Revised merger guidelines from New Zealand Commerce Commission

In December 2003, the New Zealand Commerce Commission released its revised Merger and Acquisitions Guidelines, which outline the Commission's analytical approach to considering the competitive effects of mergers and acquisitions in New Zealand.

The Guidelines:

- do not change the substantive law relating to mergers and acquisitions in New Zealand;
- include some changes to market definition, but those changes merely reflect the practical approach already followed by the Commission;
- do not explicitly incorporate recent High Court statements suggesting that the Commission should be careful that it does not rigidly apply a SSNIP approach to defining markets;
- do not alter either the Safe Harbour thresholds nor the role of Safe Harbours as merely a screening device;
- devote less time to discussing imports and accordingly, may reduce the relative weight given to the constraint imposed by imports; and
- introduce the concept of non-collusive oligopolies.

Each of these issues is discussed below. In addition, we have outlined the options open to firms seeking to enter into a merger or acquisition that affects a market in New Zealand.

New Zealand's merger and acquisitions test – substantial lessening of competition

New Zealand's competition (anti-trust) laws are contained in the Commerce Act. The Act prohibits a firm from acquiring the assets or shares of another firm if that acquisition would have the effect, or likely effect, of substantially lessening competition in any New Zealand market.

While the Commission is the administrative body responsible for regulating mergers in New Zealand, the test the Commission must apply is the statutory test above. Accordingly, the changes in the Guidelines do not represent a change in substantive law. Despite this, a thorough knowledge of the Guidelines (and the changes in the Guidelines) is crucial given that they outline the Commission's analytical approach to applying the statutory test.

New Zealand's voluntary pre-transaction notification regime places the onus on the acquiring party to assess whether a merger or acquisition will substantially lessen competition. The

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Guidelines are a useful tool in making this judgement, and, more importantly, in assessing whether the Commission is likely to reach a similar view.

Market definition: practical approach made explicit but no substantive change

While at first glance the Commission's Guidelines appear to include some changes in approach to market definition, these changes make no substantive difference to the analysis. Rather, the changes merely make explicit the practices already adopted by the Commission.

The Commission's approach to market definition is similar to the approach taken by other regulators around the world. The Commission applies a SSNIP test which, under the Guidelines, is a price rise of between 5% and 10%. While the Commission's previous Practice Note specified that a SSNIP was a price rise of 5%, in practice, the Commission actually used a 5% to 10% range.

However, more importantly, the New Zealand High Court in *Brambles New Zealand Limited v Commerce Commission*, in reversing a Commission refusal to clear an acquisition, recently warned against a mechanical application of the SSNIP test, noting that the Act requires an investigation of workable or effective competition, which:

"...contains more latitude and dynamism than can be captured in a test focused only on price and setting a fixed percentage threshold ".

A further, apparent, change in the Commission's approach to market definition is the inclusion of a 'customer dimension' in the analysis. The 'customer dimension' is described as:

"Where a significant group of buyers within a relevant market is likely to be subject to price discrimination, the Commission considers whether it would be appropriate to define additional markets based on particular uses for a good or service, particular groups of buyers, or buyers in particular geographic areas that are captive to those products, and in the face of a price increase unable to switch. For example, some customers may be captive to a particular supplier by virtue of the costs associated with switching to an alternative source of supply".

Traditionally, the Commission examined four market dimensions: product, geography, time; and function. In our view, the inclusion of a customer dimension will not change the analysis or capture any market dynamics that would not have been identified under at least one of the other four dimensions.

Indeed, the Commission's practice has been to examine the demand characteristics of different customer types as part of its analysis of the product dimension. For example:

- In clearing Cendant's (owner of Avis) acquisition of Budget , the Commission did not explicitly analyse a 'customer dimension' but nevertheless, concluded that there were separate Corporate and Leisure *product* markets for rental car services.

- In clearing ANZ's (New Zealand's fourth largest bank) acquisition of the National Bank of New Zealand (the country's second largest bank) the Commission did not explicitly analyse a 'customer dimension' but, nevertheless, in considering the 'product dimension' of the market concluded that individuals, small to medium-size business and corporates fell into different product markets.

Safe Harbours: the initial screening process

Included in the Guidelines are the Commission's safe harbour guidelines for business acquisitions. Neither the Safe Harbour Thresholds, nor the role that the Safe Harbour Thresholds play have been changed.

However, given the voluntary filing regime in New Zealand, it is important to understand exactly what is the role of the Safe Harbour Thresholds. The Commission uses the thresholds as a screening device when deciding whether it should use its scarce resources to investigate a proposed merger or acquisition in detail.

