consideration by the market share thresholds. Other mergers need to be evaluated on the basis of factors which are progressively more complex to analyse. (TPC 1992, p. 19)

The need to utilise several factors, in addition to market concentration, to analyse the anti-competitive effects of proposed mergers is well recognised overseas. For example, the Section of Antitrust Law of the American Bar Association has said that:

> To the extent that there is a consensus within the economics profession, it is that an accurate analysis of an industry must take into account other factors in addition to market concentration. Conditions of entry are especially important. (1986, p. 188)

The ACCC decides on how to define the market and whether a proposed merger gets the 'green light' by qualifying for the 'safe harbour' established under the threshold concentration ratios. However, once the ACCC decides that a merger proposal involves firms which on the basis of the market definition it applies lies outside the 'safe harbour' and requires investigation, the onus of proving that a proposed merger will not substantially lessen competition lies with merging parties:

> If the proposed merger does not fall within the 'safe haven' established by the concentration criteria, the onus lies with parties to the merger to convince the Commission that the merger will not result in a substantial lessening of competition and hence there is no need for intervention. Arguments should relate to the statutory 'merger factors' and other relevant criteria ... (TPC 1992, p. 28)

Firms involved in merger proposals investigated by the ACCC will often face significant compliance costs. Thus, it is sensible for the ACCC to arrange its enforcement priorities, as enunciated in the Draft Guidelines, so as to contain compliance costs imposed on industry, and to direct its own resources into investigating those mergers most likely to be anti-competitive.

A pragmatic approach to merger control has much to commend it:

> ... the argument for predicability and simplicity is not an argument for laissez-faire. It simply implies that attempting to obtain unattainable precision is likely to be expensive, both directly and indirectly ... When competent economists disagree on the best simple antitrust rule in a particular context, society risks little by using predicability and administrative simplicity to settle the argument. (Schmalensee 1987b, p. 80)

2.4 The rationale for enforcement thresholds

Concentration ratios are used by the ACCC ‘as a screening device to eliminate the need for detailed market studies where a merger is unlikely to give rise to any competitive concerns’ (TPC 1992, p. 19). This enables the ACCC to establish priorities for its merger law enforcement activities, and to reduce investor uncertainty and compliance costs. According to the TPC:

> Since market shares are often more readily available than other information, they are a relatively low cost means of screening out many mergers which are not likely to result in a substantially lessening of competition. The Commission has adopted concentration thresholds below which it is unlikely to intervene in a proposed merger. (1992, p. 27)

The use of simple threshold levels to screen and detect anti-competitive mergers reflects the need to strike a balance between showing diligence regarding mergers likely to be only mildly anti-competitive (or which do not have a strong likelihood of anti-competitive effects), and not undertaking fruitless, and potentially costly, investigations without obtaining the commensurate economic benefits to society. The more borderline mergers are investigated, the greater the compliance costs on firms and the likelihood of errors because of the immense difficulties of interpreting the data and making the necessary judgements.

By establishing a ‘safe harbour’ based on market concentration shares in which mergers will not be investigated, the ACCC is effectively setting threshold limits below which it considers that the probability of finding an anti-competitive merger in breach of the Act is low. The Act and the statutory merger factors, it appears to the IC, do not require the ACCC to scrutinise on a case-by-case basis all anti-competitive mergers, but only those that are likely to involve a substantial lessening of competition, meaning:

> ... an effect on competition which is real or of substance, not one which must be large or weighty. It is not enough simply to assert that a given merger *may* lead to higher prices. Rather, it is essential to separate out those mergers which create a *serious likelihood* that prices will be *significantly* higher after the merger; i.e. where there will be a substantial lessening of competition. The analytic apparatus that the Commission will use to analyse mergers is intended to do precisely that. (TPC 1992, pp. 15-16)

The ACCC is not compelled by the Act to analyse in depth all anti-competitive mergers, but only those in which there is a reasonable presumption that a case-by-case analysis of the statutory merger factors could reveal a substantial lessening of competition in a substantial market. This is precisely what the Draft Merger Guidelines have been constructed by the ACCC to do. Indeed, the Tribunal has stated:

> Section 50, in the absence of authorisation, prohibited the acquisition ... if the acquisition would have the effect or likely effect of substantially lessening competition. The phrase 'would have the effect' suggested the question must be tested against the evidence or established facts. The words 'would ... be likely to have the effect' suggested there were various shades of meaning, including 'more probable than not'. (*Queensland Wholesalers* case, at p. 40 916)

2.4.1 Priorities for enforcement

An important rationale for enforcement thresholds is that they are a cost-effective 'short-cut' to identifying those mergers that have a low probability of a substantial lessening of competition and which can thus simply be screened-out early from further analysis. As the TPC explains:

> For the purposes of practical enforcement of the legislation, concentration is a useful indicator or yard-stick by which many mergers may be quickly ruled out of further consideration. There seems little point in undertaking a detailed examination of barriers to entry and import competition if the market is highly fragmented. Only if the market is concentrated does the possibility of market power arise and hence the need for qualitative assessment of other issues. (TPC nd, p. 3)

The use of concentration ratios for this purpose presumes that a more concentrated market will tend to be less competitive (see Box 2.1). That this need not be the case is recognised by the ACCC's use of such thresholds only to screen merger proposals, and its acknowledgment that:

> Market concentration is not sufficient to establish the existence of market power. However, it is necessary. (TPC 1992, p. 26)

The nexus between concentrated market shares and reasonable suspicions of market power is therefore somewhat imprecise — concentration is a necessary but not sufficient condition. This position is not contradicted by econometric studies. Highly concentrated markets can, and do in practice, reflect both highly competitive and non-competitive situations. That is, market shares themselves provide little or no guide as to how existing or potential rivals may react to an increase in price. Thus:

> The right question to ask is whether that large share would survive an attempt to charge high prices and earn monopoly profits. If the share is maintained solely because of low prices or better products, then we are looking at what competition is supposed to do and not a monopoly. (Fisher 1979, p. 18)

At best, therefore, a highly concentrated market structure can be used only as a threshold limit to signal the need for further investigation. The more difficult judgements relate to determining the levels at which to set the threshold ratios. This is not independent of the market definition used in applying these thresholds.[19] Determining those levels will itself depend upon whether the market is defined narrowly or broadly and, once set, their future application depends on being able to continue defining the relevant market appropriately. The Draft Merger Guidelines recognise the crucial importance of market definition in the application of market concentration thresholds by stating:

> If the relevant market is properly defined, the merged firm will not normally be able to exercise market power in the absence of a significant market share. (TPC 1992, p. 26)

To be cost-effective, enforcement thresholds need to be set at levels where the risk of market power is high enough to justify further evaluation of the merger by the ACCC. Effective targeting of mergers, using relatively objective measures such as market thresholds, reflects not only the need to minimise the effects of regulatory intervention on market efficiency, as well as the compliance costs confronted by firms undergoing mergers, but also the fact that:

> The Commission generally has a very short time frame in which to evaluate issues of barriers to entry, import competition and other qualitative factors, unless it already has a detailed knowledge of the industry. (TPC nd, p. 3)

However, various industry/market classifications, all using different definitions, exist. Whether a particular merger proposal is caught by the concentration thresholds will depend to a significant extent upon how the market is defined. And, as discussed above, delineating the relevant market inevitably requires some subjective and difficult assessments.

2.4.2 The origin of the ACCC's enforcement thresholds

The current thresholds applied by the ACCC are:

> If the merger will result in a post-merger combined market share of the four (or less) largest firms in excess of 75 percent or more and the merged firm will supply at least 15 percent of the relevant market, the Commission will want to give further consideration to a merger proposal before being satisfied that it will not result in a substantial lessening of competition. In any event, if the merged firm will supply 40 percent or more of the market, the Commission will want to give the merger further consideration. Below these thresholds, the Commission is unlikely to take any further interest in the merger. (TPC 1992, p. 27)

According to the ACCC:

> These thresholds have been established on the basis of the Commission's historical experience of mergers and knowledge of current market structures, but may be revised in

[19] The number of merger proposals screened out by a certain threshold level would be expected to fall, for example, if a narrower definition of the relevant market was applied.

> the future subject to experience in the enforcement of the revised merger provisions of the Act. (TPC 1992, p. 27)

Current imports are included in the calculation of market shares and concentration ratios. A foreign exporter could count as one of the four largest suppliers, depending upon its level of Australian sales. No account is taken of foreign suppliers not exporting to Australia — a foreign firm without operations in Australia is not counted in the threshold calculation. Market shares are to be derived using the latest available sales figures, and wherever possible, be calculated on both volume and value, particularly in the case of differentiated products.

In setting the current market thresholds, the TPC analysed past cases in markets where it had been previously concerned about the competitive effects of mergers, but in which it could not prevent mergers because the statutory test in operation at that time (market dominance) was not breached. Enforcement thresholds set in the Draft Guidelines are at 'levels which would have been breached by those mergers', based on an analysis of 'historical and potential mergers against concentration criteria' (TPC nd, pp. 26-27).

However, no firm evidence or analysis has been presented by the ACCC as to why these particular mergers were used, or why they were of special concern. The ACCC's case for using its set of concentration thresholds is not adequately supported. The IC therefore would encourage the ACCC to conduct and publicly release detailed analysis of the effects of market thresholds on market power in Australia, including its experience (and that of the former PSA) in prices surveillance.

The ACCC regards its approach to mergers and the use of threshold limits as similar to those of its counterpart agencies in the USA and Canada. However, different measures and enforcement concentration thresholds and individual market shares are used. In terms of concentration ratios, it appears easier to sail into safe harbours in Australia than in the USA and Canada. [20] According to the ACCC, different market thresholds in Australia largely reflect its smaller market:

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[20] The four firm concentration ratio (the one also used in Australia - the C4) is 65 per cent in Canada, instead of the Australian level of 75 per cent, while both the USA and Canada use an individual market share of 35 per cent, compared to 40 per cent in Australia. The US Merger Guidelines use the Herfindahl-Hirschman Index (HHI) instead of the C4 ratio to measure market concentration. US concentration threshold limits, allowing the equivalent of about six to ten significant firms in the post-merger market, have been found to correspond empirically, as shown by data plots and regression analysis, to four-firm concentration ratios of 50 and 75 per cent (see Willig 1991b; Round and Miller 1993). Both Stigler (1982) and Round and Miller (1993) have noted that there is little in the way of tested knowledge to support the market shares and concentration ratios used in the US merger guidelines. The ACCC rejected the HHI in

> Similar guidelines are in existence in the US and Canada but the Commission's document differs from these in some respects, in particular by taking account of the small size of the Australian economy and its exposure to international trade. (TPC 1993a, p. 73)

As a result:

> The [four firm concentration] threshold was set 10% above and the market share thresholds were set at 5 % above those employed in Canada. (TPC nd, p. 27)

Hay and Walker see the Guidelines, which tolerate larger market shares than in the USA, as allowing 'firms more flexibility in achieving minimum efficient scale' (1993, p. 42). In smaller countries, high industrial concentration may be necessary for efficient production and technological innovation:

> Proposals to control market structures raise particularly difficult conflicts between competition policy and industrial policy. ... If a national market is small, it may be difficult to accommodate enough firms to ensure vigorous competition and at the same time to take full advantage of scale economies. The fear of scale economy losses is said to have been a deterrent to structural fragmentation measures in some nations such as Sweden and Canada and even France. *With an extraordinarily large internal market, the United States was typically able to have its cake and eat it,* which explains why it led the way towards policies curbing structural monopolies and mergers . (Scherer 1994, p. 61; emphasis added)

Market concentration thresholds applied in other OECD countries are often looser (allow higher concentration) than in the USA. However, although such international comparisons of market concentration ratios have influenced the Draft Merger Guidelines, they must be used carefully. Not only are different measures of concentration ratios used, but also other fundamental aspects can vary, such as how broadly the market is defined. Two identical market concentration ratios could lead to very different regulatory outcomes depending upon how broadly the markets of the merged firms are defined. [21]

2.4.3 Thresholds reduce investor uncertainty

Mergers and acquisitions are not costless to those involved. They will only be proposed therefore if there is sufficient likelihood that the ensuing benefits to the parties from the merger will exceed the costs.

It is important that regulation does not undermine unnecessarily business confidence to seek desirable merger possibilities. Although the Act does provide for ACCC authorisation of anti-competitive mergers found to produce net public

favour of the C4 ratio because it was less user-friendly and was responsive to both the absolute and relative levels of market concentration.

21 Or, alternatively, differences in market threshold limits may be appropriate if other factors, such as market definitions, varied.

benefits, fears among the business community of unwarranted investigations and delays by the ACCC could undermine investors' confidence and deter potentially beneficial mergers. Using 'safe harbours' to delineate those mergers that will not be investigated by the ACCC is an important means of easing these legitimate business concerns.

The need for investors to be able to ascertain when an investigation by the ACCC is likely, and to have a basis for forming a reasonable expectation about the outcome, is recognised in the Draft Guidelines. Otherwise, the merger requirements are increasingly likely to encourage firms and investors to direct their attention to projects that have no competition law implications whatsoever.

