Are the ACCC's Merger Guidelines Too Strict? A Critical Review of the Industry Commission's Information Paper on Merger Regulation

by

Henry Ergas

Working papers in this series are initial releases of research conducted under the auspices of The Centre for Research in Network Economics and Communications (CRNEC) at The University of Auckland. CRNEC is a research and teaching based interface between business and academia which focuses on the economics, law and management of network based industries. We offer written independent expert advice on matters related to network economics but require that any such work be published in this working paper series.

For further information please contact:

The Centre for Research in Network Economics and Communications
School of Business and Economics
The University of Auckland
Private Bag 92019
Auckland, New Zealand
Tel: +64 9 373-7688
Fax: +64 9 308-2317
Email: crnec@auckland.ac.nz

The views expressed in this paper are entirely my own. I am grateful to Emma Clark for excellent research assistance.

Are the ACCC's Merger Guidelines Too Strict? A Critical Review of the Industry Commission's Information Paper on Merger Regulation

Henry Ergas

The Background

The Industry Commission's Information Paper on Merger Regulation[1] (henceforth referred to simply as "the Information Paper") contains numerous errors of fact, law and analysis. My goal here is not to examine these in detail (a task already well accomplished by Warwick Anderson, Tim Grimwade, Jill Walker and Luke Woodward in a forthcoming paper in the Competition and Consumer Law Journal) but rather to explore some of the central themes in the Industry Commission's Paper.

I will, in particular, focus on three elements which are at the centre of the Paper's recommendations:

1. That the concentration thresholds built into the ACCC's Merger Guidelines[2] have been too low and should be raised;

2. That import competition should be given considerably greater weight in the ACCC's assessment of competitive conditions: indeed, whenever arm's-length imports (a term defined below) exceed 10 per cent, the presumption should be that mergers will not substantially lessen competition; and

3. That the barriers to entry are generally lower than the ACCC seems to believe, and that a lower hurdle should be set for a finding that entry is likely to nullify any price-raising effect a merger may have.

---

1 Industry Commission, Merger Regulation: A review of the draft merger guidelines administered by the Australian Competition and Consumer Commission, Information Paper, Canberra, June (1996) [henceforth: Information Paper].

2 See, for the most recent version, Australian Competition and Consumer Commission, Merger Guidelines: A guide to the Commission's administration of the merger provisions (ss 50, 50A) of the Trade Practices Act Canberra, July (1996).

As can be seen, the Industry Commission's recommendations point to a relaxation -- quite a substantial one -- of the ACCC's enforcement of s.50 of the Trade Practices Act. The presumption is that the manner in which the ACCC has enforced the merger provisions in the past has imposed substantial costs; the claim the Industry Commission is making is that enforcement on the lines it proposes would yield net benefits to the community.

Before turning to an assessment of this claim, it is worth saying a word about the evidence the Industry Commission relies on to make its case. A striking feature of the Information Paper is that it makes no use of, or even reference to, empirical studies of Australian industry. Rather, the reader is told that the data needed for empirical studies is unavailable in Australia[3]; hence, the paper relies primarily on studies carried out in the United States. The claim made in this respect is entirely unsubstantiated; in fact, Australian industry data is more than adequate by international standards, and could have been used to good effect by the Industry Commission, had it actually wanted to do so[4]. Moreover, the Industry Commission could readily have used other types of easily available data to test some of the claims it makes: for example, it could have relied on stock market prices for an "event analysis" assessment of the effects of ACCC inquiries on the prices paid in take-over bids[5,6]. Finally, the Industry Commission could have drawn on the ACCC's own published records, and decisions taken by the Australian Competition Tribunal (ACT) and the Courts, as a basis for quantitative analysis[7].

---

3 Information Paper, page 36.

4 Merely one example of the use of this data is Ergas and Wright "Internationalisation and Productivity" in Reserve Bank of Australia Internationalisation of the Australian Economy (1993).

5 "Event analysis" is a standard technique in financial economics which usually involves examining the impact of an event -- for example, a regulatory decision -- on stack market prices.

6 The Information Paper claims that ACCC investigations prolong take-over bids or erode their confidentiality, thus increasing their cost. A US study which uses event analysis to examine a similar hypothesis is McWilliams, Turk and Zardookhi "Antitrust Policy and Mergers" 31 Economic Inquiry (1993) 517.

7 See, for example, for the US, Coate and McChesney "Empirical Evidence on FTC Enforcement of the Merger Guidelines" 30 Economic Inquiry (1992) 277. Coate and McChesney draw on internal FTC material; there is every reason to suppose that the Industry Commission could have obtained access to similar material, had it sought to.

Having foregone the task of actually analysing evidence, the Industry Commission's work centres on a review of the literature. It is therefore not inappropriate to ask to what extent that literature actually supports the views the Information Paper advances. In addressing this question, I will proceed as follows: section 2 examines the role of concentration measures; section 3 assesses the impact of import competition; section 4 turns to the role and impact of barriers to entry; and section 5 examines the Information Paper's arguments in favour of basing the enforcement of merger policy on simple rules which can provide a high degree of certainty. Section 6 concludes.

Concentration Thresholds

One important element of the ACCC's Merger Guidelines is that they specify "safe harbours": concentration levels below which the ACCC will not investigate proposed mergers. Put in other words, if a merger falls below the levels set, the ACCC will presume that it will not damage competition, and hence will not make further inquiries.