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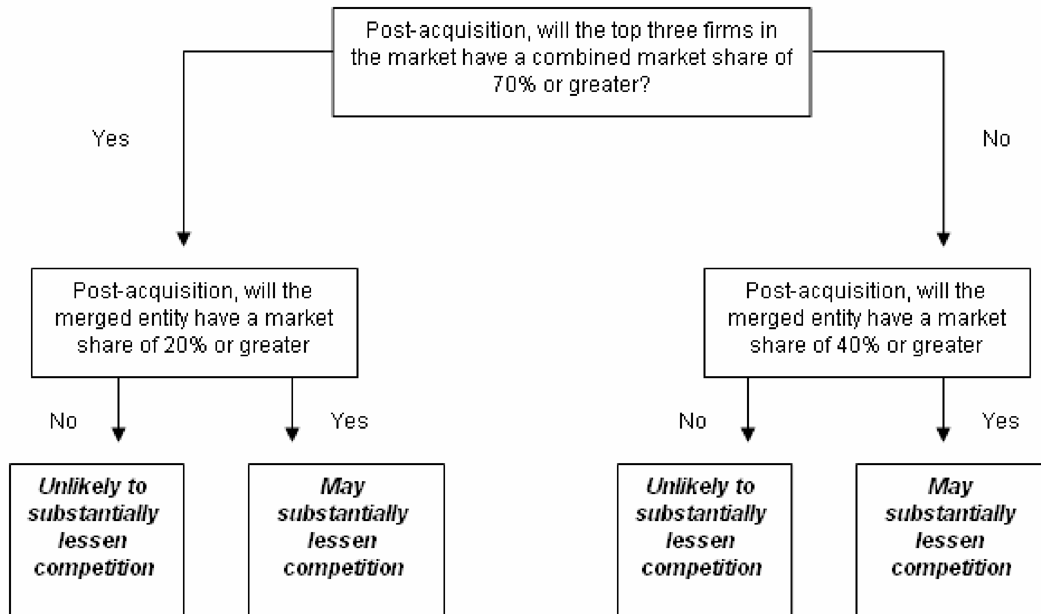
In general, the Commission considers that a merger or acquisition is unlikely to substantially lessen competition if the acquisition falls within the Safe Harbours. Figure 1 provides an outline of the Safe Harbours.

Figure 1 - Commission Safe Harbours



However, the Safe Harbours are only a screening device and are not determinative. The fact that a merger or acquisition does not fall within the Safe Harbours does not mean that the merger or acquisition will breach the Act. Conversely, the fact that a merger or acquisition does fall within the Safe Harbours does not mean that the merger or acquisition will not breach the Act.

Indeed, in the 41 clearance applications determined by the Commission under the substantial lessening of competition test, the Commission concluded that in approximately 50% of the markets it identified as relevant, the proposed merger fell outside the Safe Harbour Thresholds. Despite this, in approximately 90% of those cases, clearance was granted.

Beyond safe harbours: unilateral effects of a merger or acquisition

The Commission undertakes a typical competition law analysis of market structure and market dynamics when considering the likely effects of a merger or acquisition (i.e. number of effective competitors, barriers to entry and expansion, countervailing power, and potential competition from imports).

While all these factors were included the Commission's previous Practice Note, the relative importance given to each factor in the Guidelines may reflect a change in the Commission's views.

In the Commission's previous Practice Note, imports warranted an explicit sub-section (section 4.2). In the new Guidelines, imports are included as one paragraph at the end of a sub-section entitled "Identifying Existing Competitors".

Given New Zealand's small (about 4 million people and GDP of US$50 billion) and, by international standards, relatively open economy, any move to relegate the importance of

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import competition may have significant negative impacts for mergers and acquisitions in New Zealand.

It is not clear whether this change reflects a change in the Commission's view of the constraint imposed by imports, or whether the change is merely stylistic.

In our view, a reduction in the competitive significance of imports is not warranted. The potential for imports is still an extremely important constraint on market power, especially in a small open economy such as New Zealand.

Indeed, a high level of imports often reflects low barriers to entry and expansion, which the Court of Appeal stated in *Commerce Commission v Southern Cross Medical Care Society* is the key question in determining whether a merger is likely to substantially lessen competition.

Non-collusive oligopolies

A further, and potentially the most significant, "innovation" in the Guidelines is the introduction of the concept of non-coordinated market power.

We believe that this concept has been included in the Guidelines in response to the European Commission's Draft Notice on the appraisal of horizontal mergers (effective from May 2004), where non-collusive oligopolies are discussed.

The concept was introduced in Europe to plug a perceived hole in the law between single firm market power and co-ordinated conduct created by the dominance test. However, even in respect of the dominance test, some European commentators have expressed concern that, in practice, it is very difficult to find a substantial set of mergers that fall within the gap.