> It is important for the efficient functioning of the 'market for corporate control' that there be a reasonable degree of certainty as to whether a merger is likely to be challenged or not. ... It is likely that the majority of merger activity will pose no threat to competition and the [TPC] would not want to intervene. The market needs to be aware of this, so that they can pursue their activities unfettered by the threat of TPC intervention, and to have some indication as to when it would be desirable to approach the [TPC] for further discussions or clearance. (TPC nd, p. 1)

Parties that are likely to be caught by an enforcement threshold must factor into their plans the costs of an investigation by the ACCC. Although parties to a merger may hold off notifying the ACCC, such action risks encountering last minute (and possibly unexpected) opposition to the merger from the ACCC. To try to avoid such problems, the ACCC encourages early and confidential notification of a planned merger or acquisition of either a listed or an unlisted target. Confidential notification is not uncommon: for example, the TPC has revealed that it was unable to disclose the identity of about two-thirds of the mergers it considered in 1993-94, either because of confidentiality requirements or because there was an on-going investigation (1994). However, more than 95 per cent of the cases considered by the ACCC under the competition test relate to mergers and not to acquisitions (or takeovers), and it is in the latter 5 per cent where secrecy and speed are normally imperative to the parties concerned.

The more confidential the submission made to the ACCC, the more qualified its response is likely to be on the competitive effects of the merger. This is because the ability of the ACCC to make market inquiries will be much more limited if the merging parties request confidentiality.[22] The ACCC therefore will be in a much better position to comment on the proposed merger where details are public:

[22] Market inquiries by the ACCC include consulting with suppliers, customers, competitors, industry associations, governments, consumer groups and unions (see Fels 1995b).

> The Commission's response will depend to a large extent on whether the proposal is public and it can make market inquiries. The Commission will not give any concluded advice as to whether it will oppose a merger without making market inquiries.
>
> It would be uncommon for the Commission to give any form of informal 'clearance' to a confidential proposal, even to the extent of expressing a view that it is unlikely to oppose a merger based on, and subject to the accuracy of, the information provided and subject to the right to take a different view once it has made market inquiries. (Fels 1995b, p. 8)

Some commentators have suggested that for parties wishing to maintain confidentiality, there is little value in their approaching the ACCC, other than perhaps to resolve the issue of whether the merger covers a substantial market in Australia (Tonking 1995). It is up to the merging parties to decide whether to relax confidentiality requirements sufficiently to permit the ACCC to conduct its necessary inquiries in order to provide an assessment of the merger, or to accept the risks of proceeding confidentially:

> ... the parties want some indication that the proposal will not be opposed before taking significant steps in the proposal, for example, proceeding to due diligence, negotiating final agreement, closing plant. ... The Commission recognises that there are commercial risks and costs in announcing, and taking further steps in relation to, a proposal where the Commission has not expressed a view. However, the parties themselves are best placed to assess that risk and the costs and to determine whether they should announce the proposal and permit the Commission to commence market enquiries or proceed confidentially and take the risk. (Fels 1995b, p. 9)

Moreover, if the ACCC decides to oppose the merger and applies to the court for an injunction, this may itself be sufficient to kill the merger. The Hon Justice Heerey has said:

> Under the modern law the applicant for an interlocutory injunction need only establish that, in respect of the merits of the case, there are serious questions to be tried. This is a relatively low threshold. ... If the delay in full resolution by trial is such that the proposed acquisition is overtaken by events, such as a rival bid, the TPC can effectively prevent mergers and acquisitions by the relatively painless process (for itself) of interlocutory injunctions. (Heerey 1994, p. 3; case citation omitted)
>
> ... the consequences of the delay which occurs [in interlocutory processes] poses the question whether the power to decide whether acquisitions breach [the merger provisions of *the Act*] has, de facto, passed from the courts to the TPC. (Heerey 1994, p. 2)

Even on the fundamental issue of defining the market, it is highly unlikely that the ACCC would be in a position to provide a specific response to initial inquiries prior to the merger proposal being submitted by the parties. Thus, firms are required to develop merger proposals without knowing how their market will be defined by the ACCC. This adds greatly to investor uncertainty when considering merger possibilities.

Moreover, investor uncertainty is increased where unpredictable outcomes result from regulatory intervention. This could undermine the market for corporate control, and generate adverse effects on competition and market efficiency. It is therefore important that the Draft Merger Guidelines be transparent and predictable, so that investor uncertainty is kept as low as possible, consistent with the legislated objectives.

2.5 Market shares and market power

The threshold limits applied by the ACCC are an attempt to detect cases of *unilateral* power, where one firm has such a large share of the market that it can raise prices without fear of reprisals; *co-ordinated* market power exercised by a number of firms colluding to increase prices; and situations in which the merger will alter the structure of a market such that a group of firms, though not colluding explicitly, will be able to raise prices significantly (see Box 2.1).

Ascertaining mergers which increase a firm's market power is fundamental to the Draft Merger Guidelines which equate the legislative test of a 'substantial lessening in competition' to a 'substantial increase in market power':

> The exercise of market power is often the observable feature of a substantial lessening of competition and relates directly to the performance outcomes with which we are concerned. (TPC nd, p. 8)

2.5.1 Unilateral market power

So long as a merger results in the four largest firms having 75 per cent or less of the market, the ACCC will investigate it only if the merger would result in the merged firm having 40 per cent or more of the market. This market share enforcement threshold of 40 per cent reflects the ACCC's concern that market power can be exercised unilaterally by a firm without it necessarily having market dominance. It is appropriate to investigate mergers that result in market dominance, since there is empirical support that substantial price rises may follow some such mergers. But the position is not as clear in less concentrated markets.

There is some empirical evidence from the USA which suggests that unilateral market power may be associated with higher market shares than was previously thought. After reviewing the relevant US studies, Carlton and Perloff considered that:

> There is no agreement as to exactly what share (or change in share) is high, but many economists regard a share in the range of 30 to 50 per cent as too low to indicate

> significant market power with a competitive fringe comprising the remainder of the market. (1994, p. 803)

US lower courts rarely use market shares below 50 per cent as evidence of market power, and usually require market shares in excess of 70 per cent as strong evidence of market power. In addition, case studies from a range of countries show that competition can be strong in markets with two or three major sellers. Of course, showing this to be strong in some markets is not tantamount to demonstrating that it always will be the case.

Although such evidence is itself inconclusive, it may nevertheless be desirable for the ACCC to re-examine the current market threshold of 40 per cent to ensure that its Guidelines are not involving it (and the merger parties) in investigations where the probability of substantial post-merger unilateral market power is too low to lead to a presumption of a substantial lessening of competition. As noted, such a threshold should be set at a level that captures only those mergers involving a '*substantial lessening* in competition' — that is, where 'there is a significant likelihood that prices in the relevant product market will be maintained at a *materially greater* level than they would be in the absence of the merger' (TPC 1992, p. 16). Safe harbours used to screen out mergers from case-by-case investigation should be set as large as possible by the ACCC, consistent with the Act's objectives, to reduce compliance and other possible costs associated with merger regulation.

Recent public inquiries in Australia by the former Prices Surveillance Authority (PSA), now part of the ACCC, may provide some empirical support for the need to review the current 40 per cent market share threshold.[23] However, although these studies found competitive prices being set in many highly concentrated markets with the largest firm holding sales shares well above 40 per cent, their relevance must be qualified to the extent that it was the threat of potential, instead of existing, competition that was found to be generating competitive pricing. In its submission on prices surveillance, the IC concluded that prices surveillance should be limited in closed markets (those with substantial barriers to entry) to situations where a single firm had more than two-thirds market share (IC 1994c). This reflects the costs of surveillance and would not necessarily be appropriate for merger enforcement.[24]

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[23] In 1994, for example, the PSA conducted public inquiries into seven markets — namely, ready-to-eat breakfast cereal, tea, tampons, float glass, toothpaste, instant coffee and biscuits.

[24] The Industry Commission (IC 1994c) considered that the appropriate balance between the costs and benefits of prices surveillance could be best met using a market dominance criterion. This would limit prices surveillance to products where a single firm:

- has a greater than two-thirds market share; *and*

2.5.2 Co-ordinated market power

Provided that the merged firm has at least 15 per cent but less than 40 per cent of the market, the ACCC will investigate the merger only if it would result in the four largest firms having a market share in excess of 75 per cent. The use by the ACCC of a four-firm concentration ratio of 75 per cent as a 'safe harbour' is aimed at screening out mergers that have a low likelihood of facilitating tacit or explicit co-ordinated market power.

However, although Australia lacks sufficiently disaggregated data of the type needed to establish accurately the relationship between market structure and market power, recent empirical research (mostly from the USA) into oligopolistic market power raises doubts as to the link between seller concentration and higher prices for consumers:

> Empirical work ought to narrow the range of uncertainty but, unfortunately, much recent empirical work has served primarily to undermine the confidence expressed in earlier studies purporting to show an almost unqualified relation between higher concentration and higher prices. (Hay and Walker 1993, p. 46)

Even where higher prices are associated with concentrated markets, the appropriate concentration thresholds for detecting the possibility of co-ordinated market power would depend upon how quickly prices are thought to respond to the possibility of new entrants. Some recent overseas studies have found that the competitive effects of firms moving in and out of industries tapers off considerably in markets where there are three or more effective competitors. Prices and, in some cases, profit levels have been observed to fall substantially once a relatively large second or third firm entered the market. Carlton and Bishop consider that:

> There is indisputable evidence that prices fall as entrants enter a previously monopolised market. *The real debate is how fast price falls with entry*. Studies of individual industries seem to indicate that competition often works very quickly, with large price effects caused by entry of a second or third firm, but much lower (and sometimes zero) effects for subsequent entry. (1994, p. 415; emphasis added)

- has no major rival; *and*
- faces sporadic or trivial imports (import penetration persistently below 10 per cent of the market); *and*
- is sheltered by substantial barriers to entry (and expansion by rivals).

The Industry Commission's recommendations were contained in a p ublic submission to an inquiry by the Prices Surveillance Authority into the criteria to be used in deciding what firms should be declared subject to the prices notification provisions of the *Prices Surveillance Act 1984.* The Industry Commission considered that the benefits of prices surveillance all but disappear in markets with no dominant seller, while the costs accelerate rapidly.

> ... the link between high concentration and higher price-cost margins is ambiguous. Some studies find that the link, if it exists at all, is very weak, whereas others find no link at all. They also find that the presence of a large second or third firm greatly reduces the price-cost margins that can be earned. This finding indicates that it can be a mistake to use only four-firm concentration ratios to measure market structure. (1994, pp. 353-354)

Empirical research by Bresnahan and Reiss (1987, 1990, 1991) in the US suggests that effective oligopolistic co-ordination tends to breakdown once there are three firms in the market. Their US study of geographically isolated monopolies, duopolies and oligopolies in retail and professional services concluded that, while large price falls accompanied the entry of a second or third supplier into the market, further entry had little or no impact on competitive conduct once there were three to five suppliers. Studies of airline competition in the USA also suggest that the price effects of entry and exit taper off considerably once two to three carriers exist. [25]

The Australian Treasury also found that case studies in a range of overseas countries uncovered vigorous competition in markets with two or three sellers (1991). Furthermore, case studies in Australia also suggested that highly concentrated markets can be very competitive:

> Empirical evidence ... supports the view that in Australia there are quite a number of relatively highly concentrated industries in which there is strong competition from a variety of sources — from imports, substitute products, countervailing power, potential competitors and *rivals in the same industry*. (Treasury 1991, p. 7; italics added)

The recent literature and empirical evidence therefore also casts doubt on whether the current four-firm concentration ratio is the most appropriate indicator.

2.6 Conclusions: setting appropriate threshold levels

The IC supports the use by the ACCC of market concentration ratios as a means of screening out mergers that do not ‘substantially lessen competition’. Nevertheless, as widely recognised, implementing such thresholds raises difficult questions since the choice of particular thresholds is ultimately somewhat arbitrary:

> There is no concentration number above which anti-competitive pricing is clearly threatened and below which competition is clearly assured. (Areeda 1987, p. 977)

Moreover, considerable uncertainty and subjectivity exists in merger analysis and in deciding which mergers to oppose:

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[25] See Werden (1991), Willig (1991a), Borenstein (1992), Evans and Kessides (1993), Pautler and O’Quinn (1993), and Joskow, Werden and Johnson (1994).

> ... we should not kid ourselves about our ability to predict accurately the effects of particular mergers. Estimation of the price and output effects of mergers (assuming no efficiencies) is rather crude, and the estimation of the magnitude of unique efficiencies and prediction about entry are even less reliable. (Hay and Werden 1993, p. 176)

Under these circumstances market thresholds should be seen as ‘rules of thumb’ for filtering out for further investigation those mergers that are likely to violate the Act by substantially lessening competition from those mergers that are unlikely to have substantial anti-competitive effects and which therefore require no investigation by the ACCC. Currently, the ACCC investigates a large number of merger proposals, albeit to varying degrees, but only a few are opposed — equivalent to only 5 per cent of cases considered in 1994-95. The concurrence of a large number of investigations and relatively few ACCC oppositions to mergers suggests that the Draft Guidelines may be operating as poor screening devices, causing greater uncertainty and cost for business than is needed, or desirable.

There is some recent evidence to suggest that substantial market power occurs at higher levels of concentration and market share than previously thought, and than those on which the Draft Guidelines seem to be based. In the IC’s view, it would be desirable for the ACCC to review its enforcement thresholds in the light of these developments to assess the implications of raising them. It would be helpful if, as part of this review, the ACCC reviewed and published its own evidence. As noted, the possibility of the ACCC having to review its enforcement thresholds over time is recognised in the Draft Guidelines.

