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Towards Opportunity & Prosperity

THE TRADE PRACTICES ACT: ARE WE BECOMING A BRANCH OFFICE ECONOMY?

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Introduction

Paul Kelly reported on the front page of The Weekend Australian on 10 February 2001, that:

> *Business leaders are about to confront the Howard Government with the ultimate issue for corporate Australia: how our best companies can stay onshore and how the nation can avoid becoming a New Zealand-style branch-office economy.*

He also reported that the Business Council of Australia

> "*breaks the challenge down into three main areas where the government's response is crucial:*
>
> *first the competition law under which the ACCC chief Allan Fels makes judgments, solely in relation to the domestic market, rejecting mergers and acquisitions, which [David] Buckingham [then Business Council Executive Director] says "denies our companies the scale they need." The hostility towards Professor Fels and the Commission has now reached incendiary levels within business…"*

Kelly went on to say:

> *"at the heart of this agenda lies two questions. How much is Australia's corporate future driven by the unalterable forces of scale and currency, as opposed to the potential policy? And second, how much of the Business Council debate is consistent with the interests of consumers?"*

A list of the companies where the issue was seen as most pertinent was provided. The list was:

- Lend Lease
- BHP
- AMP
- Pioneer
- Brambles
- National Australia Bank

At the end of the list it was stated:

"nearly every efficient company now confronts these problems".

The views of the Business Council of Australia concerning merger law, however, are only one view coming from the business community. The small business sector generally supports a strong, perhaps stronger, merger law. Thus NARGA, the National

Association of Retail Grocers of Australia, has called for changes to the merger law so that it better addresses the phenomenon of creeping acquisitions in the supermarket industry. Some including NARGA and the Council of Small Business of Australia (COSBOA) also support the introduction of a divestiture law.

There is also discussion in big business quarters about the claimed need to take more account of globalisation.

Parliament, however, last year amended the Trade Practices Act to provide specifically that when considering mergers the courts and the ACCC should explicitly include the effects on regional markets in their analysis. Globalisation did not seem to be on its mind.

The Government announced during the elections that there would be a review of the competition provisions of the Trade Practices Act. This will necessarily include as one element a review of s50, the mergers provision of the Trade Practices Act.

The Commission believes that this review will provide an opportunity for interested parties to air publicly many of the arguments and debates surrounding the Act and its administration and welcomes the fact that there will be an independent body assessing these arguments and that they will be tested in an open and transparent process.

The review will also provide an opportunity to bring Australia into line with international best practice in antitrust law in a number of areas where **it** may be currently lagging.

Before addressing the topic more systematically I would like to make a couple of points about the article by Paul Kelly. The first is that the list of companies provided to him, presumably by the Business Council of Australia, includes few if any of which have had problems with the Commission regarding mergers. There was no objection to BHP acquiring New Zealand Steel, and later Tubemakers, and floating OneSteel and indeed subsequent restructuring in relation to the steel industry distribution arrangements, nor to the BHP/Billiton merger. No obstacles have been placed in the way of mergers and acquisitions by Lendlease, Brambles and AMP**.** There was no objection to Brambles' deal with GKN, nor its recent bid for Ausdoc. The ACCC did not object to AMP acquiring GIO with its many claimed benefits. The NAB's problems are with the four pillars policy. Even Pioneer is not a clear example. It has had some problems with the Commission under s45 of the Act concerning anticompetitive agreements but it did not seek to merge with CSR or Boral and when Hanson's acquisition of Pioneer was announced, Pioneer stated that the outcome was not affected by the Trade Practices Act and indeed this seemed unlikely.

Second, I am a little disappointed at the Business Council of Australia's choice of priorities. At its Annual General Meeting, the Business Council stated that it saw three important priorities for Australia: reform of training and education; tax reform; and regulatory reform (the merger law). I understand that today at this conference it listed tax at the top of its list and the review of the Trade Practices Act as the second item on its list. I believe there are higher priorities in product market microeconomic reform for example concerning energy, transport and communications. In these sectors there is a need for more competition. There are also very important interconnected issues concerning the IT and communication industries, innovation and intellectual property commercialisation which should form an important part of microeconomic policy in the years ahead. The government itself appears to recognise these matters but we have not heard a great deal from the Business Council on most of them. Is the current mergers policy debate really the displacement of a much more fundamental and urgent – and for many of the protagonists, more uncomfortable – debate into the direction and effectiveness of Australia's business leadership and of its industry policy.

Why do mergers matter?

