

Joshua Gans is Professor of Management, Information Economics with the Melbourne Business School. He is a highly experienced teacher, economic researcher and consultant to clients such as United Energy, AAPT, the National Australia Bank and the Australian Competition and Consumer Commission. Joshua is also founder and director of CoRE Research, advising on infrastructure development and regulation, as well as trade practices and competition policy. Email: j.gans@mbs.edu

Dealing with difficult mergers

Whether or not a proposed merger is difficult, i.e. detrimental to competition, determines how easily it will get through the ACCC. This article considers what makes mergers difficult and when might such mergers be judged not to be detrimental to competition?

A dramatic change has occurred in the means by which mergers and acquisitions are assessed in Australia for competition issues. In 2005, the Dawson Committee recommendations were implemented allowing merging parties to apply directly to the Australia Competition Tribunal (ACT) for merger authorisation — effectively avoiding the Australian Competition and Consumer Commission (ACCC). These cases are now heard by a panel consisting of a Federal Court judge, a lawyer and an economist. While the ACCC continues to assist the Tribunal, its regulatory power has been diminished.

Prior to these reforms, the vast majority of mergers were handled informally by the ACCC. In this situation, an acquirer (or merging parties) approached the ACCC with details about the merger. If it appeared innocuous from a competition perspective — usually because it involved at least one smaller firm in an industry — the ACCC often cleared the merger at that point. The clearance included a commitment not to oppose the merger in the courts.

If the merger was more complex, the ACCC sometimes sought the views of other market participants: competitors, suppliers and, most importantly, customers. If these were favourable, the merger was cleared. If not, more negotiations followed, with offers of undertakings (for example, to divest assets) and threats of litigation. It was at this point that the process grew more complicated and frustrating for merger applicants.

Certainly, of all the mergers about which the ACCC was notified each year, only a handful reached this stage of difficulty and, of those, only two or three were opposed by it (See Table 1). This suggests that the formal bypass arrangements to the ACCC under the new regime seems somewhat heavy-handed. [\[needs some explanation here\]](#)

In reality, it will be in the interests of parties to avoid the ACCC and its associated legal costs. However, the reason this arrangement exists is that the difficult mergers are also tend to be more prominent. It is, therefore, important to consider what makes mergers difficult and when such mergers might be judged not to be detrimental to competition.

Table 1: Mergers and ACCC Response¹

Year	Total number of mergers	Total mergers cleared by ACCC (without undertakings)	Total mergers cleared by ACCC (with undertakings)	Mergers opposed by ACCC	Difficult mergers (as % of total)
1996	50	47	1	2	6%
1997	124	116	4	4	6%
1998	133	129	3	1	3%
1999	137	122	6	9	11%
2000	75	71	4	0	5%
2001	142 [doesn't add]	129	8	4	8%
2002	103 [doesn't add]	96	4	4	8%
2003	75	72	1	2	4%
2004	36	32	2	2	11%
Totals	875	815	33	28	7%

What is a difficult merger?

All difficult mergers have one thing in common: the combined market shares of the merging firms comprise a significant (greater than 40 per cent) proportion of the market and both firms are significant in size. Thus, mergers between two smaller firms or between a large firm and a very small firm (so long as it is not part of a pattern of acquisitions) are generally not difficult. While the definition of a market can affect this, an early indication can be gained from how the merging parties themselves define the market in which they operate (for example, in annual reports and other corporate documents).

The logic behind the concern over large market share mergers is very simple. When firms compete they earn a mark-up over their marginal (or incremental) costs of providing goods and services. The extent of this mark-up depends on a number of factors. One critical factor is the sensitivity of total sales in an industry to changes in prevailing prices. More sensitivity (a higher demand elasticity) means lower prices as the possibility of consumer substitution away from the

industry constrains those prices. But mark-ups also depend on market share. The higher the market share a firm has, the greater the mark-up it can sustain. Put simply, it would cost more for a firm with a large volume of sales to lower its price to build market share than it would for a firm with a lower sales volume.

So when two relatively large firms combine their assets, their ability to earn higher mark-ups is much greater than when the assets of two smaller firms are combined. It is this distortion to pricing (and its effect on consumers) that competition regulators are concerned about, in the first instance, and market shares are a great way of quickly assessing this.