Some proposals

The IC suggests that the ACCC re-examine market share and concentration thresholds currently existing in the Draft Merger Guidelines to see whether they could be raised (loosened), while remaining consistent with the Act’s objectives. As indicated above, the legislation does not require all mergers to be screened, but only those with a likelihood of substantially lessening competition. If this were not the case, then the rationale for using any market enforcement thresholds to screen out mergers — an important basis of the Draft Merger Guidelines — would disappear.

The IC proposes that the ACCC look at the possibilities of increasing the threshold market share for an individual merged firm from the present 40 per cent to 50 per cent. This market share would still be a significant reduction from that previously used under the dominance test.

The IC also believes that there could be benefits in the ACCC reviewing its experience and evidence to consider granting a ‘safe harbour’ when the largest three suppliers have less than 75 per cent of the market (provided the merged firm has below 50 per cent of it), or when the largest three suppliers have 75 per cent or more of the market, provided that the merged firm has less than 20 per cent.

Assessment of the potential effects of changes in the market concentration thresholds on prevention rates is made difficult by the lack of published data on mergers considered by the ACCC. It does not publish data on the stages at which mergers drop out of its evaluation process or, for example, on how mergers relate to the enforcement thresholds. Similarly, public data on opposed mergers are limited, particularly if there are no court proceedings, or where competition concerns have been resolved by (confidential) negotiations between the ACCC and parties to the merger.

There would be benefits in the ACCC publishing data — at a suitable degree of aggregation to protect confidentiality — on the number of evaluation stages to which mergers are subjected before a decision is made, including data on market shares and concentration. Data should also be made available on how many weeks passed before decisions were made. Where confidentiality precludes publishing aspects of particular cases, the ACCC could study these questions internally and publish the results in summary form.

3 INTERNATIONAL COMPETITION

Mergers and acquisitions in Australian markets that are exposed to international competitive pressures are unlikely to harm competition. According to the Chairman of the TPC/ACCC, the 'Commission has not objected to any mergers in the last four years where there has been import competition' (Fels 1995d), and:

> In assessing particular mergers the Commission has had particular regard to the degree of import competition in trade exposed sectors. About 10 per cent of the matters recently considered involved mergers in markets facing a substantial degree of actual or potential import competition. It is worth noting that the Commission has not opposed any mergers where imports have been significant. (Fels 1995c, p. 7)

The importance attached to import competition by the ACCC appears to be unrelated to the introduction of the competition test:

> If there is strong actual or potential import competition in the domestic market it is unlikely that the TPC would seek to challenge a merger, regardless of whether the threshold test was market dominance or a substantial lessening of competition. (Johns 1994, p. 205)

It has been claimed that the major difference between the Australian and North American merger guidelines is the 'greater importance attached to import competition' (Fels 1995a). The role played by import competition, both actual and potential, is recognised in the Merger Guidelines:

> In an open economy such as Australia, the importance of giving special consideration to the role of actual and potential import competition in considering the potential exercise of market power is recognised. If import competition is an effective check on the exercise of domestic market power, it is unlikely that the Commission will intervene in a merger. However, the assessment of actual and potential import competition needs to be undertaken with care. (TPC 1992, p. 28)

According to the ACCC, it is unlikely to oppose mergers in markets where there is significant international competition since domestic firms in these cases are unlikely to be able to exercise market power or injure consumers. Under the Draft Merger Guidelines, the effectiveness of import competition is the first factor assessed for merger proposals outside the 'safe harbour' created by the concentration thresholds. This further evaluation involves ascertaining whether imports exert a competitive discipline greater than that indicated by their current market share.

3.1 Potential import competition

While the ACCC will treat the market share of imports as an initial indication of their competitive role in the market, it recognises that the current market share of imports offers only ‘a partial picture’ of their impact on domestic competition:

> The Commission recognises that in some markets, market shares may understate the competitive constraint provided by imports in the market, because of the potential to expand the supply of imports rapidly in response to higher prices. (TPC 1992, p. 29)

> Where imports are not subject to any restrictions other than tariffs, the market share of imports will often understate the competitive constraint which they place on other market participants. This situation will characterise many commodity items, including some differentiated items such as lower priced clothing and footwear. (TPC nd, p. 28)

The TPC/ACCC also argues that the reverse may apply:

> However, in other cases market share will overstate the role of imports. The fact that imports have established a small market share, does not necessarily imply that they could expand in response to the exercise of market power by the merged firm. (TPC 1992, p. 29)

To be regarded by the ACCC as providing effective competition, imports must be at ‘arms-length’. Imports not at ‘arms length’ resulting from Australian manufacturers locating part of their production offshore, for example, would not be considered to be effective import competition (Johns 1994).

The ACCC is also sceptical about the power of import competition in markets for products that are differentiated:

> For differentiated products, the analysis of import competition is more complicated. For a variety of reasons, the import supply schedule may be nowhere near infinitely elastic. (TPC nd, p. 30)

In such markets, the TPC/ACCC is concerned that import expansion may require a ‘switch from niche to mass production’, or it may call for ‘investment in expanded distribution and marketing facilities’ (Hay and Walker 1993, p. 44). Such requirements may make imports much less responsive to the exercise of domestic market power.

However, the ACCC’s remaining reservations about the effectiveness of import competition may be exaggerated and, in any event, are likely to be relevant to a very limited number of cases. Even in markets for highly differentiated (tradeable) products, intense competition from the greater range of varieties likely to be available internationally, as well as through the introduction of new products from overseas, is likely to constrain market power at home effectively. Even in the most concentrated Australian manufacturing industries, changes in foreign prices lead to substantial changes in the prices of domestic products (Bloch 1992, p. 374). A ‘standard finding’ of empirical studies in a range of countries is that imports have a negative impact on profits, and that this effect is strongest in more concentrated markets (Scherer and Ross 1990, p. 371).

3.1.1 Trade barriers

Where restricted, imports may or may not provide an effective discipline on domestic prices:

> The existence of tariff and non-tariff barriers, transport costs and other impediments to imports may constrain the extent to which imports can compete with domestic products in the market. (PSA 1994a, pp. 12-13)

Low import penetration ratios may also be consistent with effective import competition, and may still imply a foreign competitive discipline on the domestic market, especially in the absence of non-tariff import restrictions. Thus, import penetration ratios below 10 per cent may still be consistent with effective import competition. Hay and Walker observed (regarding the Draft Merger Guidelines) that:

> In some instances, the market share of imports may understate their competitive impact. Supply may be infinitely elastic at the world market price plus transportation costs and tariffs, placing an import parity cap on domestic prices. In some markets, this may result in a very low market share for imports as domestic firms price to maintain market share; however, if a merged firm tried to raise domestic prices they would face a flood of imports. This is particularly likely in markets for homogeneous goods not subject to import quotas. In these markets, it may be relatively straight forward to establish the presence of effective competition. (1993, p. 44)

Low import shares are potentially most likely to indicate a lack of competitive discipline on domestic prices where effective non-tariff import restrictions, such as quotas, apply. Where only tariffs restrict imports, the market generally would be seen as sufficiently competitive to allow a merger proposal to go ahead, unless duties were judged to be high enough to prohibit or seriously impede import competition:

> After March 1993, when clothing and footwear quotas disappear, the only protection for manufacturing industries will be in the form of tariffs. Tariffs should not pose a problem for importers trying to *increase* their share of the domestic market in response to a price increase, if they have been able to overcome those barriers at existing prices, except in the context of niche marketing. (TPC nd, p. 29)

Now that most Australian tariffs — with the exception of motor vehicles and textiles, clothing and footwear — are being reduced to a maximum rate of 5 per cent by 1 July 1996 when the current general reduction program expires, tariffs alone would be unlikely to restrict import competition, or its threat, sufficiently to make the home market anti-competitive, even where a single domestic producer exists.[26] Nevertheless, the ACCC recently departed from normal practice and linked its decision not to oppose the acquisition of Comalco's Yenora aluminium rolling mills by KAAL Australia Pty Ltd to the removal of the tariff (through a Tariff Concession Order) on aluminium bodystock.[27] According to the ACCC:

> The acquisition will deliver the entire domestic market for aluminium bodystock production to Alcoa [a joint venture partner of KAAL]. The only constraint would be imports, which are currently subject to a tariff of seven per cent, reducing to five per cent in July 1996.
>
> The removal of the tariff on aluminium bodystock will limit the ability of the sole domestic supplier to raise prices charged to canmakers. These prices flow through to consumers of products such as beer and soft drinks. (ACCC 1995, p. 1)

3.2 When is actual competition international in scope?

The ACCC's evaluation process assesses whether actual 'arms length' import competition is sufficient to maintain a competitive domestic market following the merger. Actual import competition is much stronger in Australia following the Government's trade liberalisation measures. Manufacturing imports, for example, have doubled, in the last 25 years, and accounted for 30 per cent of domestic sales in 1992-93 (see IC 1993).

Thus, an inappropriate treatment of imports would miss the most pronounced current change in the nature of competition in many Australian markets:

> Many Australian producers face import competition which, in principle, augments and strengthens competition. Import competition also raises doubts about the validity of market share based solely on domestic production data and other domestic structural indicators of 'competition'. (Corones 1994b, p. 249)

While potential import competition constrains the use of market power, actual imports make foreign sources of supply a more tangible and credible threat.

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[26] While the tariff still maintains higher domestic prices, efforts to raise domestic prices substantially following a merger are likely to be constrained by import competition. This is not to say, however, that tariffs should not be lowered to zero. Doing so would remove the still substantial costs imposed on consumers and downstream producers through higher prices resulting from existing tariffs. It would also benefit the economy through improved efficiency and resource allocation, as well as achieving potentially significant savings in administrative and compliance costs.

[27] The implications of this ACCC decision is unclear following the recent decision by the current Government to modify the Tariff Concession System. From 1 July 1996, the tariff concession granted on imported consumer goods and business inputs is to be reduced — from the total duty — to a concessional duty rate of 3 percentage points, thereby representing a saving of at least 2 percentage points for most goods imported under concession orders.

Persistent non-trivial imports show that foreign firms already have overcome transport costs, tariff as well as distribution and other distance-related hurdles to sell in Australia. Foreign firms, once established in Australia, should be able to meet the requirements of a relatively small Australian market at the prevailing price without stretching overseas production and shipping capacities. Foreign supplies generally can be changed readily, at no appreciable higher cost to the exporter, in response to domestic price signals (Landes and Posner 1981, pp. 963-968). Indeed, a foreign supplier operating in several large international markets often is able to expand sales quicker than a home firm which may have to expand production capacity in order to service new business.

Effective import competition would constrain domestic suppliers from raising prices above import parity (the landed-duty-free price of competing imports plus any tariff). While for many Australian products import parity prices (plus any tariff) will be relevant in setting limits on domestic prices, for those products in which Australia has a comparative advantage, a truly competitive home market would be expected to reduce the domestic price below import parity to export parity levels (given by the free-on-board export price). The difference between export and duty-free import parity levels, also called natural protection, reflects import costs (freight, insurance etc).

The ACCC’s use of import or export parity pricing as the appropriate competitive benchmark depends upon market conditions. The IC understands that the ACCC would not use export parity as an appropriate benchmark in all industries. This choice would depend on whether the industry is a net importer or net exporter; in industries that are net importers, import parity would be used as the appropriate competitive benchmark.

A dominant domestic firm producing mainly for the home market may have considerable scope to exercise market power and charge higher prices if it has high natural protection — for example, due to the high shipping costs incurred on imports. It is also possible that the domestic price of products whose production is mostly exported, which would be expected in a competitive market to fall below import parity to export parity, could be increased to import parity (plus any tariff) following a merger. Again, with no or minimal import restrictions, such as the relatively low tariffs now applying in Australia, the extent of any such price rises would be set by the degree of natural protection.

Although the amount of natural protection varies somewhat across products, the IC's experience from industry inquiries suggests that it would rarely exceed 10 to 15 per cent of the export parity price. This implies that the level of natural protection in many cases would be unlikely to be sufficient to stop unrestricted imports from effectively limiting price rises of a dominant domestic producer. [28]

3.3 When is import competition effective?

Import competition should be considered to be effective if overseas suppliers represent a discipline on the potential exercise of market power by the merging firms that is similar to that exerted by existing or potential domestic competitors. In the *Queensland Wire* case, Mason, C.J. and Wilson, J. said that:

> Market power can be defined as the ability of a firm to raise prices above supply cost without rivals taking away customers in due time, supply cost being the minimum cost an efficient firm would incur in producing the product. (p. 184)

The Draft Guidelines provide an indicative list of factors that the ACCC will use in deciding whether import competition is effective. These include factors such as the extent to which imports and domestic products are substitutes and evidence that domestic prices are inhibited by actual or potential imports; the independence of domestic and foreign suppliers; and any regulatory restrictions on the supply of imports. Overseas suppliers will be effective competitors if they are able to serve in due time, at no appreciably higher cost, sufficient customers of the merging domestic firm that a price increase by the latter would be unprofitable.

Importers are particularly well-suited to exerting a destabilising influence in oligopolistic domestic markets. This is because the scale economies of many foreign producers are unlikely to hinge on large sales in any one market.