The Information Paper argues that the current thresholds are too low. It suggests replacing the current thresholds of a 75 per cent <u>four</u> firm concentration ratio (and a merged firm share of 15 per cent) or a merged firm share of 40 per cent, with a 75 per cent <u>three</u> firm concentration ratio (and merged firm share of 20 per cent) or a merged firm share of 50 per cent.

To those familiar with the contemporary literature in Industrial Organisation (as what used to be called "industrial economics" is now more grandly known, with the associated acronym "IO"), this is curious stuff. In effect, the entire trend in the literature points the other way. Some explanation may be useful.

Traditionally, economists were concerned about high levels of concentration because these were likely to facilitate collusion. Holding everything else constant, there were good theoretical grounds for believing that the smaller the number of firms in a market, the more readily they could coordinate their pricing behaviour -- not only because they would encounter fewer difficulties in determining the collusive profit-maximising price but also because they could more easily detect and punish cheating[8]. As a result, an increase in concentration was viewed as making it likely that firms would engage in cooperative behaviour, either through express cartels or through tacit pricing coordination.

At the same time, oligopoly models showed that even if firms did not explicitly cooperate, higher levels of concentration were likely to lead to higher price-cost margins. Thus, many theories of how oligopolies work yield an equilibrium in which the margin of price over cost depends on the Herfindahl-Hirschman Index (HHI), which is calculated by summing the squares of the market shares (in percentage terms) of all the market participants[9]. In its most general formulation, this equilibrium can be characterised as:

$$(P - C)/P = (H*Beta)/e$$

where P is price, C is marginal cost, H is the Herfindahl-Hirschman Index, e is the constant elasticity of demand for market output and Beta is a parameter which represents the manner in which firms in the market interact. While pure cartel behaviour corresponds to Beta = 1/H, Cournot-Nash behaviour[10] can be shown to correspond to Beta = 1. If oligopolies are taken to behave on Cournot-Nash terms, then the HHI can be interpreted as the ratio of the (likely) non-cooperative mark-up to the cooperative (collusive) mark-up. Each percentage increase in the HHI then translates into higher mark-ups, <u>regardless of whether firms actually collude</u>.

In short, simple oligopoly theory suggests that increased levels of concentration raise concern on two grounds: (1) because for a given pattern of interaction (the Beta coefficient above) higher concentration will yield higher margins of prices over costs; and (2) because as

---

8 The classic formulation is Stigler "The Theory of Oligopoly" Journal of Political Economy 72 (1964) 44-61. More recent formulations are reviewed in Jacquemin and Slade "Cartels, Collusions and Horizontal Merger" in <u>Handbook of Industrial Organization</u>, Schmalensee and Willig (eds.) (1989) Amsterdam and New York: North-Holland.

9 This index has many desirable numerical properties, one being that it will tend to zero as the number of equally-sized participants rises and to 1 as the market approaches pure monopoly.

10 In the Cournot-Nash oligopoly model, firms producing a homogenous product under the same cost conditions first must commit to their productive capacity, and the price becomes that which clears the market of this output. See, for example, Shapiro "Theories of Oligopoly Behaviour" in <u>Handbook of Industrial Organization</u>, Schmalensee and Willig (eds.) (1989) Amsterdam and New York: North-Holland.

concentration rises, the pattern of interaction may change towards or to collusion.

This approach begs a host of empirical questions, many of which centre on whether a "critical" level of concentration can be defined below which firms act competitively and above which prices are likely to tend towards collusive levels[11]. It is attempts to answer these questions which have informed the definition of thresholds and "safe harbours" built into the ACCC's Merger Guidelines, as well as the similar efforts of the ACCC's counterparts overseas.

More recently, however, attention has focused on the scope which mergers may create for the merged entity to raise price unilaterally -- that is, even assuming that the other firms in the market hold their own prices constant[12]. These "unilateral effects" models make sense in contexts where firms are not homogenous -- for example, because the products they sell are differentiated, their costs differ, or they have different production capacities. Once the analysis is placed in these circumstances, the conventional emphasis on market share loses much of its value.

Consider, for example, a market in which products are extensively differentiated. In such a market, mergers are not likely to materially facilitate coordinated price effects, if nothing else because the gains from coordinating a price increase between distant substitutes are probably low. However, if two firms supplying relatively close substitutes merge, then the merged entity will have incentives to increase its own price relative to the prices bordering it on the chain of substitution. The closer the two firms are to each other in the chain of substitution, and the further they are from other firms, the greater this effect will be. Put slightly more technically, the extent of the post-merger price rise will depend on the pre-merger ratio, for each of the merging parties, of (1) the cross-price

---

[11] See, for example, Geithman, Marvel and Weiss "Concentration, Price and Critical Concentration Ratios" 63 Review of Economics and Statistics (1981) 346.

[12] See notably Salant, Switzer, and Reynolds "Losses from Horizontal Merger: The Effects of an Exogenous Change in Industry Structure on Cournot-Nash Equilibrium" 48 Quarterly Journal of Economics (1983) 185-99; Deneckere and Davidson "Incentives to Form Coalitions with Bertrand Competition" 16 Rand Journal of Economics (1985) 473; Willig "Merger Analysis, Industrial Organisation Theory, and Merger Guidelines" Brookings Papers on Economic Activity: Microeconomics (1991) 281 at 299 and following; and Werden and Froeb "The Effects of Mergers in Differentiated Products Industries" 10 Journal of Law, Economics and Organisation (1994) 407.

elasticity of demand between its product and that of the other merging party, to (2) its own-price elasticity of demand[13].