Undertakings as signals

In the case of a difficult merger, the competition concern is that post-merger the merging firms' market share will actually be *lower* than their combined pre-merger share. This is because anti-competitive actions generally involve firms selling less and charging more. That may not be the objective of the merger: it may be to generate efficiencies and otherwise maintain share. In addition, any share lost would be made up in part by increased sales by rival firms. They will gain the margins lost by the merged firms.

The problem is that while a firm may have good intentions, the ACCC's concern is that following a merger a firm's goals can change causing market share to fall and prices to rise accordingly. The merging firms need to make a credible commitment that this won't happen. This can be achieved by providing a court enforceable undertaking. An undertaking is like a contract offer to the regulator including well-formulated undertakings to alleviate the regulator's concern that the merger will be anti-competitive. If the rationale for the merger is not anti-competitive, most likely it will create efficiencies and other benefits.

One clear means of alleviating the regulator's concerns and signalling that the merger will not be anti-competitive is to divest sufficient assets to third parties so that the market share of the merging firms is low. This may certainly be an option if the rationale for the merger is to consolidate the most efficient plants in a single enterprise. Divestiture, however, requires finding a buyer for these assets and this may be difficult.

Teresa Fels, Stephen King (the current Commissioner in charge of mergers at the ACCC) and I² proposed an alternative a few years ago: if the ACCC is concerned about a rise in prices or a fall in sales, then merging firms should provide an undertaking not to do that. While this might at first glance seem impractical, there are many industries that are subject to price cap regulation and so providing a mechanism for this may be possible. With such an undertaking in hand, however, the difficult merger is automatically transformed into an easy one.

The international dimension

A situation where this type of price undertaking is very feasible is in industries that face actual or potential competition from imports. To backtrack a little, import competition is potentially a free pass to otherwise difficult mergers. Put simply, the ACCC has never objected to a merger involving firms in markets where more than 10 per cent of sales can be demonstrably said to be supplied from overseas.

But in many industries, even where imports are not actually significant, suppliers face import competition. For this reason, suppliers may practice import-parity pricing: that is, they calculate what price goods could potentially be landed from overseas and set their price to match that. In the end, there are no actual imports but import competition is providing the necessary constraint anyway.

It is harder for firms to establish that it is actually using import-parity pricing to external parties. However, if there are readily available international pricing lists, then this is a means by which they can immediately offer a pricing undertaking: by using those lists to cap price movements. This is very easy to implement in practice as suppliers actually sign import-parity pricing contracts in many situations.

Capacity versus sales

Of course, potential competition can be provided internally as well as externally. **[not clear]** In a recent merger that I gave advice on, it turned out that while the merging parties had 80 per cent of sales in a market, the industry had so much excess capacity that their capacity share was about 50 per cent. This meant that if their output was substitutable with output produced by others, even if they were to merge and shut down all of their production, demand in the industry could still have been served by existing participants.

In that case, there was an issue as to whether capacities were substitutable but that is not the key point: when looking at potential competition, it is the capacity to compete that matters more than the actual sales achieved. Indeed, when there is excess capacity in an industry, there are limited opportunities to exercise market power by merging or other means.³

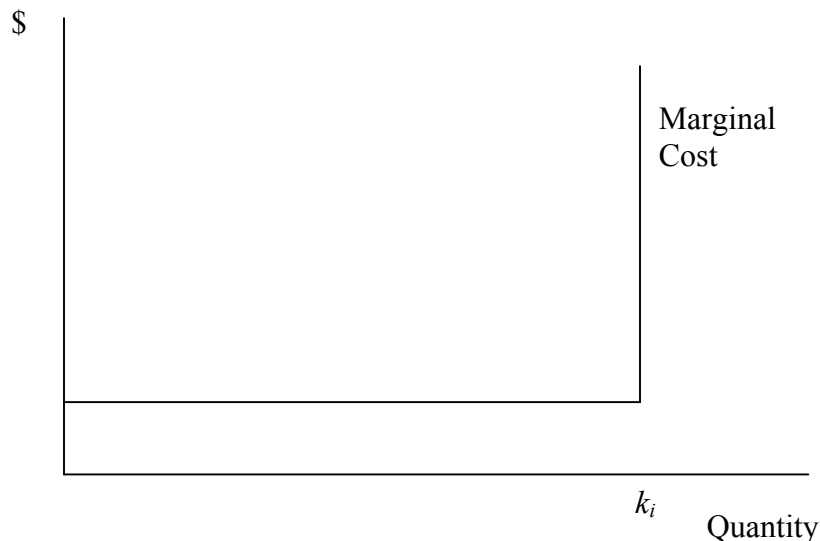
This issue was borne out in the recent decision by the Australian Competition Tribunal with regard to the quasi-merger of Qantas and Air New Zealand on trans-Tasman routes. The ACT found that new entrants such as Virgin Pacific and Emirates had built up sufficient capacity to constrain the pricing policies of Qantas and Air New Zealand even if that pricing was coordinated. The New Zealand High Court was not convinced about this and, as a result, the quasi-merger hasn't proceeded.