Colluding domestic sellers risk incursions — 'hit-and-run' entry — by overseas suppliers who already should be taking full advantage of scale economies, but have little need to make a long-term commitment to the Australian market. For example, the wide range of industries where local firms make dumping allegations (involving imports on a scale to cause 'material injury' to local

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[28] The issue of natural protection arose in 1993 when the TPC considered an industry-wide joint venture application concerning sugar. It found that while the threat of imports imposed a cap on local prices, transport premiums were large enough to leave scope for the exercise of significant domestic market power if the joint venture was authorised (see Pasternak 1994). Moreover, significant tariffs applied to sugar imports at the time would have enabled domestic prices to be further increased. The TPC considers that its refusal to allow the merger has ensured that domestic sugar prices continue to be set at world (FOB) levels by virtue of domestic competition (see Fels 1995a).

producers) implies that the necessary transport, distribution and marketing infrastructure easily facilitate imports that are competitive on price. [29]

3.3.1 A proposed benchmark for effective import competition

The market penetration at which 'arms length' imports are an adequate discipline on domestic firms is a matter of judgement, to be made on the basis of evidence and reasonable assumptions (on important issues) that will be, in some sense, arbitrary.

The IC sees some merit in specifying a credible import market share for identifying a 'safe harbour' where it is presumed that mergers will not be anti-competitive. Such a threshold could be used by the ACCC in the same way as market concentration ratios.

In a paper for the UK Office of Fair Trading, National Economic Research Associates concluded that:

> Invariably, some material degree of trade is required in order to make a market international in scope. Even though it is possible to argue that the potential for trade alone provides a competitive constraint, such claims deserve to be treated with scepticism unless significant trade has been shown to be feasible. Once import penetration has reached a level of around 15% of domestic sales, the case for arguing that import competition is capable of exerting a decisive influence on the way in which UK price levels are set becomes stronger. (NERA 1993, p. 77)

Notwithstanding that such a market share threshold for imports is somewhat judgemental, the IC has previously suggested that 10 per cent penetration by imports (for which there are local substitutes) is an appropriate benchmark for classifying a market as international in scope (IC 1994c). The IC still considers that an import penetration ratio of 10 per cent or more for three years is a reasonable indication that, in the absence of quotas or other special factors restricting imports, foreign suppliers have established a sufficient market presence.

The IC therefore proposes that consideration be given to using this figure as another 'safe harbour' threshold above which mergers will not be investigated by the ACCC, unless there is evidence of unusual barriers to import expansion, such as significant non-tariff measures, or other special circumstances, such as imports

29 Dumping allegations have been made against imports in almost all manufacturing industry sectors (see IC 1995a). In 1993-94, Australia had the third highest number of anti-dumping measures notified to the GATT under the Anti-dumping Agreement, behind the US and EU (see IC 1995a), although the number of measures fell significantly in the following year. Anti-dumping action may reduce the potential for effective import competition in some areas.

which are not at ‘arms length’. Where such unrestricted ‘arms length’ import shares have been 10 percent or more for, say, three years, it would appear reasonable to assume that tariffs and the level of natural protection against foreign goods (that is, the transportation and other costs of importation) are not sufficient to prevent imports from being competitive in the domestic market.

While the ACCC would still need to conduct some research to determine whether a particular merger was in fact within the ‘safe harbour’, there would be more certainty for the firms involved, because of the explicit guidelines.

Import penetration ratios below 10 per cent may (and in many cases would) be consistent with effective import competition, but at these levels the IC suggests that no ‘safe harbour’ should exist and their effectiveness would need to be assessed individually. Where domestic prices are substantially below import parity, the ability of a domestic monopolist to raise domestic prices following an anti-competitive merger would, in principle, be capped by the level of natural protection on competing imports.[30]

In these cases of negligible import competition and no or minimal import restrictions, it may be useful for the ACCC to ascertain the level of natural protection provided to domestic producers to see whether it was sufficient to enable a home supplier to raise prices substantially following a merger. Only in cases where this was significant — say, above 10 per cent — would a domestic monopolist be likely to be able to charge a substantially higher price. As noted earlier, for many or most products, the degree of natural protection may be below this level.

[30] The domestic price cap would be increased by the rate of duty where tariffs are applied to imports.

4 ENTRY

The conditions affecting new entry into markets are often of critical importance in evaluating the market power of merging firms. However, the difficulty of assessing entry conditions is recognised by the ACCC:

> The assessment of barriers to entry in particular market circumstances is quite difficult, often more difficult than assessing the role of imports. Consequently, this stage of the review process has been placed after the concentration threshold test and also after the assessment of import competition. (TPC nd, p. 31)

According to the Draft Guidelines:

> Even where a merger breaches the concentration thresholds, if the market is not subject to significant barriers to new entry, incumbent firms are likely to be constrained by the threat of potential entry, to behave in a manner consistent with competitive market outcomes. However, if there are significant barriers to the entry of new suppliers into the market, an increase in concentration to levels beyond the Commission's thresholds is likely to give rise to a substantial lessening of competition. (TPC 1992, p. 30)

Moreover, in the *Queensland Wire* case the High Court considered that market power would be short-lived unless there were barriers to entry. Mason, C. J. and Wilson, J. said that:

> A large market share may well be evidence of market power, but the ease with which competitors would be able to enter the market must also be considered. It is only when for some reason it is not rational or possible for new entrants to participate in the market that a firm can have market power. There must be barriers to entry. (*Queensland Wire* case, p. 185).

However, neither the *Trade Practices Act* nor case law provides much guidance on the mechanics of entry analysis. As such, the business community will need to look to the Guidelines for an analytical framework concerning entry conditions. Clarification of the nature of entry barriers is especially important given that the economic literature itself is somewhat divided.

Since merging with incumbents is an important means by which new firms can efficiently overcome barriers to enter markets, it is important that merger regulation not be applied too rigidly. Otherwise, merger regulation itself runs the risk of reducing market contestability:

> ... in the relevant economic sense, it is possible to have simultaneously both relatively low entry barriers and a relatively low probability of actual de novo new entry. In such circumstances, generally the only practical way for more efficient operators to displace inefficient incumbents is for an acquisition or merger to take place. Ironically, in such circumstances competition law is often used by inefficient incumbent management to

> prevent displacement by more dynamic and cost-effective firms who are willing to buy out existing shareholders (Swan 1995, p. 84).

4.1 What is effective entry?

The ACCC defines effective entry as:

> ... that which is likely to occur within a two year period if the merged firm was to exercise significant market power, and would be on a sufficient scale and sufficiently attractive to consumers to provide a competitive restraint on the pricing of the merged firms. (TPC 1992, p. 31)

However, the Guidelines provide no clear indications as to how the ACCC will assess whether there are barriers which effectively restrict entry. According to the Guidelines, a ‘concentrated market is often an indication that there are significant barriers to entry’ (TPC 1992, p. 31). Although this may be so in a very large market, it may not be the case in a small market where significant economies of scale and/or scope exist.

The Draft Guidelines also indicate that the ACCC will examine evidence of firms entering, failing and leaving the market in assessing whether there are effective entry barriers. In addition, evidence would be sought of ‘concrete plans’ by major firms to enter on a large scale (TPC 1992, p. 31). If the market has a history of failed new entry, the Draft Guidelines foreshadow that the ACCC will need to be convinced that these plans are likely to be more successful than previously.

However, although the successful entry of new ‘arms length’ firms would indicate no effective barriers, unsuccessful entry or lack of attempts at entry say nothing about barriers and may easily be mis-interpreted (Schmalensee 1988, p. 342). New entries may not occur because of the incumbents’ efficiency, and past attempts may have failed for the same reason.

Given the debate among economists about what constitutes effective entry, obtaining a consensus on ways of improving the assessment of entry barriers is difficult. The various factors which have been advanced over the years as barriers to entry have been subject to a remarkable amount of controversy (Harbord and Hoehn 1994). While some admit a great many things as barriers to entry, others have difficulty finding any entry barriers at all. Schmalensee has said:

> ... economists do not have a single, precise, reliable way of measuring ease of entry in particular markets. There is some agreement on what relevant factors one ought to consider. But there is much less agreement about how to assess those factors, and even less about how to combine them into an overall measure of the difficulty of entry. (1988, p. 339)

4.2 Barriers to entry

Market power can be self-destructive. High profits eventually attract new entry, so incumbents cannot exercise market power for long in the absence of barriers to entry or natural monopoly. The lower are entry barriers, and the shorter are the delays on effective new entry, the less is the market power of existing sellers, and the less relevant are the existing market structures for assessing competition. Only when there are no significant alternative actual and potential sources of supply, and no substitutes from the consumer's perspective, is a large market share likely to represent a reliable signal of power over price. Thus, a large market share, although a necessary feature, is not by itself sufficient to indicate a substantial degree of market power.

The Draft Guidelines define a barrier to entry as any feature of a market that places an efficient prospective entrant at a significant disadvantage relative to the incumbent firms. The Guidelines require firms to demonstrate that 'effective' entry is likely to occur. This means that it must be timely (be possible within two years); likely (profitable at pre-merger prices and room exists in the market for an efficient scale operator at those prices); and sufficient (entry to be that required to restore prices to their pre-merger levels). However:

> The draft guidelines do not commit the Commission to a particular 'view of the world', as regards what may or may not constitute a barrier to entry in particular circumstances. Rather the approach taken in the draft guidelines is to give a general acknowledgment of the types of barriers which may exist and to place the onus on parties to demonstrate in a practical sense that entry is likely to occur if the merged firm exercised market power, despite the high level of concentration in the industry. (TPC nd, p. 34)

The Draft Guidelines follow the Full Bench of the Federal Court in the *Arnotts* case in identifying factors that may constitute a barrier to new entry:

- legal or regulatory barriers;
- exclusive access by incumbents to scarce resources or particular cost advantages;
- economies of scale;
- product differentiation and brand loyalty; and
- the amount of sunk investment which is required in production capacity, access to shelf-space, advertising and promotion costs.

To help recognise barriers to entry, the Guidelines indicate;

> ... the type of concrete evidence which the Commission will consider in evaluating the likelihood of entry, with the emphasis placed on empirical evidence of entry or lack of entry, rather than theoretical discussions of the nature of barriers to entry in a particular market. (TPC nd, p. 35)

The ACCC’s Guidelines appear to be based on the view that a broader definition of entry barriers is needed for effective anti-trust enforcement so as to cover a wider range of factors than normally might be considered. This is the view of the Office of Fair Trading in the UK:

> Entry impediments are any factors which delay the process of entry into a market without increasing the (sunk) costs of entry, or creating an asymmetry between incumbents and entrants. They are therefore not entry barriers that afford persistent incumbents supernormal profits, but they may be important to antitrust decisions to allow a merger for example, because they influence the amount of time that incumbents may exercise market power before they occur. (London Economics 1994, p. 38)

However, although the measures identified in the Guidelines as possible entry barriers have been regarded as such by many commentators, a significant body of economic literature suggests that, on closer examination, most do not in themselves constitute entry barriers.[31] Superior efficiency by the incumbent producer(s) is often the greatest obstacle to new entrants, but this hardly constitutes a barrier to entry. It reflects the proper functioning of the market, with some firms always being first into a new market and continuing to dominate until others can rise to their standard of efficiency:

> Accordingly, a barrier to entry must be something that interferes with competition. ... It follows that not everything that makes entry appear difficult or uninviting is necessarily a barrier to entry. The mere necessity of building a plant when incumbents have already built theirs is not such a barrier (although associated economies of scale with sunk costs can be). Neither is the necessity of advertising or creating a reputation automatically a barrier. (Fisher 1987, p. 33)

The IC believes that preventing or discouraging mergers on the grounds of the existence of entry barriers, if not administered carefully, could effectively make markets less contestable. Any workable definition of a barrier to entry for antitrust purposes must establish a standard to identify factors which prevent market forces from eroding positions not based on efficiency. In this sense, the existence of higher costs imposed on potential entrants relative to incumbents is the key to ascertaining whether newcomers can duplicate the competitive advantages of existing firms at comparable costs. Thus, the IC supports the definition of barriers to entry as:

> ... anything that requires an expenditure by a new entrant into an industry, but imposes no equivalent cost on an incumbent. (Baumol, Panzar and Willig 1982, p. 282)

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31 The literature itself contains a range of views about barriers to entry. At two extremes are the Harvard School and the Chicago School. The first has ‘tended to admit a great many things as barriers to entry and abuses of market power, including economies of scale and capital requirements’, while the second ‘could be accused of admitting no entry barriers at all, other than those created by government policy or regulation’ (Harbord 1995, p. 320).

Although the ACCC's position is based on the view that the disciplinary effects of entry depend critically upon the type, size and success of entry, the IC has some reservations about the weight of these arguments and the lack of detail contained in the Draft Merger Guidelines on how these matters are assessed by the ACCC.

4.2.1 Sunk costs

The Draft Merger Guidelines recognise that the most important barrier to entry is large sunk costs since these are irreversible commitments that cannot be recovered if the business fails. This may be because the assets are so specialised that they will have little or no re-sale value.[32] Although sunk costs may provide an advantage to those first into the market, and are incurred by both incumbents and new entrants, the special hurdle of large sunk costs faced by new firms is that entry on a large scale in a concentrated market may result in a larger than anticipated fall in the price:

> ... 'contestable markets' ... presumes the existence of 'hit and run' entrants who are able and willing to enter an industry whenever profit opportunities arise. Such entry makes sense if the potential entrant has little at risk ... The key ... is how quickly prices move in response to new entry ... If prices move quickly in response to entry, then hit and run entry becomes very risky if there are any sunk costs. (Gilbert 1989b, p. 112)

In any ensuing price competition, low prices are less of a threat to an incumbent than to an entrant, because the former has lower opportunity costs — it needs only cover current operating costs (including any on-going financing costs associated with sunk costs) to stay in business.[33] Williams has said:

> The large minimum efficient scale means that competitive entry will be on such a large scale that the capacity of the industry is significantly increased. The sunk costs mean that, although the expansion of capacity depresses prices so as to throw doubt on the decision

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[32] An operational definition of a sunk cost is the difference between the purchase price and the maximum re-sale price of an asset. Sunk costs therefore are fixed costs which not only do not vary with output, but also cannot be recouped if the business ceases operations. The 1992 US Merger Guidelines define sunk costs as:

'The acquisition costs of tangible or intangible assets that cannot be recovered through the redeployment of these assets outside the market. That is, costs uniquely incurred to supply the relevant product and geographic market.'