Market share plays no obvious role in this formulation. Rather, what counts is the "diversion ratio": the share of their output which the firms, pre-merger, would have lost to each other had they attempted to increase price unilaterally. Although there are circumstances in which market shares may act as a proxy for this ratio, these are likely to be few and far between[14]. No less importantly, it is a fairly common result in these models that mergers between even relatively small producers can yield substantial increases in prices, if they are strategically located in the chain of substitution[15].

Although the formulations used differ slightly, similar mechanisms are important in the analysis of mergers when firms are differentiated in terms of costs. Consider, for example, electrical generators selling electricity into the pool. The competing generators can be viewed as lying on an upward-sloping supply curve, with the baseload generators at one end, and the high variable costs CGCT generators at the other. If generators are either "in" or "out" of merit, and can bid so as to either be "in" or "out", even a merger between infra-marginal firms may increase price if the choice left to the market manager is to pay more to the merged firm or contract with (bring into merit) an even more expensive marginal supplier[16]. Here too, the extent of the price rise does not vary in any simple way with market share or concentration; rather, it depends on the slope of the supply curve in the neighbourhood of the number of units the purchaser needs to obtain. And here too, even quite "small" mergers may lead to large increases in prices.

---

[13] See also Baker and Bresnahan "The Gains From Merger or Collusion in Product-Differentiated Industries" 33 Journal of Industrial Economics (1985) 427; and Hausman, Leonard and Zona "Competitive Analysis With Differentiated Products" 34 Annales d'Economie et Statistique (1994) 159.

[14] In essence, for market share to play this role, there must be a link between intensities of preferences and the pattern of market share. Rather special assumptions need to be made to generate such a link. See Willig "Merger Analysis, Industrial Organisation Theory, and Merger Guidelines" Brookings Papers on Economic Activity: Microeconomics (1991) 281 at 301 and following.

[15] See Baker "Product Differentiation Through Space and Time" The Antitrust Bulletin, forthcoming.

[16] A detailed formulation of a bidding model of this kind can be found in Baker "Unilateral Competitive Effects Theories in Merger Analysis" (Manuscript, August 1996). See, for an application, FTC Will Seek to Block Rite Aid/Revco Merger, FTC News, Federal Trade Commission, April 1996.

In short, even the smallest step away from the assumptions of traditional models of oligopoly leads to the conclusion that mergers may lead to substantial increases in prices even when industry concentration is low and the merged firms have low market shares. This is now well-recognised in the literature, and even those experts who support the use of market share screens and "safe harbours" accept that these do not apply in markets where firms are extensively differentiated[17]. Given that these are surely far more common than markets involving homogenous goods supplied by homogenous firms, the Industry Commission's recommendation that the ACCC's "safe harbours" -- which are already far more generous than those applied in the United States or Canada -- be made even broader, is nothing if not surprising.

Import Competition

In addition to proposing an increase in the concentration thresholds, the Industry Commission recommends that import competition also be seen as creating a "safe harbour" for merger proposals.

The Information Paper states that an inappropriate treatment of imports would miss the most pronounced current change in the nature of competition in many Australian markets.[18] The impression given is that the ACCC's approach is, in fact, inappropriate. So as to correct this alleged deficiency, the Industry Commission recommends providing a "safe harbour" for mergers in markets where arms-length imports have accounted for at least 10 per cent of sales for three years[19].

Taken as it stands, this is an extremely curious recommendation. In effect, it amounts to proposing that a firm which has a 50 per cent market share should be permitted to merge with a firm with a 40 per cent market share so long as imports account for the remainder of the market. Thus, were such an approach adopted, GM could merge its Australian

---

[17] See, for example, Hay and Werden "Horizontal Mergers: Law, Policy and Economics" 83 American Economic Review (1993) 173 at 176: ".. we think there is considerable merit to a merger policy that relies to some extent on simple rules.. [However,] we would not invoke any such presumptions for differentiated products".

[18] Industry Commission, op cit, at 44.

[19] Imports are arms'-length when they are not accounted for by the firms directly involved in the merger.

operations with Ford, with the ACCC not even inquiring as to the competitive effects which the merger would entail.

It is hard to take this seriously; but the element of hyperbole in the Industry Commission's recommendation does not mean that the competitive impact of imports should be ignored. It is therefore reasonable to ask here too, whether what the contemporary literature has to say is broadly consistent with the Industry Commission's approach.

There can be little doubt that import competition can have a significant disciplining effect on domestic producers[20]. Nonetheless, the linkages involved are considerably more complex than the Information Paper recognises.

Conventionally, imports are seen as imposing a substantial constraint on domestic price-setting for two reasons: first, at least for small countries, the elasticity of supply of imports can usually be taken to be high; and second, it is likely to be more difficult for importers to collude with domestic producers than for domestic producers to collude amongst themselves.

Although these factors make good sense, two additional points need to be borne in mind:

Almost any sensible model of import competition must start from the premise that domestic and foreign output are differentiated -- for if they were not, one would not normally observe both (and inter-industry trade as well).