Capacity constraints

While excess capacity in an industry might make a difficult merger easier, tight capacity constraints can do a similar job. Put simply, **when there are capacity constraints, the operational difference between monopoly, oligopoly and perfect competition breaks down.** Consequently, it is very difficult to conceive of situations where a merger that does not create a dominant player, can lead to a substantial lessening of competition in terms of downstream prices.

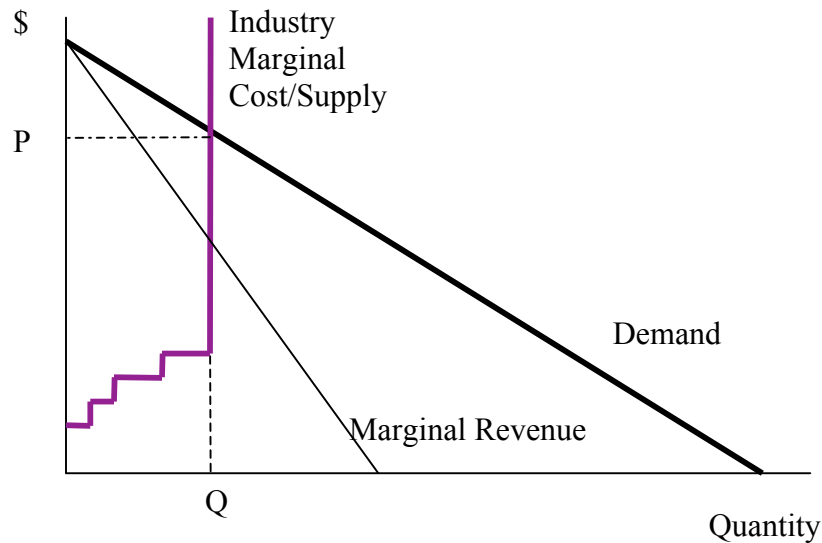
To see this, note that a capacity constraint means that a production facility cannot operate beyond a certain capacity, k_i . As production approaches k_i , the cost of producing even one additional unit becomes very large (possibly infinite indicating that such production is not possible). Below k_i , the unit cost of production may be much lower (comprised mainly of variable fuel, labour and raw material costs). As firms producing at close to full capacity will only incur these 'book' costs on their balance sheet, it can appear that their costs are low. However, this masks the capacity constraint, which means — from an economics and business perspective — the costs of producing more are very high. The nature of these costs is depicted in Figure 1.

Figure 1: Capacity Constraints



Consider first a perfectly competitive industry where market demand is such that all firms in the industry are operating at full capacity. If there are, say, four firms, then this outcome may be as indicated in Figure 2. In this situation, as is well known, competition drives prices to be equal to the marginal cost of the least efficient active producer. In this case, given the capacity constraints, the perfectly competitive pricing outcome would be P . Thus, the capacity constraint means that prices are high and that firms, even under perfect competition, will earn profits.

Figure 2: Perfect Competition



Suppose instead that there is a single firm that owns all four production facilities. In this situation, its profit maximising price will be determined by the intersection of marginal revenue and marginal cost as depicted in Figure 2. Notice that this results in exactly the same price and output as the perfectly competitive case. Specifically, price is equal to marginal cost. The monopolist who is capacity constrained does not want to use its market power to restrict output as it is producing below its desired level. Thus, the pricing outcomes of a monopolist are precisely the same as in a perfectly competitive (or indeed oligopolistic industry).

Put simply, capacity constraints are the ‘event horizon’ of industrial economics: traditional (textbook) conceptions that mergers reduce competition and prices exceed marginal cost break down as those marginal costs themselves rise to infinity. For mergers, this means that tight capacity constraints reduce the scope for the usual anti-competitive effects.