Possible examples of sunk costs are investments in equipment that can produce only a specific product, facilities dedicated to a particular market such as a pipeline or distribution terminal and advertising campaigns for new product launches (when the product name or goodwill is not marketable).

[33] Of course the financial costs (debt) arising from the purchase of the assets which involve 'sunk' costs may be continuing, and must be covered in the longer term to stay in business. 'Sunk' investments may involve continuing financial costs.

> to enter, these low prices do not eliminate the incumbent because it needs to cover only its unit operating costs in order to stay in the market. (1994, p. 111)

Thus, new entrants:

> ... by definition, do not face risks arising from the ability of incumbents to ignore their sunk costs when setting prices. (Baumol, Panzar and Willig 1982, pp. 290-291)

This has been recognised by the Canadian Bureau of Competition:

> Each of these potential sources of sunk costs can create significant impediments to entry by presenting potential entrants with a situation where they must factor greater costs into their decision making than incumbent firms that have already made their sunk cost commitment, and can, therefore, ignore such costs in their pricing decisions. This asymmetry typically presents potential entrants with a recognition that they face greater risks and a lower expected return than what is faced by incumbent firms. In general, risk and uncertainty increase, and the likelihood of significant entry decreases, as the proportion of total entry costs accounted for by sunk costs increases (1991).

Without sunk costs, therefore, it is difficult to conceive of situations where the new entrant is at an inherent cost disadvantage relative to the incumbents.

4.2.2 Scale economies

Both the decision in the *Arnotts* case and the Draft Guidelines fail to give adequate recognition to the fundamental link between economies of scale and sunk costs. After evaluating (and opposing) some mergers and acquisitions in the pharmaceutical and grocery distribution industries, the TPC also came to the view that scale economies *per se* may be a barrier to new entry:

> Perhaps contrary to economic theory, economies of scale do appear to be a substantial barrier to entry in the distribution sector, even in the absence of sunk costs. This is because of the level of minimum efficient scale required for successful and significant new entry. In many Australian distribution markets, this scale represents a substantial share of the market. Any business considering entry on that scale, which would result in substantial over-capacity, would anticipate a sharp response from the incumbents resulting in severely depressed post-entry prices and returns. (Fels 1994, p. 21)

According to the Draft Merger Guidelines:

> Economies of scale are perceived to be a barrier to entry for two main reasons. Firstly because the larger the minimum efficient scale (MES) of operation, the larger the capital investment that is required in order to enter the market. Contestability theory argues that this only constitutes a barrier to entry to the extent that those capital costs are sunk. However, in many markets this will be the case.
>
> The second factor which is likely to deter entry in a market where there are significant economies of scale, is the expectations of potential entrants regarding post-entry prices. Perfectly contestable markets require that firms do not take these into account when

> making their entry decision. However, where MES entry will add significant capacity to the market, this may be an important factor. (TPC nd, p. 32)

Since the optimal number of producers in any industry is determined by the interaction of the costs of supply and the level of demand for the product, it follows that where the minimum efficient scale is large (scale or scope economies are considerable) relative to current demand, then the number of efficient firms in the industry will be small:

> Some economists will say that economies of scale are a barrier to entry, meaning that such economies explain why no additional firms enter. It would be equally possible to say that inadequate demand is a barrier to entry. (Stigler 1968, p. 67)

While scale and scope economies may be associated with sunk costs in constituting a barrier to entry, it is the sunk costs, and not the economies of scale or scope per se, that restrict entry because only the sunk portion of the costs incurred in achieving the scale economies will be irrecoverable should the firm fail. Hence in any assessment of entry barriers, it is necessary to evaluate the significance of the sunk cost component.

Some significant empirical studies support the logic that scale economies are not in themselves impediments to entry. An international study surveying over 70 studies of entry and exit patterns in eleven countries, concluded that scale economies *per se* receive 'little empirical support as entry impediments' (Siegfried and Evans 1994, p. 121).

4.2.3 Product differentiation and brand loyalty

In the *Arnotts* case, brand loyalty and product differentiation were also considered barriers to new entry (again without making a connection to sunk costs). This seems to be based on the proposition that it is difficult for new entrants to attract market share by offering a lower price if an incumbent enjoys brand loyalty. More specifically, the TPC stated:

> Product differentiation and brand loyalty may act as a barrier to entry in a number of related ways. Firstly, it affects the demand schedules facing new entrants versus incumbent firms. The level of demand which new entrants can capture may be limited by brand loyalty; and the price elasticity of demand which they face will generally be higher than that of incumbents. On the cost side, the ongoing investment in advertising and promotion which is required to maintain a differentiated product will accentuate economies of scale, because of the fixed threshold level needed to have any impact on the market. Furthermore, there will be additional penetration costs for new entrants, which increase with the level of market penetration which is required. (TPC nd, p. 33)

However, product differentiation and brand loyalty themselves can be an important form of non-price competition between incumbents and also an important means by which to enter a market. Many markets subject to product differentiation are extremely competitive, and may appear to be uncompetitive simply because competition takes a different form:

> ... the focus of competition in such markets [product differentiated markets like computers and cars] is often on factors other than price. Firms try to capture customers through such non-price offerings as the best or most responsive service network, the best warranty protection, or the most reliable equipment. Excessive antitrust scrutiny could penalise firms for engaging in the kind of competition that is often the most robust in concentrated markets for durable technical equipment. (Hovenkamp 1993, pp. 1447-1452)

Smith said in regard to a merger case dealing with non-price competition — *QIW Retailers v. Davids Holdings Pty Ltd* (1993):

> Failure to understand the nature of non-price competition contributed significantly to underrating the significance of the constraint. Frequently (but not always) the key aspect of competition (or its absence) is price competition. Yet, in imperfectly competitive markets, non-price competition is often at least as important as price competition, particularly where one market participant is keenly aware that its actions will be responded to by rivals. (Smith 1994, pp. 103-104)

Brand loyalty can itself be a rather fickle advantage that usually requires the incumbent to incur continuous advertising costs, especially following the arrival of a new competitor. Indeed, new entrants may find it easier to penetrate advertising-sensitive markets despite the large costs involved, so that the requirement to incur high advertising costs — that may be sunk — may not deter entry. It also is commercial reality that brand loyalty will slow new entry only to the extent that buyers find the established products superior:

> Prices and quality of goods have primary sway over most markets. Some buyers will be faithful to enterprises for reasons other than price, quality, and service, but they are too few and too shallow in their faith for an enterprise to prosper if it fails to perform well in the basic functions of business. (Stigler 1988, p. 96)

In addition, while latecomers to highly product differentiated markets may suffer the disadvantages of brand loyalty to the incumbent producer, they have the benefit of a more informed customer base, and of leap-frogging in technology. Thus, while there are obvious advantages in being the first into a market, there are also some costs relative to potential new entrants:

> The entry barrier concept highlights the idea that there are substantial advantages to being first. Industry pioneers benefit from taking the lead in exploiting scale economies, establishing reputations, and investing in highly specialised capital. These *‘first mover advantages’* may raise entry barriers by forcing newcomers to bear costs that are not borne by firms that entered the industry in the past. On the other hand, latecomers may benefit from the pioneering investments of first-movers who, by demonstrating the profitability of a new product or a new market, reduce the costs of subsequent entry. (Shughart, Chappell and Cottle 1994, p. 342)

In any case, the high profits of market pioneers, at least in new markets, may be more apparent than real. Pioneers into new markets often seize the biggest and best product niches, but they also face much higher costs due to the greater uncertainty of entering unknown and untested markets (Robinson, Kalyanaram and Urban 1994). They found that product and market development costs in new markets typically exceed any monopolistic pricing benefits from being first; and that the initial losses of market pioneers are usually two to three times those of later entrants.

4.2.4 Strategic behaviour

A new entrant's expectations about the reaction of incumbents may deter entry, and these may be affected by a history of previous failed attempts. Incumbents may fight entrants aggressively in part simply to cultivate a reputation for aggression against entry:

> The original intuition here, often associated with Joe Bain, was that under suitable if vaguely specified cost and demand conditions, incumbents could profitably diminish entry incentives. (Peltzman 1991, p. 206)

The main form of strategic behaviour advanced is that incumbent firms may utilise their sunk costs to deter future entry with strategic over- and under-investments.[34] Firms could choose to retain excess capacity so as to be able to cut prices and expand output to supply the resulting additional demand whenever there is new entry. Such strategic over-investments in capacity increase the sunk costs of the merging firms, but they allow incumbents to make credible threats to start a price war (at low cost) if there is new entry.[35]

If the merged firm has significant excess capacity, the higher prices — levels that normally would make new entry profitable — may be a mirage to potential new entrants. As soon as there is new entry, prices may drop well below pre-merger levels in order to clear the market (because of the additional production capacity of the new firm). This prospect may deter new entry in the first instance, particularly if there are significant sunk costs, even though prices and profits may be above competitive levels (Coate and Kleit 1991).

[34] It has also been suggested that strategic behaviour can occur after entry, through, for example, price cutting, product differentiation and heavy advertising. However, these appear to be sensible competitive outcomes that can benefit consumers rather than examples of strategic behaviour aimed at stifling competition.

[35] Some fixed costs will represent opportunity costs of staying in business (such as debt or holding on to assets that are saleable) while others, being sunk, are therefore not opportunity costs.

However, strategic investments can be costly to a firm's productive efficiency; it costs money to carry excess capacity, while the pay-offs, in terms of securing the market from would-be entrants, tend to be uncertain and distant:

> Two general points about entry-deterring strategies are worthwhile making at the outset. First, it costs something to block entry. [Second, if] the outsiders are less efficient (have higher costs) than the insiders, conscious attempts to deter entry are unnecessary. Similarly, if the outsiders are more efficient (have lower costs) than the insiders, then entry-deterring strategies will be ineffective. Thus the possibility that established firms in an industry can jointly undertake actions that prevent the entry of new firms into an industry is of concern only if such actions block the entry of competent rivals. (Shugart 1990, pp. 127-128)

Moreover, when there are multiple incumbents, joint action is difficult. The complexities of inter-firm co-ordination, needed to ensure that all firms participate in the strategic use of sunk costs, may mean that this prospect largely disappears in markets that have more than one significant incumbent firm:

> ... a conspiracy to predate would be incalculably more difficult [than predation by a single firm]. The conspirators would have to allocate losses during the fighting and also allocate the gains afterward. Aside from the dangers of entry, there would be the very real dangers of cheating by some of the conspirators and the detection of the illegal price-fixing necessary for the conspirators to recoup their losses and make additional returns. (Bork 1993, p. 66)

Although the nature of the problem makes it difficult to undertake reliable empirical studies on its use, evidence appears to support non-use of strategic investments by incumbents as a means of preventing future entry by new firms:

> There is no empirical evidence whatsoever of the deliberate use of excess capacity by incumbents as an entry barrier to deter new entrants. (Siegfried and Evans 1994, p. 136)[36]

> ... the technological characteristics of most industries are such that a single firm could not commit to a production level that prevented entry, even if it had desired to do so. ... The available studies constitute only fragile evidence that established firms take potential entry into account when developing their competitive strategies. (Gilbert 1989b, p. 118)

The IC's experience yields similar conclusions. While there are clearly cases where substantial excess capacity exists, there is little evidence to indicate that incumbents have maintained continually and intentionally over-investments and excess capacity for strategic reasons alone. [37]

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[36] This study, however, relates only to cross-sectional results and did find evidence of incumbents taking advantage of the entry-inhibiting effects of *unintended* excess capacity to raise prices.

[37] In its recent study into the NSW electricity industry, the IC found, for example, that the excess capacity maintained by Pacific Power — which posed a strategic threat to

Predatory pricing

A particular type of strategic behaviour often alleged to be used by incumbents to prevent entry is predatory pricing:

> A somewhat controversial category of potential entry barrier is the capacity of incumbent firms to engage in some form of predatory activity, e.g. by maintaining excess capacity and engaging in predatory pricing against new entrants. (TPC nd, p. 34)

A price is said to be 'predatory' if it is set below short-run marginal costs to deter new entrants or to discipline their pricing policies. Short run losses are incurred in the expectation that large subsequent profits will be earned following the price war.

However, virtually all writers in the field agree that profitable predation cannot occur in the absence of significant barriers to entry; otherwise the continuous threat of entry would limit future price rises needed to recoup the losses. Moreover, it would be sensible for incumbents to launch a price war only if they maintained sunk investments in excess capacity that enabled them to increase supply at low marginal cost. This is recognised by the ACCC:

> However, these activities [predatory pricing against new entrants] are generally related to some other barrier to entry, such as sunk costs in production capital; otherwise it would not be rational for the incumbents to maintain excess capacity, and predatory pricing will only be effective if barriers to entry deter new entrants after prices have been restored. (TPC nd, p. 34)

Predatory pricing is really only rational against equally competent rivals — the less efficient will falter on their own — while forays against the more efficient are foolhardy (Shughart 1990). There are also very few documented cases of successful predatory pricing (Carlton and Perloff 1994). The suspicions about the existence of predatory pricing behaviour were also reflected in a recent US Supreme Court decision that predatory pricing suits should be dismissed out-of-hand, unless the plaintiff can show below-cost pricing and be able to advance a plausible scenario on how the alleged predator can reasonably be expected to recoup losses (Calkins 1994).[38]

4.3 Assessing the height of entry barriers

The *Act* requires the ACCC to take into account the height of entry barriers when evaluating a merger. This is not easy in practice, given that:

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entrants — was a legacy of the government-legislated monopoly that was aimed at increasing size rather than profits (IC 1995b).