There is no reason to suppose that importers appear to domestic producers as a "competitive fringe", not engaged in strategic interaction with local firms. Rather, particularly if imports are substantial and are accounted for by a few large producers, the likelihood is that both foreign

---

[20] There is an enormous empirical literature on the effect of international trade on market power, dating back to Esposito and Esposito "Foreign Competition and Domestic Industry Performance" 4 The Review of Economics and Statistics (1971) 343. Many of the relevant issues are well set out in Geroski and Jacquemin "Imports as a Competitive Discipline" 47 Recherches Economiques de Louvain (1981) 197. See also the discussion in Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace: A Report by the Federal Trade Commission Staff, 70 Antitrust & Trade Regulation Report (June 1996) at S-47 and following.

and domestic producers will be aware of, and respond to, their interdependence.

Two consequences follow:

First, given that imports and domestic output are differentiated, market shares will not -- for the reasons discussed above -- be an immediately useful indicator of competitive effects. Thus, even in the presence of substantial imports, a merger of two domestic suppliers, producing goods close to each other in the chain of substitution, can still result in significant unilateral price effects.

Second, in addition to being influenced by the extent of differentiation, the impact of import competition will depend on the pattern of interactions which the interdependence between domestic and foreign suppliers creates. For example, an increase in foreign supply (say, as a result of more rapid productivity growth overseas) may increase domestic prices if domestic producers (1) accommodate the increase in imports by reducing their own output; and (2) in the process forego economies of scale. Even more plausibly, foreign firms, faced with a domestic merger which increases prices in the domestic market, may themselves simply go along with the price rise, especially as this is by no means inconsistent with some increase in the market share accounted for by imports[21]. It is therefore not surprising that empirical studies find (1) that the effects of import competition vary substantially from industry to industry[22]; and (2) that intensified competition from imports does not invariably result in lower prices in the domestic market[23].

All of this points to the dangers of treating competition from imports less cautiously, in a merger assessment, than the competition which comes from domestic sources. Two further factors underscore this point.

To begin with, import competition is subject to the effects of exchange

---

21 Usually, a merger in a Cournot oligopoly will (all other things being held constant) lead to a reduction in the market share of the merged entity. Imports would presumably fill some part of the gap.

22 See, for example, de Gellinck, Geroski and Jacquemin "Inter-Industry Variations in the Effect of Trade on Industry Performance" 37 Journal of Industrial Economics (1988) 1; and Clark, Kaserman and Mayo "Barriers to Trade and the Import Vulnerability of U.S. Manufacturing Industries" 38 Journal of Industrial Economics (1990) 433.

23 See Lopez and Lopez "Market Structure and the Impact of Imports on Price Cost Margins" 11 Review of Industrial Organisation (1996) 107.

rate fluctuations. These are systematic risks[24] and hence drive a wedge between the resource costs of imports and those of domestic output, as well as influencing the response of importers to domestic price shocks[25].

Second and even more important, importers are subject to threats of constraints which do not bear on domestic producers. Especially relevant here is the threat of anti-dumping measures -- a threat all too liberally available to Australian producers. There is strong evidence that domestic firms primarily use these measures to "discipline" foreign competitors when they disrupt, or threaten to disrupt, oligopolistic price coordination[26]. Looked at from the perspective of competition policy, the ready availability of these forms of "contingent protection" must at the very least dissuade the "import surge" which would be needed to undo the price-raising effect of a substantial merger. So long as domestic producers can rely on this threat, the more credible scenario will involve importers "going along" with the price increases which such mergers allow.

All of this suggests that imports are no panacea for the harm which mergers can cause. Rather, as with domestic competition, their impacts need to be assessed on a case-by-case basis, taking account of the nature and extent of producer differentiation, the pattern of interaction between domestic and foreign producers, and the likelihood of competition being distorted by resort to trade protection.

---

[24] Contemporary finance theory, notably the Capital Asset Pricing Model, distinguishes "systematic" from "unsystematic" risk. The latter refers to risk which can be diversified by holding the market portfolio; the former to risk which cannot be so diversified and hence must give rise to a higher rate of return if it is to be held. It is commonly accepted that long-term exchange rate risk can only be hedged or diversified in part, and hence involves systematic risk.

[25] Thus, in even the simplest oligopoly models, anticipated changes in the exchange rate alter the competitive dynamics between domestic and foreign firms. An anticipated depreciation, for example, is equivalent to a rise in the discount rate applicable by importers (because future sales in the domestic market are worth less), and hence will reduce the attractiveness of investing in securing domestic market share. See Klemperer "Competition When Consumers Have Switching Costs: An Overview With Applications to Industrial Organization, Macroeconomics and International Trade" 62 Review of Economic Studies (1995) 515.

[26] A report I prepared some years ago at the OECD suggested that in oligopolistic industries, most forms of protection primarily served to alter the strategic interaction between domestic producers and their foreign competitors: see OECD The Costs and Benefits of Protection (1985); see also Prusa "Why Are So Many Antidumping Petitions Withdrawn?" 33 Journal of International Economics (1992) 1; and OECD Competition Policy And AntiDumping (1995).

Entry

A third plank in the Industry Commission's argument relates to the effects of entry. Although the discussion of this issue in the Information Paper is somewhat diffuse, the main theme is clear enough: the threat of entry can be a substantial constraint on post-merger price rises; the ACCC needs to give this threat more weight in its merger assessment[27].