Mergers further upstream

Much of economic analysis regarding mergers presumes that the firms involved are pricing to a mass market of consumers. In this situation, firms post prices and the merger itself leads to a coordination of that pricing.

However, the notion of pricing to a mass market does not necessarily apply for wholesale markets. In these markets, upstream firms bargain with downstream firms over procurement terms. These terms do not necessarily involve a ‘one price fits all’ outcome; instead, the outcomes of each supply agreement are tailored to the specifics of that agreement. In this regard, it is far less obvious that

an upstream merger will involve a lessening of competition in a manner that harms final consumers.

Importantly, supply agreements struck through bilateral negotiations are likely to be efficient in the sense that unit prices for inputs reflect upstream firms' marginal costs. Starting from any supply agreement where unit prices are above marginal cost, an upstream and downstream firm can always find, say, a mutually beneficial fixed payment that would compensate the upstream firm for lowering unit prices to marginal cost. Recent research has established that this outcome carries over to the situation where there are many upstream and many downstream firms.⁴

This implies that if two upstream firms merge, unit supply prices will still reflect marginal costs. Even if that merger gives the upstream firms a better bargaining position, there will be no pass-through of such higher costs to final consumers. The only time this may have an adverse impact on them is (i) if it causes some downstream firms to exit the market; or (ii) it causes some upstream firms or resources to exit. The former concern will not likely arise if there are credible alternative supply sources for the downstream firms. The latter concern may arise if upstream firms are able to shut down capacity. However, if new upstream firms are able to enter with new capacity, an upstream merger will only stimulate this. Indeed, under those circumstances, *final consumers will be better off if competition authorities permitted all upstream mergers.*

Of course, this all applies to upstream mergers between firms that do not own downstream assets. In 2004, Boral proposed a takeover of Adelaide Brighton with an undertaking to divest downstream assets so that its market share downstream remained unchanged. However, while this nominally made the merger an upstream one, its downstream presence raised concerns and the ACCC opposed the merger. The merger did not proceed.

The rule of thumb is that when the downstream assets of an integrated firm are greater than its upstream assets, a merger consolidating upstream assets is less problematic than if the integrated upstream firm is a net seller in wholesale markets.⁵

If the customers are happy ...

The key to getting a difficult merger approved by competition authorities — ACCC, the Tribunal or the Courts — is to alleviate concerns that consumers will be harmed by increasing prices. Demonstrations of potential competition, efficient bargaining and undertakings are one thing but there is no better evidence than the consumers themselves. In many industries, the customers of the merging firm will be in the best position to consider the merger's impact. If they believe that the merger will lead to more competition by creating a more viable competitor to existing incumbents,⁶ or to efficiencies and quality

improvements that will be passed along to them, then this is the best indication that a merger will be pro- rather than anti-competitive.

What this suggests is that pre-contracting with customers is a desirable path to take especially if a merger is likely to be difficult. Merger-contingent price discounts are like price-cap undertakings to a regulator but can be agreed upon on an individual firm's terms. Roadshows that market the merger to customers can also be very advantageous. Ultimately, it is these factors that will separate the favourable from the unfavourable mergers.

ENDNOTES

¹ This table is modified from data contained in Phillips Fox, *Merger Monitor*, September 2004 (2004 data is part year only).

² Teresa Fels, Joshua Gans and Stephen King 2000, 'The Role of Undertakings in Regulatory Decision-Making,' *Australian Economic Review*, 33 (1), March, pp.3-16.

³ For more on this see Joshua Gans, Glenn MacDonald and Michael Ryall 2005,

'Operationalizing Value-Based Business Strategy,' *Working Paper*, IPRIA, (www.ipria.org).

⁴ For instance, see Catherine de Fontenay and Joshua Gans 2005, 'Vertical Integration in the Presence of Upstream Competition,' *RAND Journal of Economics*, (forthcoming).

⁵ See Joshua Gans, 'Concentration-Based Merger Tests and Vertical Market Structure,' *mimeo.*, Melbourne Business School (www.mbs.edu/jgans) for a more comprehensive discussion of these issues.

⁶ As may arise if the merger creates more 'competitive balance.' See Joshua S. Gans 2000, 'The Competitive Balance Argument for Mergers,' *Australian Economic Review*, 33(1), March, pp.83-93.

ENDS

[Sections marked in blue are potential pull-out boxes.]