The focus on mergers arises from the recognition of the link between conduct in a market and the structure of that market. The research, production, marketing, pricing and selling decisions of firms are often largely responsive to the structural aspects of the market. While not determinative, higher levels of concentration, absent contestable markets, import competition or other such balance, can often lead to a loss of competitive market discipline.

The Commission recognises the broad benefits that may accrue to mergers, including: disciplining errant or ineffective management; allowing firms to achieve efficiencies otherwise unattainable on their own terms; providing access to capital, better management, additional markets, technical talent or other synergies.

However, they can also lead to an effect on competition such that there is increased scope for price rises, coordinated behaviour and a lessening of the dynamic elements driven by competition that so influence market development. These include innovation, more effective management, better use of resources and a more responsive attitude to the demands of the consuming public.

Competition helps promote an efficient allocation of resources in a market economy and a high degree of productive efficiency. Adam Smith recognised this point back as far back as 1776, when he observed that "monopoly … is a great enemy to good management." The chill winds of competition are the spur that prevents inertia and lethargy taking over within a firm.

Competition also drives innovation. Firms innovate in order to improve their competitiveness. Innovation can help a firm lower its production costs and/or produce better products giving it a competitive edge over its rivals. Left to compete in terms of price alone there is in some industries little scope for an individual firm to enhance its profitability even temporarily. The ability of a firm to change the products that it sells or the technology it uses increases the field over which it can compete.

Merger regulation plays a critical role in ensuring competitive conduct by ensuring competitive industry structures. In a nutshell, we have laws to ward off anti-competitive mergers to promote and enhance economic efficiency.

If we had no merger law the economy would have a highly anti-competitive structure. We would see more monopolies, higher levels of concentration and fewer market participants, to the great detriment of all Australians.

We would see harm to business itself for its suppliers would be uncompetitive, inefficient and costly.

We would also almost certainly see higher demand for direct regulation of business in concentrated sectors.

Merger activity

It is quite illuminating to look at actual statistics relating to the Commission's assessment of mergers.

These show the Commission considered a total of 265 mergers in 2000-2001. This compares to 234 in 1999-2000, 185 in 1998-99, 176 in 1997-98 and 149 in 1996-97, a rising trend.

Of the 265 assessed in 2000-2001, 13 were opposed, with 10 of these proceeding following the provision of enforceable undertakings.

Generally, the Commission opposes around 4 to 5 per cent of the matters assessed. Over the last five years the Commission has assessed around 1008 mergers, with 57 being opposed. Of these, 33 were resolved through undertakings. To date in this financial year the Commission has opposed seven proposals out of a total of 150, with 4 resolved through undertakings.

In the last ten years the Commission has not opposed any mergers where imports make up ten per cent or more of the market, and in some cases lower shares or potential import competition has been enough to remove concerns about mergers.

Some mergers in the traded goods sector have even resulted in domestic sole suppliers or near sole suppliers.

Amcor/APPM; BHP/New Zealand Steel; Caroma/Fowler; the Qantas/British Airways agreement on the kangaroo route; Email/Southcorp; Ardmona/SPC; and Manildra/George Weston in regard to starch operations are just a few of the mergers, acquisitions or joint ventures not opposed in the traded goods sector.

It is in this traded goods sector that arguments relating to critical mass are strongest.

Even in the non-traded goods and services sector, deregulating sectors and those without strong import competition, very few are opposed.

Recent examples include: Bunnings and BBC Hardware; Toll and Lang's acquisition of National Rail/Freight Corp; the Grain Pool of WA and Cooperative Bulk Handling Authority; Suncorp/Metway and AMP/GIO; the acquisition of Wreckair Hire by Coates; Mayne's purchase of Faulding and the Commonwealth Bank's acquisition of Colonial.

However, the Commission opposes mergers and acquisitions likely to substantially lessen competition. Judgements are not made lightly and follow inquiries of customers, suppliers, competitors and others and analysis of submissions from interested parties, including applicants and their teams of advisers, consultants, lawyers and executives.

Recently the Commission opposed the IPMG/PMP print merger - even after an offer of divestiture. There was widespread opposition to this acquisition from a range of industry customers, both large and small. Users were concerned at the effect of the very high level of concentration, while no potential competitors were in a position to exert pricing discipline on the merged entity. Barriers to expansion quite high and there was little if any constraint exercised by offshore printers.

The Commission also opposed an Adelaide radiology merger in May 2001. In that case it was found that the acquisition would substantially lessen competition in the provision of radiology services to private patients in the Adelaide region. The new entity would have in excess of 50 per cent of Adelaide private patients with associated market power providing the potential to adversely affect those patients.