Here too, the Information Paper's approach will strike the reader with an interest in Industrial Organisation as curious. In effect, the trend in the literature is largely in the opposite direction. Again, some clarification may be helpful.

It is useful to begin by distinguishing two forms of entry. Following the 1992 U.S. Merger Guidelines[28], I will term these "uncommitted" and "committed" entry respectively.

Uncommitted entry broadly corresponds to supply substitution. Uncommitted entrants are firms that can enter quickly, and with little or no sunk investment[29]. As a result, they can readily exploit any short-term opportunities arising from anti-competitive conduct by incumbents, and exit at low cost should those opportunities disappear. In contrast, committed entrants are ".. in for the long haul. Once they enter, they expect to stay, because to abandon the market would mean walking away from a substantial sunk investment. Since they are in for the long haul, they must consider what competition will look like after they enter in

---

[27] Specific recommendations made in the Information Paper include that only sunk costs be viewed as constituting entry barriers and that the ACCC view the likely effect of these costs in a five year horizon (as against the two year time horizon the ACCC has tended to use).

[28] U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (April 2, 1992). See also Ordover and Baker "Entry Analysis Under the 1992 Horizontal Merger Guidelines" 61 Antitrust Law Journal (1992) 139.

[29] Not too much should be made, in this context, of the distinction between investments which are sunk and those which are not. In practice, the bulk of the investments needed for market entry are likely to be sunk, in the sense that scrap values are often very low relative to acquisition costs. As a result, it is not too inaccurate to start from the presumption that the investment costs of entry will be sunk, and then discount the resulting estimate for assets which clearly have ready alternative uses (for example, because they are available on a rental basis). Viewed in this perspective, the distinction between uncommitted and committed entry hinges on the investment costs involved.

deciding whether it is profitable for them to enter in the first place"[30]. The issue then is how much discipline each of these is likely to impose on price increases following a merger.

Uncommitted entrants are, effectively, already part of the market: they can so readily swing into production that current suppliers must take their capacity into account in making pricing decisions. (Indeed, the ACCC's approach counts this capacity fully in calculating market shares, thereby overstating -- perhaps significantly -- the likely extent of its price-reducing impact[31]). For the reasons discussed above, the prospect of this capacity's entry will constrain price rises consequent to a merger in oligopolies with undifferentiated goods but not in those where goods are differentiated[32].

The main work must therefore be done by committed entry -- that is, by entrants willing to engage in substantial investment outlays. For such entry to constrain post-merger price rises, it must not only be timely but also on a sufficient scale to counter the market power of the merged firms. Yet a moment's reflection suggests that entry of this kind is unlikely.

In effect, to be sufficient to defeat the merged firm's market power, entry must drive price back to the pre-merger level. Since the entrant can be expected to know that market price will fall consequent on entry, its decision to enter must be based on the profitability of adding capacity at the pre-merger price. However, if entry would be profitable at that price, it would be reasonable to expect it to have occurred prior to the merger. As a result, other circumstances must have changed for the merger-defeating entry to occur.

---

30 Baker "The Problem With Baker Hughes and Syufy" Conference on Economists' Perspectives on Antitrust Today (Boston, April 1996) at 2.

31 This is because not all of this capacity may be available for use in the market. Moreover, whether it is or is not brought to bear in that market will depend on its opportunity cost in other uses. If it is currently used in a market where price-cost margins are high, whereas in the market at issue they are low, a very substantial post-merger price rise will be needed to induce them to shift.

32 This assumes Cournot behaviour in the homogenous goods case, and Bertrand behaviour in the case of differentiated products. (In Bertrand (Cournot) oligopolies, firms set prices (quantities) and markets determine quantities (prices)). In the latter case, the uncommitted capacity has a response function and thereby affects the pre-merger price. The merger then reduces the number of independent producers, with the result that equilibrium prices rise. See Salop "Comment" Brookings Papers on Economic Activity: Microeconomics (1991) 313 at 320 and following.

In general, the extent of this effect will depend on both the sunk costs involved in entry and the economies of scale in production (and not just on the former, as the Industry Commission asserts). In effect, the greater the extent of the scale economies, the greater is the likelihood that at the post-merger level of output, the residual demand curve facing the entrant will lie everywhere below the entrant's average total cost curve, making entry unprofitable[33]. Moreover, the greater the economies of scale, and consequently, the entrant's initial level of output, the lower must be the likelihood that the incumbents will simply accommodate the output expansion which entry will cause. Finally, if the capital costs involved in entry are sunk, then entry on a substantial scale will expose the entrant to large losses.

In short, entry on a scale sufficient to defeat merger-induced market power is prima facie unlikely. But this does not mean that entry itself is impossible. Three factors are significant in this respect.

First, circumstances may change. Thus, the merger itself may involve some reduction in the merging firm's market share, creating room for entry. In differentiated goods markets, the rise in the equilibrium price consequent on the merger may have the same effect. Last but not least, the market itself may be growing over time, so that integer effects allow the presence of a larger number of competitors.