[38] Even before this ruling, few predatory pricing suits were successful in US courts (OECD 1989).

> There are real barriers to entry in most real markets. ... In most real markets, the question 'is entry easy?' is thus improperly posed. The proper question is 'How easy is entry' or 'how high are the barriers to entry?' Entry conditions, like market power, are logically measured along a continuous scale: not yes or no, but more or less. (Schmalensee 1988, p. 339)

The Draft Guidelines do not provide transparent benchmarks for the evaluation of the height of barriers to entry. If entry analysis in the ACCC's Guidelines is to be reasonably predictable and transparent, the business community needs clear signals about the relative importance of particular factors and about how conflicting evidence and considerations will be resolved.

In particular, although the Draft Guidelines recognise the importance of sunk costs as an entry barrier, they give no indication on how sunk costs are to be used in making an assessment about market power. This is somewhat understandable:

> Economics offers many useful insights about entry, but reliable predictions normally are not possible. Theory has demonstrated the crucial role of sunk costs, but it has not indicted how large sunk costs must be or how long investments must be committed in order to deter entry. (Hay and Werden 1993, p. 174)

However, if new entrants can expect to recoup their sunk costs of entry at expected post-entry prices within a reasonable time frame, potential competition would still be a credible discipline on the prices of the merged firm. That is, sunk costs of entry are unlikely to be a significant barrier if they can be re-couped relatively quickly.

It follows that any assessment of entry barriers must attempt to relate the level of sunk costs with the expected time period required for their recoupment. One such way would be to use pay-back periods for sunk investments as a guide to help clarify the entry conditions in assessing market competitiveness. Pay-back periods refer to the expected time required to recoup sunk costs following entry.[39] These have been used for this purpose for some time by the US antitrust authorities, which take one year as the planning horizon for the recovery of the sunk costs of entry (Willig 1991a; Ordover and Willig 1993).

There are some conceptual and practical difficulties in using pay-back periods to assess the significance of entry barriers. In particular, the pay-back method for evaluating investment projects suffers from not taking directly into account the time-value of money and differences in risks across various industries. Nevertheless, given its widespread use in business as a common 'rule-of-thumb' for assessing investment projects, the IC believes that it could be worthwhile for

[39] Although pay-back periods are generally inferior to other methods, such as discounted cash flow techniques - like the internal rate of return concept — which take into account the time-value of money, they are commonly used by firms for evaluating investment projects.

the ACCC to review the merits of using a maximum pay-back period to help clarify entry conditions (though not as a 'safe harbour' rule). Moreover, although what is an acceptable pay-back period is likely to vary between markets, a period of five years, as a 'rule-of-thumb,' could be more consistent with business practice in many industries where time horizons beyond one year are often used for assessing investment projects.

4.4 When is threat of potential entry sufficient?

Espousal of efficiency-promoting competition is based on the proposition that, sooner or later, 'excessive or supernormal' profits should entice new entry and be competed away. The more quickly new entrants and market outcomes respond following anti-competitive mergers, the better the market is performing and the less likely it is that the merger will result in any sustainable reduction in competition:

> The possibility of market entry often makes it possible for antitrust regulators to countenance a merger between firms with high market shares; if their post-merger exercise of market power would attract competition quickly and at a low cost — *an empirical question* — then the merged firm will not find it profitable to exercise that power in the first place. (Ginsberg 1990, p. 333; emphasis added)

However, the empirical evidence on how quickly the market responds is somewhat mixed. Some studies show that new firms do move into markets in response to high profits (with varying degrees of success); that potential competition is important, although not as powerful as actual competition; and that market forces do eliminate excess profits over time, albeit sometimes at a slow pace. However, some other evidence suggests that market power may be exercised in some areas for substantial periods despite the threat of potential competition:

> Experience teaches that entry can be a powerful engine of competition — so powerful that mergers may not matter. Experience also teaches that market power may be exercised for a long time despite the possibility of entry. (Hay and Werden 1993, pp. 174-175)

Nevertheless, the ACCC's Merger Guidelines, in line with North American antitrust arrangements, explicitly assume that, by and large, competition works relatively effectively, provided entry barriers are low. The main problem for antitrust regulators is in deciding when the threat of entry is sufficient, and more particularly how long it would be before effective entry occurs. After all, high prices from an anti-competitive merger are real and present, while new entry, if and when it occurs, may merely restore competitive pricing and prevent further losses in consumer welfare. The intervening social losses from the exercise of market power are real:

> ... the loss to competition resulting from a merger is a present fact, while the new entry that might overcome that detriment is speculative. ... [we should] hesitate to give up the bird in the hand (present competition) in the hope that a bird in the bush (future competition) will make up for that loss. The prospect of new entry is not a perfect substitute for the loss of present competition and can seldom be judged very precisely. (Areeda 1987, p. 978)

Consequently, antitrust rules, including the ACCC's Draft Guidelines, focus on the amount of time that would be needed for new entrants to enter the market as a means of determining whether potential competition is likely to be sufficiently effective to maintain a competitive market. The entry lag approach to assessing potential competition was selected by US agencies because, according to Hilke and Nelson (1993), it is easier to ascertain if new entry is unlikely within a certain period of time than it is to establish that entry barriers are high enough to deter new entry in the long run. As in the US and Canada, the ACCC Guidelines regard the threat of entry as effective if it is likely to occur within two years of the post-merger exercise of market power, and on a sufficient scale that is likely to provide a competitive restraint on the pricing of the merged firm.

However, the US merger Guidelines have been criticised by some authors for using a two year period as the benchmark for effective and timely entry:

> ... planning and executing entry in many industries can take well over two years; I agree with Fisher that a longer test period may be appropriate. (Schmalensee 1987a, p. 53)

Hilke and Nelson (1993) found, for example, that the time lag for new entry was more than two years in two thirds of US industries where the entrant starts from scratch.

Thus there is evidence to suggest that a two year benchmark for effective new entry may lead to relatively few markets being identified as subject to effective potential competition, and imply that market power may be wide-spread, when it is generally agreed that it is not. The IC proposes therefore that the ACCC should consider increasing the estimated time period above two years under the Guidelines for judging the effectiveness of the threat of entry. The European Commission regards the threat of new entry as effective if it is likely to occur no later than five years after a post-merger price increase (Carlton and Bishop 1994). The ACCC may wish to consider implementing a similar time period.

The ACCC could review its recent merger law enforcement decisions to see if use of a longer time period of five years as the benchmark for establishing effective new entry would have changed its judgement regarding mergers it has opposed. In addition, the ACCC could study those pre-1993 mergers that it said might have been opposed under a substantial lessening of competition test (see TPC nd). These studies could evaluate the price effects (if any) of those mergers and acquisitions and the time lag of any new entry.

5 AUTHORISED MERGERS AND OTHER ISSUES

When confronted with an application for a proposed merger which it considers will result in a substantial lessening of competition, the ACCC may authorise these mergers to proceed where they are judged to provide public benefits. The ACCC also may not oppose a merger proposal where its anti-competitive concerns have been met through the negotiation of written enforceable undertakings between the parties and the ACCC. Other mergers may not be not be opposed by the ACCC where ‘failing firms’ are involved. This section considers mergers involving ‘public benefit authorisation’, ‘enforceable undertakings’ and ‘failing firms’.

5.1 Mergers authorised as providing public benefits

Firms may apply for a merger to be authorised by the ACCC on public benefit grounds (s.88). In addition, where the ACCC receives a merger proposal that it considers will substantially lessen competition, it will encourage the parties, where considered appropriate, to apply for a public benefit authorisation. In these circumstances, parties to the merger must apply to the ACCC for authorisation. Any decision by the ACCC on an application for public benefit authorisation may be the subject of appeal to the Australian Competition Tribunal, whose decision is final. Applications for mergers on public benefit grounds are determined by the ACCC through a public process. Most details are made public by the ACCC through its public register, although certain commercial details may be kept confidential.

Authorisations on public benefit grounds may require certain undertakings by parties covering post-merger conduct:

> The Commission will seek undertakings from parties in relation to authorisation applications where such undertakings change the balance of the public benefit/ detriment assessment in favour of authorisation. (TPC 1992, p. 42)

The authorisation process for mergers is distinct from the competition test. While the competition test is in principle concerned only with whether the merger substantially lessens competition, authorisation examines whether the merger will result in net public benefits and permits such mergers where the benefits are likely to outweigh their negative effects on competition:

> Moreover, even if the merger is anti-competitive, Australia’s distinctive authorisation process allows mergers to occur if the parties can demonstrate to the satisfaction of the

> Commission and on appeal to the tribunal that the public benefit exceeds any detriment to competition. However, assertions that mergers will contribute to international competitiveness are not automatically accepted. Arguments about national champions have been discredited in recent years. ... Firms proposing anti-competitive mergers must positively demonstrate the value of their merger. (Fels 1995d, p. 12)

Although efficiency considerations associated with anti-competitive mergers are not considered under the competition test, they will be taken into account for merger authorisations.[40] Because mergers will be authorised only if there are net public benefits, the more anti-competitive the merger, the greater must be the public benefits derived from the merger. Once an authorisation has been granted by the ACCC, the merger is immune from further action under the Act until such time as the authorisation is rescinded by the ACCC.

5.1.1 What are 'public benefits'?

The statutory test for authorising mergers on these grounds is that the proposed acquisition would result, or would be likely to result, in such a benefit to the public that the acquisition should be allowed to proceed. Therefore, the ACCC is required to assess the applicant's claim of the key public benefits likely from the proposed acquisition. The onus on proving public benefits rests with the applicant.

The Draft Merger Guidelines do not define the meaning of public benefit. They refer to a Tribunal ruling in the *Queensland Milling* case that the term should be given the widest possible reading to include:

> ... anything of value to the community generally, any contribution to the aims pursued by society including as one of its principal elements ... the achievement of the economic goals of efficiency and progress. (p. 17,242)

Furthermore, the TPC has stated its support of this decision:

> Public benefit is not something that is defined in the Act, but the Commission considers that the concept of public benefit is capable of wide interpretation. The Commission has stated its support of the view taken by the Trade Practices Tribunal in QCMA and Defiance Holdings...
>
> The Commission recognises a range of matters as constituting a public benefit ... including: economic development; fostering business efficiency; industry rationalisation; expansion of employment; industrial harmony; assistance to small efficient business; improvement in the quality and safety of goods and services and expansion of consumer choice; supply of better information to consumers and businesses; promotion of equitable dealings in the market; promotion of industry cost savings resulting in contained or lower prices at all levels in the supply chain; development of import replacements; growth in export markets; steps to protect the environment. (*ACI* case at 56,067)

[40] Of course, it is efficiency which underlies the Act's endorsement of competition.

The Guidelines specify that the ACCC will be concerned principally with increased efficiency which will benefit the community through lower unit costs, including realisation of scope and scale economies, industrial rationalisation, and investment in more efficient plant and equipment.

The ACCC also has a statutory requirement to pay attention to the public benefits from a significant increase in the real value of exports or a significant substitution of domestic products for imported goods, in the light of all matters surrounding the international competitiveness of Australian industry, in addition to any other benefits to the public. According to the Guidelines, 'if the total level of consumption of an Australian product rises at the expense of consumption of foreign-produced goods, and this change is attributable to the merger, the merger may be said to have produced a substitution of domestic products for imported goods' (TPC 1992, p.39). The economic basis for such a preference for Australian over foreign production is not explained.

In determining public benefits, the ACCC is also required in the Act to take into account all other relevant matters that relate to the international competitiveness of any Australian industry:

> Changes in international competitiveness may be attributed to a wide range of matters, which it is impossible to list exhaustively, but could include matters such as changes in the quality of inputs, improvements in technology, or better work practices. The range is qualified by the requirement that the matters looked at be "relevant", which indicates that they should be attributable to the merger in question. It is not required that the improvement in international competitiveness be in the industry in which the merger occurs.
>
> Applications should specifically examine the likely impact of increased efficiency, and a more dynamic industry structure on the level of exports, imports and the international competitiveness of both the industry in which the firms participate and the industries to which they provide inputs. (TPC 1992, p. 39)

The ACCC also considers the beneficial effects of mergers on employment, including regional effects. According to the Chairman of the ACCC:

> Firms proposing anti-competitive mergers must positively demonstrate the value of their merger. (Fels 1995d, p. 9)

Moreover, the Draft Guidelines specify:

> As well as immediate benefits to efficiency, the Commission will consider the dynamic benefits that may accrue to the public from mergers, through exploration, research and development, innovation and the introduction of new technology (TPC 1992, p.39).