In New Zealand, where the test is a "substantial lessening of competition", it may be even more difficult to identify a substantial set of mergers that would fall within the gap that is said to be closed by the non-collusive oligopoly concept. Indeed, the Guidelines retain a section on co-ordinated market power, which is described as:

Co-ordination covers both explicit agreements and tacit forms of behaviour. Tacit co-ordination involves the use of facilitating devices such as price signalling, conscious parallelism and price leadership.

In our view, the line between price signalling, conscious parallelism and price leadership and non-coordinated oligopoly behaviour is, at best, blurred and, at worst, non-existent.

One case often cited in Europe as potentially falling within the non-coordinated oligopoly market power concept was the United Kingdom Competition Commission's decision in *Lloyds TSB/Abbey National.*

In that case, the four major banks in the United Kingdom held approximately 80% of the market between them and Lloyds (with market share around 20%) was not permitted to acquire Abbey National a small player with around 6% of the market. However, critics of the non-collusive oligopoly concept have argued that the Commission framed its decision in terms of tacit collusion, which is more properly described as a coordinated effect.

Interestingly, when the New Zealand Commerce Commission cleared ANZ to acquire the National Bank in a situation where, in many markets, the combined entity had over 40% of the market, neither coordinated market power in the form of tacit collusion nor non-collusive oligopoly power appeared to be issues for the Commission.

As a result, although critics of the introduction of the non-collusive oligopoly concept in Europe have labelled its inclusion "interventionist", it is unclear whether the inclusion of the concept in New Zealand will dramatically alter the Commission's merger analysis. In fact, in decisions released under the previous Practice Note, the Commission recognised that in oligopoly markets:

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"...economic theory suggests that even where firms do not coordinate their behaviour but instead seek independently to maximise their profits, it is possible for unilateral market power to emerge".

However, given the small size of New Zealand markets and high seller concentration, it is an area of the Commission's analysis that we will monitor closely, as the ramifications for business if the Commission further develops this line of thinking are significant.

Options for dealing with merger issues in New Zealand

As noted above, the Guidelines have not altered New Zealand's voluntary pre-transaction notification regime. Accordingly, where an acquirer does not believe that a proposed merger or acquisition will substantially lessen competition, the acquirer may:

i. apply to the Commission for a formal "clearance";

ii. make an informal submission; or

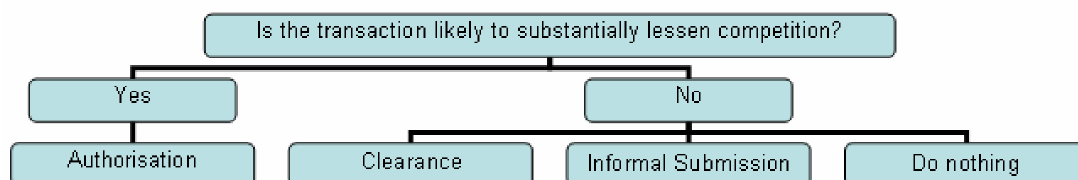
iii. do nothing.

If the acquirer believes that the proposed acquisition will be likely to substantially lessen competition (or the Commission declines clearance), the acquiring party may apply for an "authorisation" of the transaction.

The Commission will grant an authorisation where, although it considers that the likely result of a proposed acquisition would be a substantial lessening of competition, the acquisition will result in benefits to the public that outweigh any detriments arising from a loss of competition.

The options are depicted in Figure 2.

Figure 2



Of the options listed above, authorisations and formal clearances provide the most protection to an acquirer because they protect the acquirer from any subsequent legal action brought by the Commission (or by a third party) alleging that the acquisition breached the Act. However, there is a time and cost aspect involved in filing for authorisation or formal clearance.

Can an acquirer do nothing? The short answer is yes, but there are downside risks associated with a 'do nothing' approach. The Commission is likely to become aware of the transaction via news media coverage or otherwise so in general it is not possible to undertake an acquisition 'unnoticed'.

In our experience, in certain cases it is difficult to give a firm view as to whether a proposed acquisition will substantially lessen competition. For example, the parties and the Commission may reach different views on market definition, with significant consequences.

Given that the penalties for breaching the Act are severe and include divestment, an informal submission that briefly sets out why there are no competition law issues may be a prudent safeguard. Of course, an informal submission to the Commission does not provide the cast iron immunisation that a clearance provides.

However, an informal process does shift the burden of proof from the Applicants in a formal application process, to the Commission in an informal process. If an acquiring party does not

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formally apply for clearance or authorisation, ultimately, the Commission must be able to evidence to the satisfaction of the High Court that a proposed merger will "substantially lessen competition".

By comparison, in the formal process, the Commission can be conservative in its approach and refuse to clear or authorise where the Commission is not satisfied that a breach will not occur. The Applicant is then faced with a formal appeal in order to remove the block created by the Commission's decision. The time needed for such an appeal may be too restrictive for many sale processes.

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