Second, there may be low-risk entry opportunities. For example, consumers affected by the merger might integrate into the affected market; or an entrant may cover its capital commitments by entering into long-term contracts. However, these too are no panacea, for the incumbent may be able to block the opportunities for low-cost entry through market foreclosure, with the largest customers being better off as a result of this foreclosure than they would be contracting with the entrant[34,35].

---

[33] See Gilbert "Mobility Barriers and the Value of Incumbency" in Schmalensee and Willig (ed.s) Handbook of Industrial Organization (1989), Amsterdam and New York: North-Holland.

[34] Contrast Aghion and Bolton "Contracts as a Barrier to Entry" 77 American Economic Review (1987) 388 with Masten and Snyder "The Design and Duration of Contracts" 52 Law and Contemporary Problems (1989) 63.

Third, the entrant may be able to give credible commitments which make it rational for the incumbents to accommodate entry -- for example, by committing to low production capacity[36] or through forward announcement of its pricing policies[37].

Just to list these options is to suggest that the entry they involve will likely be on a relatively small scale. It is consequently not surprising that the empirical literature on entry is dominated by two findings: (1) that entry usually occurs on a small to very small scale; and (2) that it usually has little effect on price-cost margins in the markets being entered[38].

In short, both the theoretical and empirical literature suggest that if a merger is anti-competitive, it is only under fairly narrow conditions that entry will undo the resulting rise in prices. Testing for these conditions requires a careful examination of a broad range of factors, much as the ACCC now undertakes. The Industry Commission's view that this analysis can be substantially stream-lined, and that the ACCC should place even greater weight than it already does on entry as a factor offsetting the harm mergers may cause, therefore seems rather poorly grounded.

Guidelines, rules and standards

---

[35] Similarly, in a differentiated goods market, a firm may be able to re-position its product in such a way as to make it a closer substitute for the products being produced by the merged parties. Here too, however, the merged firm can seek to foreclose the opportunity by "packing" the product space closest to the goods it supplies. See the classic study by Schmalensee "Entry Deterrence in the Ready-to-Eat Breakfast Cereals Industry" 9 Bell Journal of Economics (1978) 305; and Scherer "The Breakfast Cereal Industry" in Adams (ed.) The Structure of American Industry, 7th ed. (1986) Macmillan.

[36] See Gelman and Salop "Judo Economics: Capacity Limitation and Coupon Competition" 14 Bell Journal of Economics (1983) 315.

[37] Though note that it is more likely that the incumbent will use price commitments to dissuade entry; see Klemperer "Competition When Consumers Have Switching Costs: An Overview With Applications to Industrial Organization, Macroeconomics and International Trade" 62 Review of Economic Studies (1995) 515 at 526-7.

[38] See Gilbert "The Role of Potential Competition in Industrial Organisation" 3 Journal of Economic Perspectives (1989) 107 at 124; Geroski Market Dynamics and Entry (1991) Oxford at 258; and Mueller "Entry, Exit and the Competitive Process" in Geroski and Schwalbach (ed.s) Entry and Market Contestability: An International Comparison (1991) Oxford at 12.

All of this suggests that mergers can be anti-competitive under a far broader range of circumstances than the Industry Commission suggests. Indeed, a fuller examination of contemporary work in Industrial Organisation could extend the list even further -- for example, to vertical mergers[39], mergers which involve firms that would otherwise engage in independent efforts at innovation[40], and mergers which by bringing firms into contact with each other across a range of markets, increase the likelihood of price coordination[41]. Of course, the vast majority of mergers in any of these categories will not have harmful effects; but some will, even in cases quite far removed from the textbook paradigm of high market share firms merging in relatively concentrated industries.

What role can merger guidelines then play? The Information Paper places primary stress on the contribution guidelines can make to reducing uncertainty among firms planning mergers; and it implies that some accuracy in enforcement should be sacrificed for the sake of avoiding the costs which uncertainty entails. This, in turn, underpins the Paper's endorsement of "safe harbours", bright lines and, more generally, simple rules (such as those it proposes in respect of imports).

To those familiar with the history of competition policy, the Paper's presumption in favour of simple rules will strike a strong note of "deja vu". Particularly in the United States, such rules long played a central part in the implementation of the competition statutes. These included the per se prohibitions[42] on price-fixing, on a broad range of non-price-related horizontal restraints and on vertical restraints such as resale price maintenance, as well as the near per-se prohibition on mergers increasing market concentration[43]. The stark contrast between conduct covered by these per se rules, on the one hand, and conduct subject to a

[39] See Riordan and Salop "Evaluating Vertical Mergers: A Post-Chicago Approach" 63 Antitrust Law Journal (1995) 513; Reiffen and Vita "Comment: Is There New Thinking on Vertical Mergers?" 63 Antitrust Law Journal (1995) 917; and Riordan and Salop "Evaluating Vertical Mergers" 63 Antitrust Law Journal (1995) 943.

[40] See Gilbert and Sunshine "Incorporating Dynamic Efficiency Concerns in Merger Analysis" 63 Antitrust Law Journal (1995) 569.

[41] See Scott Purposive Diversification and Economic Performance (1993).

[42] A prohibition is "per se" if the conduct in question is prohibited regardless of its effects. In the cases referred to, this means that establishing a violation does not require a competition analysis of the conduct; it merely requires making out that the conduct has occurred.

[43] See, for a good review, Pitofsky "Proposals for Revised United States Merger Enforcement in a Global Economy" 81 Georgetown Law Journal (1992) 195.

competition assessment under the "rule of reason", on the other, provided an important element of certainty in the interpretation of the competition laws[44].