5.1.2 Defining the 'public': consumer versus producer interests

Central to the above difficulty of identifying and measuring public benefits is defining who is the 'public' — ie. deciding who received the benefits covered by the authorisation process. This is ambiguous since the Act does not define who might constitute the public. An important distinction in assessing public benefits is whether the public includes society as a whole — which can include the parties to the merger — or whether it implies only non-private (ie other party) benefits. According to the Draft Guidelines:

> The benefit must accrue to the community at large and not purely to the parties to the merger. Private benefits that accrue to the applicant or some limited group are not ruled out as long as they clearly have a beneficial impact on the public at large.
>
> The Commission will have regard to public benefits in the form of increased efficiency, which will benefit the public through lower unit costs and prices. These may include, for example,
>
> - the achievement of economies of scale or scope in production, distribution and /or marketing;
> - industrial rationalisation, adjusting capacity to demand and/or reducing unit costs; and
> - investment in more efficient plant and equipment or distribution facilities. (TPC 1992, p. 38)

It has been suggested by several commentators that the ACCC's Merger Guidelines — along with previous TPC cases on authorisation — have adopted a narrow interpretation of public benefit, rather than the broader view of public benefit which includes benefits to any group in society:

> Although these [the draft Merger Guidelines] may still be revised, they indicate that the same distinction between public and private benefit is alive and well within the Commission - even if dead and buried among economists (Officer and Williams 1995, p. 165).

Under the current interpretation, the efficiency gains from anti-competitive mergers appear to be taken into account only when the ACCC can be assured by the applicant that these benefits are to be passed on to consumers through lower prices. In other words, benefits to consumers are included in the authorisation assessment as public benefits, while benefits to the producers themselves through lower costs are largely discounted as private, and hence non-public benefits. This approach appears to provide greater weight to consumers than to producers in the assessment of public benefits under the authorisation process. Such an outcome also runs counter to the basic objective of Part IV of the Act of promoting efficient or optimal resource allocation:

> The implication behind the argument of those who believe public should be contrasted with private is that consumers must weigh more heavily in the minds of those

> administering the Act than producers, including shareholders. This is clearly at odds with our interpretation of Part IV of the Act which is the promotion of efficient or optimal resource allocation. (Officer and Williams 1995, p. 159)

The narrow view of public benefits adopted by the ACCC appears to contradict that of the Tribunal:

> It is perhaps surprising that while the Commission has re-enunciated its views on what constitutes public benefit as recently as the draft Merger Guidelines, it has been unaffected by the views of the Trade Practices Tribunal which take the broader and, in our view, correct interpretation of public benefit. The first authorisation test before the Trade Practices Tribunal, Re Queensland Co-operative Milling Association Ltd ... the Tribunal clearly indicated that the public was not to be restricted to just the consuming public (Officer and Williams 1995, p. 165).

In the *Queensland Milling* case, the Tribunal in addressing the question of what is the public stated:

> This we see as anything of value to the community generally, any contribution to the aims pursued by the society including as one of its elements (in the context of Trade Practices legislation) the achievement of the economic goals of efficiency and progress. If this concept is adopted, it is clear that it could be possible to argue in some cases that a benefit to the members or employees of the corporations involved serve some acknowledged end of public policy even though no immediate or direct benefit to others was demonstrable (*Queensland Milling* case, at 17, 242).

5.1.3 Improving the authorisation process

Given that efficiency-enhancing considerations of mergers do not enter the competition test, but are dealt with at the authorisation stage, it is imperative that this latter process works effectively to ensure that efficiency considerations of mergers are adequately taken into account. Otherwise, mergers assessed by the ACCC to be anti-competitive may not be authorised, even though the efficiency-enhancing benefits outweigh the anti-competitive effects. Moreover, and perhaps even more importantly, potential mergers could be deterred if the business community believed that the authorisation process failed to take adequate account of these efficiency gains from mergers.

In the IC's view, public benefits should be interpreted broadly to cover all aspects of national welfare. Assessing the net effects on national welfare in cases where mergers enhance market power at the same time as lowering production costs or improving product quality is very difficult. However, guidelines which effectively require merger parties to demonstrate to the ACCC that the firms will pass any efficiency savings on to consumers through lower prices may be inappropriate. The increase in society's overall welfare resulting from an anti-competitive merger is not dependent upon a price reduction to consumers following the merger. Efficiency gains to merger firms would represent an *a* *priori* increase in overall welfare provided there was no price increase to consumers following the merger [41]. It is even possible that the adverse effects on welfare of a price increase following the merger may be more than offset by efficiency gains. Thus, focussing on the need to demonstrate price reductions to consumers following efficiency-enhancing mergers may be undermining the important role that the authorisation process can play in allowing mergers that raise efficiency.

The IC believes that the efficiency-enhancing benefits of mergers need to be given due consideration in the authorisation process. It has doubts whether the authorisation process is currently fulfilling its proper role in this respect. Despite efforts by the ACCC to encourage firms to apply for authorisation, the IC understands that the authorisation process has not applied to over 99 per cent of mergers considered by the TPC/ACCC.

There appears to be a genuine reluctance by firms to apply for merger authorisation, because they consider that to do so is to concede that the merger is anti-competitive. The process is also very public and firms are being increasingly required to reveal information that they believe should remain confidential:

> Generally firms have been reluctant to apply for authorisation, despite some urging to do so by the Trade Practices Commission (Australia's only antitrust enforcement authority). The reluctance arises from the delay occasioned by the authorisation process and the public nature of the process. Publicity sometimes disadvantages the applicant against its competitors who may be potential bidders for the target firm. (Johns 1994, p. 192)

Moreover, authorisations are likely to be unpopular because of the onus placed on firms to demonstrate a public benefit, rather than merely private benefits, and because they inevitably include an analysis of the effect of a merger on competition. The more competition is perceived to be reduced, the greater the presumption that there is little incentive for the merged firms to pass on to other parties any of the resulting benefits. Thus, the Guidelines, by placing emphasis on the need for any efficiency gains to flow to consumers through lower prices, may be biasing the authorisation process against allowing efficiency-enhancing mergers.

The IC believes that the Guidelines surrounding the public benefit test should be re-examined and clarified. [42] The criteria and rules need to be given more economic substance, and made more transparent. The Background Paper on Draft

[41] This can be so even though the merger may result in increased profits for the firms concerned.

[42] The recent decision by the ACCC to grant authorisation in the Davids Holdings-QIW has done little to clarify the situation.

Merger Guidelines provides virtually no discussion on merger authorisation, and it is still not clear how the ACCC applies and assesses the public benefit criteria.

Moreover, the statutory inclusion as public benefits of certain factors, such as the substitution of imports with domestic production, places an interpretation on public benefits which is hard to justify. Such legislative requirements add to the confusion that exists in understanding the application of the Draft Guidelines to the public benefit test. There is no *a priori* reason for claiming that the substitution of imports for domestic production, or *vice versa*, either increases or decreases public welfare. National efficiency and welfare can be expected to increase when goods come from their most competitive source, irrespective of whether they are produced domestically or imported.

The ACCC should release more public information on the operation of the public benefit criteria, including details of past cases where such authorisations have been approved and rejected. Consideration should be given to expanding the scope for public benefit authorisation to include, for example, a broader interpretation of public benefits which includes efficiency considerations within the merged parties and not only '... increased efficiency, which will benefit the public through lower unit costs and prices' (TPC 1992, p. 38). The privacy provisions, which appear to be a major disincentive for parties to apply for authorisation, need to be reassessed, especially in cases where the benefits through increased efficiency are mainly confined to the parties concerned. In these cases, it would appear reasonable to expect that the same confidentiality provisions would apply as for the competition test.

Furthermore, the Draft Merger Guidelines provide little information on what other detrimental aspects, apart from anti-competitive effects, it will take into account in determining whether the merger is likely to result in net public benefits:

> In its determination of an application under s.88(9), the Commission also takes into account detriments which may come about as a result of the acquisition, including anticompetitive effects. (*ACI* case, p. 50,067)

According to the Tribunal, these may be regarded as negative public benefits:

> Benefit and detriment were to be determined in accordance with the values of the community in general. Public benefit referred to anything of value to the community generally. Public detriment referred to any impairment to the community generally, especially anti-competitive detriment. (*Queensland Wholesalers* case, pp. 40,915-40,967)

Moreover, it was also stated by the Tribunal in that case:

> The application of the authorisation test for merger contained in sec 90(9) and 90(9A) required a more comprehensive analysis of competition in the relevant markets than

> would be necessary under sec 50, as the elements of public benefit and detriment had to be identified and weighed. (*Queensland Wholesalers* case, p. 40,918)

A number of other aspects contained in the Merger Guidelines would appear, at least potentially, to limit the effectiveness of the authorisation process in giving proper weight to efficiency considerations. These include:

> Although the Commission is not required by the [public benefits/detriments] test to undertake a quantitative balancing of the likely public detriment arising from a substantial lessening of competition, the Commission will nevertheless consider the relative size and timing of the two when making a determination. Furthermore, unless the applicants are able to indicate the likely magnitude of the public benefit claimed, the Commission will be unlikely to give it significant weight in its determination. (TPC 1992, p. 37)

5.2 Enforceable undertakings

Where the ACCC has difficulties with a proposed merger, the Act (s.87B) allows it to negotiate with and accept written undertakings from the parties concerned as a means of persuading them to modify their arrangements so as to satisfy the ACCC. According to the Act, these undertakings are legally binding obligations which, if breached, may be enforced through the courts. Courts may order compliance with the undertakings by the merger parties, and the ACCC may request that they repay any financial benefit, and seek financial compensation for any loss or damage, resulting from a breach of the undertakings.

Enforceable undertakings were included in the Act to overcome the previous unsatisfactory arrangements whereby private ‘deals’ tended to be done between the TPC and the parties to the merger to bring the degree of market power back to acceptable limits following the merger. These deals typically provided for a partial divestiture of assets in conjunction with the merger, or for some voluntary restraint on post-merger conduct by the merged entity. The TPC was criticised widely for engaging in these private deals which largely bypassed the public scrutiny required by the authorisation process. The arrangements eventually became unworkable when some of these private arrangements proved unenforceable in court.[43]

Enforceable undertakings are one tool available to the ACCC to encourage merger parties to restructure their proposals in order to meet the ACCC’s objections and comply with the Act.[44] Their use and acceptance is at the

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43 See, for example, the News/Herald and Weekly Times and the Anse tt/East West merger cases.

44 In addition, the ACCC has used enforceable undertakings to ensure that an acquisition is not completed until the Commission has had the opportunity to conduct the appropriate

discretion of the ACCC, which cannot be compelled by merger parties to accept an undertaking. Nor is it the policy of the ACCC to demand such undertakings. [45] The ACCC believes that achieving an administrative resolution of matters is an evolving process that should be pursued as an innovative means of gaining ongoing compliance with the Act, and of fulfilling its objectives in a resource-efficient manner. It views undertakings pursuant to s.87B as a flexible alternative to simply opposing an acquisition where the ACCC believes that the acquisition is likely to substantially lessen competition. In these cases, the parties may choose to offer undertakings aimed at restructuring the proposal in such a way as to address the ACCC's concerns.

5.2.1 What form of undertaking?

Merger undertakings may take the form of a restraint on conduct, a restriction on future acquisitions or a post-merger partial divestiture obligation within a specified time period (Tonking and Castle 1993). The ACCC will consider mainly undertakings aimed at addressing structural issues arising from the merger in the particular markets, such as divestiture obligations. [46] The IC understands that the ACCC prefers structural to behavioural undertakings because the former are easier to enforce and provide an ongoing basis for the operation of competitive markets. The regulatory costs of structural undertakings are considered by the ACCC to be one-off, while behavioural undertakings, such as

market inquiries. Where the ACCC has had insufficient time to consider a merger proposal that falls outside the 'safe harbour' provided by the market thresholds, it may request that the parties give an undertaking not to complete the merger until the ACCC has made its decision. If the parties do not agree, the ACCC normally will apply to the courts for an injunction.

[45] The ACCC may try to encourage the merger parties to apply for authorisation under the public benefit provisions, where it feels that a net public benefit exists from the merger. However, as noted above, parties to a merger frequently reject this route.

[46] For example, the Commission accepted undertakings in the Village-Austereo merger which resulted in the divestiture of certain capital city radio stations, in order to maintain competition in those markets. In the Davids-IHL acquisition, the Commission accepted an undertaking to divest IHL's shareholding in CBL if the Commission reached the view that Davids' acquisition of those shares would breach S.50. In the Sigma-QDL acquisition, the Commission accepted an undertaking from Sigma, that if it obtained control of QDL, it would move to sell QDL's business in Victoria, in order to maintain competition in that State. In the Caltex and Ampol merger case, the Commission accepted undertakings which provided a structural underpinning for independent operators to continue to play a competitive role in petrol markets, undermining any attempts to co-ordinate pricing between the major suppliers. The undertakings provided for the sale of surplus import, storage and retail sites created by the merger to independent distributors and retailers, with guaranteed supply of petrol at a competitive price during a transition phase.

price and access commitments, require continuing regulation, with associated higher compliance and enforcement costs.

However, although preferring structural remedies, the IC understands that where infeasible, the ACCC will consider behavioural undertakings, taking account their regulatory costs in balancing the likely public benefit and detriment.

5.2.2 The legal status of undertakings

According to the amendments introduced to the Act in 1993, undertakings, once accepted by the ACCC, are final and cannot be overturned by the courts. Moreover, undertakings cannot be varied or removed without the ACCC's consent.