Flexibility on the application of s50 is enhanced, however, by the use of undertakings and Section 87B has become an important part of the Act. It provides the Commission and parties with an effective alternative to opposition to an acquisition that the Commission believes may substantially lessen competition.

The Commission initially opposed the Mayne Nickless proposed acquisition of Australian Health Care. The problem was that Mayne would have acquired nearly all of the private hospitals in a very large part of Melbourne, and in the Gold Coast. However, by undertaking to sell off certain hospitals, doctors, patients and health funds were given a degree of choice and the opportunity to benefit from competition.

The recent managed sell down of the Franklins stores could not have been accomplished in the manner it was absent the ability to address concerns through undertakings. The SPC/Ardmona approval relied on undertakings to address anti-competitive concerns at the upstream grower level. The deal concerning Smorgon/OneSteel and Email was made possible with undertakings to protect future competition. Wesfarmers and IAMA was also allowed to proceed once undertakings had addressed specific concerns in the Western Australian market.

Clearly the undertaking route is a valuable means for companies to address concerns allowing potential merger benefits to be achieved.

Australia's competition law differs from that in many other countries. In the USA anticompetitive mergers are prohibited, irrespective of any wider public benefits that may accrue. In Europe, the same approach applies in practice, under the dominance/collective dominance approach.

In Australia, however, in recognition of the small size of our economy, we have decided that our competition law will "authorise" mergers and other anticompetitive behaviour where applicants can satisfy the ACCC and on appeal the Australian Competition Tribunal (ACT) that there is a sufficient benefit to the public to outweigh the harm to competition. In other words, compared to many other countries we have been prepared to balance our competition law to resolve the conflict by means of an "authorisation" process.

But we still think the promotion of competition is vital in our economy. Anticompetitive conduct or mergers are only authorised under stringent conditions – the onus is on applicants to satisfy the Commission/Tribunal of their case; they must demonstrate a benefit to the public that outweighs the detriment to competition; the process is public and transparent with provision for customers, consumers and others to contribute. This seems appropriate – for a regulator to allow a merger that gives rise to, say, a monopoly is not something that should be done easily, privately and without consideration of the interests of the whole public.

Business interests sometimes argue that many matters that may be in the national interest are not brought forward out of fear of the Commission's automatic rejection.

It is difficult to accept that a CEO of a major Australian corporation who is convinced of the national interest arguments in relation to his or her acquisition would not at least raise the issue confidentially and tentatively with the regulator. The regulator is responsible for the administration and enforcement of a law which permits mergers which, even if anticompetitive, are in the public interest. If, having regard to the Act where mergers that are in the public interest are allowable, a CEO believes that there are strong public interest arguments it would seem appropriate that it should bring that matter forward. This does not happen a great deal, but there are occasional assertions by some in big business that many mergers that could benefit the public are not even being seriously considered because of the Act.

The authorisation process, which grants immunity on public benefit grounds, allows the Commission to balance the various trade-offs that may arise in a particular merger. For example, particular efficiencies, economies of scale or scope that may arise in a merger that would otherwise be construed as anti-competitive are able to be balanced against that detriment.

The process also takes account of the need for Australian business to be able to merge to achieve economies to compete internationally.

In fact, the statutory test for merger authorisations directs the Commission to have regard **to** the public benefits to be achieved from:

- a significant increase in the real value of exports;
- a significant substitution of domestic products for imported goods; and
- matters that relate to the international competitiveness of any Australian industry.

Some concerns that have been expressed with regard to the authorisation process, particularly in respect to mergers. It is not heavily used. This may need consideration at the review though I counsel careful consideration before adopting changes.

The ASX/SFE matter is sometimes raised as an example of where the Commission did not give enough weight to global considerations. I do not agree, nor did many business users of their services. However, that proposal could have been better brought forward as an authorisation to allow arguments concerning economies of scale and international competitiveness to be tested in the market and balanced against the perceived detriment. The parties did not see fit to use this avenue even though many of their arguments to the Commission were more appropriately put in that context.

Merger Law, Globalisation, National Champions & the Branch Office Economy

Global issues and merger assessment

Lowering of trade barriers, rapid technological change, falling transport costs and massive innovations in transport modes, along with sustained economic growth has altered the landscape in which our firms operate.

The ACCC recognises the impact of globalisation on business. Our merger guidelines were developed with particular reference to the small, open nature of Australia's economy. Concentration ratios were raised above countries such as the USA and Canada and significant weight was given to the impact of imports or the threat of imports in the analysis.

The Commission's record demonstrates that it recognisees the reality of global markets and open borders. Recent decisions in the case of Manildra and George Weston and SPC and Ardmona both demonstrate this.