By the late 1970's, however, this certainty was largely gone. It had, in fact, become apparent that the per se rules were (1) impeding behaviour which was socially desirable, such as that involved in certain types of horizontal and vertical restraints[45]; and (2) impelling behaviour towards less socially desirable forms of activity, such as conglomerate mergers (which escaped the market share constraints imposed on their horizontal counterparts)[46]. As a result, the clarity and certainty of the earlier approach has been replaced by the complexities of individualised screening, with the various "guidelines" issued by the enforcement agencies providing a degree of guidance, but not assurance, as to the process[47].

The U.S. experience highlights the need for a careful cost-benefit analysis of using simple rules to guide competition policy; and a large literature has developed as to the nature of the tests to be applied in carrying out this analysis. The Information Paper ignores this literature altogether; but even a cursory examination would point to outcomes quite at odds with those the Paper recommends.

A full review of this literature is well beyond the scope of this paper, but central elements can be readily summarised. A useful starting point is to distinguish rules (such as "driving at more than 80 kilometers per hour is prohibited", or "no merger will be challenged if imports account for more than 10 per cent of sales in the relevant market") from standards (such as "driving in a reckless manner is prohibited", or "mergers will not be challenged if import competition is sufficient to exercise competitive

---

[44] See, for example, the discussion of the advise lawyers provided to clients in this regard in Fox and Sullivan Cases and Materials on Antitrust (1989) St. Paul: West Publishing at 307-308.

[45] See Baker "Per Se Rules in the Antitrust Analysis of Horizontal Restraints" 36 The Antitrust Bulletin (1991) 733.

[46] See Fligstein The Transformation of Corporate Control (1990) Cambridge: Harvard, especially at 230-356; and Davis, Diekman and Tinsley "The Decline and Fall of the Conglomerate Firm in the 1980's" 59 American Sociological Review (1994) 547.

[47] Noting, however, that in the U.S., the bulk of antitrust litigation is private, and hence is not affected by the Guidelines.

discipline on the merged parties"). Each of these is associated with distinct costs and benefits[48]:

1. From an economic point of view, the cost of a rule has two components: the costs of its formulation; and the costs of its over- and/or under-inclusiveness[49].

2. Conversely, a standard imposes costs in terms of the greater investment required to determine whether or not the conditions which trigger the prohibition have been violated.

Putting aside the costs of actually formulating the rule or the standard, the relevant trade-off will therefore involve: the extent of over- and under-inclusiveness, and the associated economic costs; as compared to the costs -- in terms of ex ante uncertainty, and ex post enforcement -- which arise from the standard's more open-ended formulation[50].

Seen in these terms, the striking feature of the Information Paper's recommendations is that, on any reasonable measure, they greatly under-state the costs which simple rules would impose, while equally greatly over-stating the benefits which they would bring (all of this being aided by the fact that the Paper adduces no empirical evidence on either score).

[A] Turning first to the costs, the issue must be what consequences would flow from a rule which exempted all mergers falling within the safe harbours recommended by the Industry Commission from

---

[48] In thus characterising "rules" and "standards" I am following Hart and Sacks The Legal Process (1958 - 1994) Eckridge and Frickey (ed.s) New York: Foundation Press at 139-40, and Kennedy "Form and Substance in Private Law Adjudication" 89 Harvard Law Review (1976) 1685. Others, notably in the English legal tradition, view these as merely different points on a continuum, defined by dimensions of specificity: see Atiyah and Summers Form and Substance in Anglo-American Law (1987) Oxford: Clarendon Law Series, and Twining and Miers How To Do Things With Rules (1991) London: Butterworths.

[49] For example, formulating the rule "Driving at more than 80 kph is prohibited" involves an investment in determining ex ante what the appropriate speed limit should be; and than imposes costs because there are circumstances in which it would be perfectly safe to drive at 100 kph (so that the rule is over-inclusive), and others in which driving at 20 kph is reckless (the corresponding under-inclusiveness).

[50] See Shapiro "The Choice of Rulemaking or Adjudication in the Development of Administrative Policy" 78 Harvard Law Review (1965) 921; Diver "The Optimal Precision of Administrative Rules" 93 Yale Law Journal (1983) 65; and Kaplow "Rules versus Standards: An Economic Analysis" 42 Duke Law Journal (1992) 557.

further inquiry or challenge by the ACCC. Five points can be made in this respect:

1. In practice, some of these would be anti-competitive; and (bearing in mind the discussion above) there is every reason to believe that this share would be greater -- perhaps substantially so -- than the Information Paper suggests.

2. The Trade Practices Act precludes private parties from seeking injunctive relief against mergers; as a result, absent investigation by the ACCC, the mergers at issue would almost certainly proceed.

3. The extent of the increase in anti-competitive mergers would be accentuated by the scope which a "simple rules" approach would create for those proposing such mergers to "walk the line": that is, to structure matters so that proposals fell just inside of the protected area. The greater the zone within which this could be done, the stronger the incentives in this respect would be.

4. Such an outcome would obviously impose costs on consumers, in terms of (some mix of) higher prices, lower quality and reduced productivity growth.