> The person may withdraw or vary the undertaking at any time, but only with the consent of the Commission. (s.87B(2))
>
> If the Commission considers that the person who gave the undertaking has breached any of the terms, the Commission may apply to the court for an order. (s.87B (3))

However, the precise legal status of these enforceable undertakings appears uncertain following a decision by the Tribunal in the *Queensland Wholesalers* case. In that case, the Tribunal questioned the validity of undertakings obtained by the Commission as part of its merger authorisation process, and overruled several such undertakings. The Tribunal rejected the ACCC's argument that the written undertakings it had agreed to and accepted were unlimited and would remain in force independently of the findings and orders made by the Tribunal, unless and until the merger party sought to withdraw or vary them, which can be done only with the consent of the ACCC. Instead, the Tribunal ruled that:

> Only those undertakings considered by the Tribunal to be appropriate would have effect after the Tribunal's decision. Undertakings not regarded by the Tribunal as appropriate would not have effect after this time, as they would not be part of the Tribunal's affirmation of the ACCC's decision. The undertakings in question were given by Davids as part of its application and authorisation, and had no existence independently of the application to the TPC and of the authorisation subsequently granted by the TPC. (*Queensland Wholesalers* case, p. 40,917)

It has been suggested also that the legislation, which enables the ACCC to refuse a variation or release from an undertaking without providing the merger parties with a right to approach the court, may be challenged on three possible bases. [47] These are lack of power; review on administrative law grounds; or a private law

[47] The right to approach the court for variations to the undertakings may be , it appears, negotiated as part of the undertakings. See Tonking and Castle (1993, p. 46) and the *ACI* case. In the ACI case the TPC agreed to give ACI the right to apply to the court from time to time to have the undertakings varied.

right (Tonking and Castle 1993, p. 46). However, to the IC's knowledge, such refusals by the ACCC have not been tested.

Since 1993, enforceable undertakings have been made in some 10 to 12 merger cases. Although relatively few in number, substantial undertakings have been made in important industries where the economic ramifications on other industries are likely to have been large, such as in the recent Caltex-Ampol merger case.

5.2.3 Maintaining the right balance

It has been questioned whether the inclusion of enforceable undertakings into the Act in 1993 may have altered the balance of power too far in the direction of the ACCC.[48] The current legal uncertainty as to the unfettered power or otherwise of the ACCC in accepting undertakings and consenting to their variation or withdrawal raises a number of fundamental issues.

Although the IC would agree generally that the current system of formal enforceable undertakings is superior to the informal pre-1993 practices which lacked transparency, it nevertheless has some reservations concerning the use of enforceable undertakings. Meeting enforceable undertakings is not costless; they are likely to impose substantial costs on the merger parties — and ultimately the economy generally — which, if not imposed carefully, may exceed the potential adverse effects of the merger on the industry's competitiveness. Moreover, enforceable undertakings may impose special obligations on the merged firms which no other firm in the industry is required to meet.[49]

Since the ACCC prefers structural outcomes, such as partial divestiture of assets and production units within a specified time following the merger, it is potentially in a position to change the industry's structure and future development. Although firms may refuse to give such undertakings, and proceed with the merger, taking their chances in the court, it is often easier, potentially less expensive and more certain for parties to enter undertakings. Commercial reality may, in the end, dictate that undertakings be made by the parties to allow the merger to proceed, despite them having serious misgivings over their desirability or appropriateness.

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48 See, for example, Tonking and Castle (1993).

49 In the Caltex/Ampol merger, the parties are required to supply and sell assets to independent operators, a requirement which no other refiner has to face. It was estimated by the parties concerned that the cost of these undertakings represented approximately 10 per cent of the total efficiency gains from the merger, amounting to between $500 million and $700 million (Shann 1995).

The Act also provides very limited scope for a merger party to seek a variation or release from its enforceable undertaking, such action requiring ACCC consent. Since market conditions can change quickly, so can the rationale for such undertakings. There is also the question of ensuring that such undertakings do not harm or impinge on the freedom of action of third parties.

These difficulties with enforceable undertakings lead the IC to conclude that their use should be minimised. Otherwise, setting structural undertakings to approve mergers seriously risks tampering with market outcomes in a way that undermines, rather than strengthens, competition. This risks replacing competitive outcomes resulting from market forces with those thought to be more appropriate by the competition regulators.

The IC believes that the current uncertainty surrounding the legal status of enforceable undertakings, and subsequent variations to them, should be resolved as quickly as possible. If enforceable undertakings and questions of their withdrawal are in future to be increasingly reviewed by the Tribunal, this is likely to improve their public scrutiny, thereby enabling greater assessment of their effects and better justification for them.

The IC strongly supports the ACCC's efforts to use public benefit authorisations as an alternative to making undertakings, where appropriate, and to limit its reliance on such undertakings. Moreover, where a choice existed, enforceable undertakings would seem to the IC to be preferable as part of the public authorisation process than being developed as part of the competition test (s.50). However, these suggestions are likely to be of little practical use unless the problems the IC has identified with the authorisation process are redressed.

It also encourages the ACCC to continue with its efforts to make enforceable undertakings as transparent as possible. This should include publication of details of all enforceable undertakings, along with their rationale, and any subsequent requests for variations or withdrawal of these undertakings, in a way that does not breach confidentiality.[50] Moreover, although the TPC/ACCC foreshadowed in its Draft Merger Guidelines the intention to release separate guidelines on enforceable undertakings, this has not yet happened. The IC encourages the ACCC to release these guidelines as quickly as possible.

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50 The IC recognises that certain details of the undertakings will need to be kept confidential to protect the commercial interests of the merger parties. For example, where the undertakings involve asset or ownership divestiture, any publicly available information about the period of the divestiture, or that certain assets or shares would be affected, could harm the interests of the merger parties by making the divestiture effectively a forced sale, thereby benefiting potential purchasers.

The IC also questions whether steps should not be taken to place some limits on the degree of structural undertakings that can be agreed to by the ACCC. At the moment, there is no limit on the form or extent of these undertakings, other than their rejection by the parties concerned. Although structural undertakings may be preferred by the ACCC, there are downside risks to competitive market outcomes of such undertakings should the ACCC misinterpret (either current or future) market conditions. The IC, although not making specific suggestions in this regard, believes that the predominant use of structural undertakings should be reviewed by the ACCC.

5.3 Mergers involving ‘failing firms’

In October 1993, the TPC augmented its Draft Guidelines with a discussion paper issued jointly with the New Zealand Commerce Commission covering mergers involving failing companies. The ‘failing firm’ argument falls under the general substantial lessening of competition test:

> The relevant test is not whether a company is likely to fail. The test is whether, without the acquisition, the supply presently coming from the company would no longer come to the market and its resources would no longer be employed in that market as a result of the failure of the company. If these resources would not continue to provide an actual or potential constraint in the market, allowing their acquisition by another market participant probably will not enhance the market power of the acquiring company. In such a case, the acquisitions are unlikely to raise dominance or competition concerns under the Acts. (TPC and New Zealand Commerce Commission 1993, p. 7)

The paper foreshadows that the ACCC is unlikely to oppose a merger or takeover if the target company is likely to fail (or has already failed and is in receivership), and where no alternative purchaser is willing to keep the firm in operation, even though it was the ‘failing firm’ which had been providing the actual or potential constraint in the market — ie. even where the merger would normally be opposed as substantially lessening competition. ‘Failure’ is viewed as when the resources in the failing company are likely to exit the industry or otherwise likely to cease to bring supply to the market in any form or through any channel.

However, the Guidelines stop well short of allowing a ‘safe harbour’ for mergers involving a ‘failing firm’. Such mergers are treated in Australia under the same competition test as are other mergers; ‘failing firm’ issues only arise where the merger is likely to lead to a substantial lessening of competition and does not meet the threshold tests. The same market enforcement thresholds operate and the ACCC may authorise such merger applications where public benefits are judged to outweigh the anti-competitive effects. In contrast to practice in the US, there is no automatic ‘failing firm’ defence available in Australia that immunises mergers considered to be anti-competitive.

The Draft Guidelines provide investigation procedures aimed at ascertaining whether the 'failing firm' argument is relevant to the merger. It will only be applied where the company is judged, firstly, to be 'failing' and exiting the market, and secondly that its resources will leave the industry. The Guidelines list a number of possible factors to be investigated. [51]

5.3.1 Arguments for a 'failing firm' defence

The ACCC's Guidelines for cases involving a 'failing firm' are based on the economic argument that mergers with such firms cannot undermine competition since, without the merger, it would have ceased operations anyway. This rationale is well advanced in the literature:

> Union of two healthy firms causes a competitor to disappear; in the failing firm context, however, the competitor will disappear whether or not the healthy rival acquires its assets. Acquisition, therefore, can impact no additional market power in the failing firm case. ... Except in highly unusual situations, acquisitions of assets cannot augment the increase in demand that surviving firms will experience anyway, once the failed firm disappears. (McChesney 1986, p. 19)

Thus, acquisitions of failing firms are likely to have only minimal anti-competitive effects because the realignments in demand and market shares would have occurred in any event. The exit of a failing company is a manifestation of earlier changes in the industry. [52] Regardless of whether the assets of the failing firm are broken-up or are sold to a rival, the failing firm will cease to exist. The industry will be more concentrated and the surviving number of firms will be market-determined as those which can operate profitably in the market.

Allowing otherwise anti-competitive mergers involving failing firms permits industrial rationalisations to be accomplished expeditiously, unhindered by the regulatory framework. The takeover of a failing rival leads to earlier market rationalisation, thus accelerating adjustment and the return to sustainable prices. A move to a more sustainable industrial structure will reduce the premium that must be paid to investors to induce them to carry the industry through bad

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[51] These include factors set out in the TPC's decision on the proposed acquisition of the Daily News by Western Australian Newspapers Ltd (A90502, 10 September 1990). It also lists other factors, some drawn from experiences in the USA.

[52] Surviving firms will be interested in buying the failing firm only if the acquisition lowers its overall costs (including, perhaps, the cost of expanding the product range). For example, cost synergies from a merger may keep in production goods which the separate firms cannot supply at a profit. Moreover, the management team best placed to revive a failing firm typically may be one that is part of a rival company in the same market.

periods. Industry returns therefore are stabilised at a faster rate, thus lowering the cost of capital and long-run prices to consumers.

However, although stated as unlikely, the Guidelines do enable the ACCC to oppose a merger involving a 'failing firm' where it considers that the merger is associated with anti-competitive risks that would substantially lessen competition. There is a body of literature that argues against exempting mergers involving a 'failing firm' from the standard competition test, believing that it would be preferable for the 'failing firm' to exit the market. Parades (1996), for example, in examining the 'failing firm' argument in the US, has identified as one of a number of anti-competitive risks arising from the merger with a 'failing firm':

> ... a competitive market that would remain competitive if a failing firm exited may become subject to a dominant price-setting firm if a leading competitor is permitted to acquire its failing rival. In this case, the financially troubled firm's exit may be preferable to permitting the transaction ... (pp. 365-371)

Posner and Easterbrook (1981, p. 242) also disapprove of the failing firm defence as being 'one of the clearest examples in antitrust law of a desire to subordinate competition to other values'.

5.3.2 Setting transparent guidelines and 'failing firm' criteria

The IC believes that the ACCC's Guidelines on mergers involving failing firms do not provide sufficient guidance as to how the ACCC will apply the 'failing firm' test. They provide little information on how the ACCC is to determine whether the firm is likely to fail commercially and that the firm's resources will exit the market. While a number of factors that may be investigated are listed, the Guidelines inadequately describe how they are to be applied and assessed.

Although several factors are concerned, for example, with having to determine the firm's commercial viability, no guidance is given on how this is to be measured or identified. Moreover, although the Guidelines state that the 'time frame for the forecast must be specified ... and limited to the short term future', they provide no guidance on this important point, stating that 'the particular period [is to be] determined by the state of the firm and the industry and the typical parameters for transfer of resources' (TPC and New Zealand Commerce Commission 1993, p. 11).

The Guidelines mainly raise a number of questions that 'might be asked' or 'which may also have application', without providing definitive answers. The lack of clear direction contained in the Guidelines on the application of the 'failing firm' test is acknowledged in the paper:

> The investigation of company failure and of resource exit are matters of judgement, based on commercial fact and experience, rather than matters of formula. Nonetheless, there are factors that *might* be checked in the investigation. These factors are *neither necessary nor exhaustive but they may be helpful in establishing directions of inquiry*. (TPC and New Zealand Commerce Commission 1993, p. 9; emphasis added)

It would be highly desirable in the IC's view to re-examine and clarify the 'failing firm' Guidelines. This should include an understanding of how they are to be applied in practice. Since the Guidelines state that it would be unlikely for a merger involving a 'failing firm' to be opposed by the ACCC on competitive grounds, it would be desirable to include in the Guidelines the criterion used to apply the 'failing firm' test, and a discussion of the unlikely circumstances under which such mergers would be opposed.

The Guidelines could also provide greater guidance on the definition of a 'failing firm' for merger purposes. The IC believes that the ACCC should consider examining the possibility of setting transparent criteria for identifying a failing firm for merger-control purposes. For example, although involving practical difficulties, the ACCC may wish to examine the scope for using reputable investment ratings. Firms identified by these means could be presumed to be 'failing firms' for purposes of merger control, unless the ACCC can show special reasons not to do so.[53] Efforts to facilitate mergers involving 'failing firms' are likely to have little practical effect without clear guidelines on how to identify such firms.

Revised guidelines on mergers involving 'failing firms' should be incorporated into the Final Merger Guidelines issued by the ACCC.

[53] This could imply that firms being downgraded could have their value increased as they become more attractive merger or acquisition targets.

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