In the case of SPC/Ardmona a 90 per cent market share was not opposed in the context of a contestable import market. In the case of Manildra the international context of its operations was a deciding factor in the Commission's decision not to intervene following the offer of divestments.

Business people, and some of their advisers, frequently raise the question of whether or not the merger provisions of the Trade Practices Act prevent the mergers necessary for Australian firms to be of the size necessary to take part in global markets. The answer to this is rarely, if ever. As I have said it is impossible to argue this in the traded goods sector where the argument is most relevant because we don't block mergers there. Where mergers are prevented the ACCC does so only in circumstances where it is on balance undesirable because of the harm from the anti-competitive effect in the Australian market outweighing any benefits to Australia.

The Commission does give little weight to factors such as Australian ownership in its competition analysis, under s50. However, the Commission is not blocking mergers in such a way as to inhibit the international competitiveness of Australian firms. If one is concerned at foreign acquisitions of Australian businesses, then one should press for greater use of foreign investment and ownership laws rather than distort competition law. Ownership may also be included in authorisation cases as a public benefit.

Critical Mass/National Champions

Many argue that firms need to reach 'critical mass' in order to achieve economies of scale and scope of sufficient magnitude so that they can be competitive on international markets. Additionally, some segments of business are arguing that merger law is actually working to drive firms offshore, the so-called branch economy effect.

However, it is important to note that obstacles to export growth may face industry participants of all sizes.

It is not apparent that, simply by entering a collaborative arrangement like a merger or joint venture, a participant's ability to compete internationally is automatically enhanced. Size is often not necessary to enhance the ability to compete on world markets. It has been argued that, in many cases, domestic rivalry rather than national dominance is more likely to breed businesses that are internationally competitive.

There are circumstances under which the ACCC will accept arguments in relation to critical mass. They are set out in its publication Exports and the Trade Practices Act.

One concern however, is that, when firms merge with the aim, for instance, of enhancing exports, there is the prospect that domestic prices may rise until they reach import parity (if the goods were previously priced below import parity) while exports are at a lower price. A merged entity may use its market power to increase domestic prices and so subsidise its export price. Ultimately, Australian consumers and industry may be forced to pay a higher price in order to underpin the merged entity's export sales.

Most mergers that could enhance international competitiveness would involve firms that already trade internationally, are likely to be subject to the discipline of global market pricing or are subject to the threat of import competition. The recent Manildra and SPC/Ardmona matters referred to above clearly demonstrate this.

The numerous mergers in the resource and resource related sectors are also clear evidence of this approach. The Commission rarely, if ever, opposes mergers in this sector of the economy based in the main on its reading of the dynamic market factors affecting a particular entity, especially the international environment in which the companies operate. Once again examples abound: Woodside/Shell; Rio Tinto/North; BHP/Billiton; Anglo Gold and Newmont's bids for Normandy; a number of coal matters; and ancillary service sectors with businesses such as Metso/Sveldala.

A weak or compromised merger policy in response to national champion arguments could actually damage the international competitiveness of Australian firms. The prevention of anti-competitive structures fosters a more efficient, resilient and responsive domestic economy. This leads to the production and supply of more efficient and lower cost inputs for Australian exporters and import competitors. Competitively supplied inputs are essential for the health of domestic industry.

Porter's arguments

In *The Competitive Advantage of Nations* in which Professor Michael Porter undertook an extensive survey of the international competitiveness of ten nations, he found a strong empirical link between vigorous domestic rivalry and the creation and persistence of competitive advantage in an industry.

In a more recent examination of Japanese competitiveness, Porter and Sakakibara found robust evidence that domestic rivalry is positively associated with international trade performance. These findings provide strong support for Porter's initial work mentioned above.

Only last week David James wrote in the *Business Review Weekly* about the challenges facing Australia in achieving global success. He quoted Michael Porter extensively in reference to his views on mergers. Once again Professor Porter is highly critical of arguments that would lead to higher levels of concentration. He noted that

> *"..(he) would be wary of mergers that excessively consolidate a local industry because that pretty much means you will never have a dynamic cluster."*
>
> *"(L)ocal competition has very strong benefits in terms of (outside influences on) productivity. So…when you look at anti-trust, or a merger, you…should put a lot of weight on the local competition*".

According to Professor Porter that means that Australians should be turning down mergers that turn industries into monopolies or near monopolies.[1]

In short, there is not strong evidence available to support notions of national champions. As a consequence, one should be very wary of changing public policy based on notions lacking a strong factual basis.

Branch Office Economy

Recent work undertaken by the Productivity Commission lends support to the arguments I have put and sheds additional light on the Branch Office debate.[2]

In its recently released survey of offshore investment by Australian firms it found that commercial factors were a more important influence on the investment decisions of firms than factors associated with government policy. Access to global markets, finance, material and labour inputs all ranked in front of government policy factors.

When questioned on government factors the Australian tax regime was cited as the most important, with merger law ranked fairly low. In fact even of the 8 companies that had actually shifted their head office overseas or were going to, half of those rated mergers law as having a nil or zero degree of importance in inhibiting their domestic growth. The other half rated it as of middle to high influence.

Once again, access to international markets was the key factor influencing their decisions, with access to key business services, key personnel and capital also rated as important.

Importantly, the survey also confirmed that the foreign operations of Australian companies generally lead to benefits to the broader economy.

Perhaps we should indeed do as Ross Gittins has suggested.

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[1] David James, *How to Kick Global Goals*, BRW, 28/03/2002

[2] Productivity Commission, *Offshore Investment by Australian Firms: Survey Evidence*, 2002. As the PC is contributing to this session, my comments are brief.

"Relax. Rumours that we are about to become a Branch Office Economy are greatly exaggerated…"

Are Australia's merger laws are outdated?

There have been a series of recent criticisms that the merger laws contained in the Trade Practices Act is out of date and badly in need of reform.

According to the BCA (2001):

"The nature of competition has changed since the Act was last reviewed. The BCA has raised the concern – as have many of its members - that the Act, and its application, does not sufficiently recognise that markets are increasingly global and that the Australian economy has opened up substantially in the past 20 years.

"Any weaknesses in the competition regulatory regime have several potential adverse consequences for Australia, particularly if mergers are being prevented that would otherwise deliver net public benefits."

One way I can respond to assertions that Australia's merger laws are antiquated is to ask whether our approach is out of step with what happens in the rest of the world. Section 50 of the Trade Practices prohibits mergers or acquisitions which would have the effect or likely effect of substantially lessening competition.

Australia joins the United States, Canada and New Zealand in a having a substantial lessening of competition test in regard to mergers. The United Kingdom is also moving to enact a substantial lessening of competition test. The Australian approach to merger laws is indeed fully consistent with the approach taken across the entire English-speaking world.

The European Union published a Green Paper last year that canvassed the possibility of changing its merger laws to a substantial lessening of competition test. Even now, the collective dominance test and the manner of its assessment are very similar to that undertaken by the Commission under its SLC analysis. Individual nations within the EU, such as Germany, have also published discussion papers foreshadowing moves toward a clear SLC test in their jurisdiction.

While the rest of the industrialised world appears to be moving in Australia's direction, do our business leaders want to take Australia down a different path altogether?

Mergers v spin-offs

There is another facet of the merger debate that is often overlooked. That is, just how successful are mergers and how much do they really enhance shareholder value?

The virtues of mergers and acquisitions are loudly asserted, and pressure to make them easier whatever the public interest impact might be is unrelenting from particular quarters of the business community. Yet there is silence about the virtue of shareholder value creation though corporate spin-offs and equity carve-outs.

As McKinsey so starkly puts it, “breaking up is good to do” (Anslinger, Klepper & Subramanian 1999).

McKinsey’s study of a decade’s worth of large ownership restructurings in the US involving parent companies with revenues of $US200m plus at the time of disaggregation found considerable evidence of shareholder value being boosted by break-ups. They found a wide range of measures improved with disaggregation: expansive revenue growth, improved P/E multiples, and better returns on invested capital.

In the context of empirical research like this, and examples of conglomerate stagnation evident in our own economy – the unfortunate case of Pacific Dunlop comes to mind – the silence on the shareholder benefits of disaggregation compared to the volume of support for a slacker merger policy is puzzling indeed.

Conclusion

Competition plays a vital role in promoting economic efficiency. In addition, the weight of evidence is that strong domestic rivalry is an important contributing factor to success on international markets. As Mr Peter Smedley, Chairman of Mayne Nickless, was recently reported in The Australian, “I don’t think I have seen a player hurt in a duopoly.”

To conclude:

- the evidence that Australia is in danger of becoming a branch office economy is not compelling
- to the extent that Australia may be becoming a branch office economy and that this is in some way undesirable, the evidence for the link between this and merger law is very weak
- if any policy actions are required the priorities lie in such fields as tax policy and foreign investment review policy
- if there is to be a serious debate about merger law the claim that it is causing Australia to become a branch office economy seems to have little role to play in it.