5. Somewhat perversely it would also increase the costs involved in enforcing the national competition policy. This is for three reasons:

   (i) The ACCC would have to invest resources in screening out proposals which clearly only fell within the protected zone as a result of a sham[51].

   (ii) The increase in anti-competitive mergers would enhance the likelihood of collusion. The penalties involved, although higher now than in the past, are not likely to prove an effective deterrent; the ACCC would therefore necessarily bear higher costs in enforcing the prohibitions against price-fixing and other collusive practices.

   (iii) At the same time, with more anti-competitive mergers being allowed, greater resources would need to be invested in trying

[51] It is, for example, highly likely that far greater resources would be invested in the definition of the relevant market and the precise calculation of market shares.

to obtain divestitures under s.81 of the Trade Practices Act. Since both price-fixing investigations and divestiture proceedings are far more costly than the assessment of mergers[52], the net budgetary effect could be substantial.

[B] Against these costs must be balanced the benefits, notably in terms of reduced uncertainty, which would come from the greater precision of the simple rule (when compared to the more loosely formulated standard). But three points need to be made in this respect.

1. It cannot be denied that -- as in almost any area of law -- there is a measure of uncertainty about what constitutes an anti-competitive merger. Indeed, given that mergers are readily observable, if there were no such uncertainty, anti-competitive mergers would not occur. The fact that competition law is economic law, and hence must evolve with our understanding of how the economy functions, makes it inevitable that some uncertainty will persist, even as the case law accumulates.

2. However, what matters is not this uncertainty itself but the economic costs it gives rise to. These costs take the form of resources invested in analysing the law which would not need to be if the law were more readily interpreted; the burden which arises from enforcement and compliance; and the socially desirable actions foregone as a result of the uncertainty. In practice, each of these is likely to be small. Thus, the advisory community is well-skilled in assessing the likely effect of mergers, and now has a substantial body of case law to guide it. Companies -- particularly those of a size sufficient to risk being in breach -- are themselves used to dealing with some uncertainty in important areas of law. And the ACCC provides a range of opportunities for consultation, so that uncertainty can be reduced during the corporate planning process, which in turn reduces the risk that socially worthwhile projects will be abandoned. It is consequently not surprising that the Industry Commission itself could not point to material costs associated with the ACCC's enforcement of s.50 [53].

---

[52] They are also likely to be far more intrusive on firms.

[53] The only "uncertainty" costs the Industry Commission could point to were the penalties which delays might impose on hostile take-overs. In practice, however, take-overs of this kind account for an extremely low share of mergers: according to one estimate, less than 3 per cent. This is the finding of an Ernst & Young survey of 300 listed companies, reported in The West Australian 7 February 1996 at page 46.

3. Of course, these costs, however low they might be, could be further reduced by relying on simple rules. But even assuming that these rules provided greater certainty, it is apparent that this benefit would be mirrored in an offsetting social cost -- and that the greater the benefit, the greater would be the cost:

   (i) In effect, the value of the certainty which a simple rule provides depends on the difficulty of determining, without a detailed investigation of the facts, whether conduct does or does not fall within the scope of a prohibition.

   (ii) This in turn, will depend on the variability of the circumstances at issue, and on the complexity of the mapping between these circumstances and the prohibition.

   (iii) However, it is precisely when circumstances are highly variable that any simple rule is likely to most frequently err in meeting the policy goal[54].

As a result, certainty is never a "free good", and this is no less true in the control of mergers than in other areas.

It is disingenuous to argue, as does the Information Paper, that any problems associated with relying on simple rules could be dealt with by setting the Guidelines (amended to meet the Industry Commission's recommendations) aside when they would allow a merger to proceed which ought to be stopped.

To begin with, were the Guidelines amended as the Industry Commission proposes, the ACCC would actually investigate virtually no mergers. Hence, it would never discover whether one or more of these violated the

---

[54] "To take an extreme example, if the sentence of death were imposed in accordance with simple rules strictly applied, people (including those contemplating committing capital crimes) could predict with some confidence which acts would generate the death penalty. That predictability, however, would come only at the risk of putting to death some people who would live if their particular acts were scrutinised in the full richness of relevant detail". Schauer Playing By the Rules: A Philosophical Examination of Rule-Based Decision-Making in Law and in Life (1991) Oxford: Clarendon Law Series at 143. See also Raz "The Rule of Law and its Virtue" 93 The Law Quarterly Journal (1977) 195, especially at 208 and following.

statute. The option of setting the Guidelines aside would consequently be of little practical relevance.

Second, the Guidelines are clearly a form of tertiary legislation[55], and hence can give rise to legitimate expectation. Were the ACCC to clearly disregard its own Guidelines, having announced that they had value in guiding its decisions, it would inevitably open its position to challenge.

Last but not least, such flexibility runs in the face of the very goal the Industry Commission professes: namely, that of increasing the certainty of private decision-makers' planning. An approach which only applies rules so long as their result conforms to that which would be yielded by applying the underlying standard, can be no different from directly applying the standard[56].

The simple but efficient rules which the Industry Commission seeks are therefore a chimera. The Information Paper itself does not any attempt any systematic cost-benefit analysis of these rules; on any reasonable assessment, such an analysis would show costs well in excess of the benefits.

Conclusions

The vast majority of mergers pose no threat to competition. But some do, and those should be stopped. It is important to identify correctly the mergers which are significantly anti-competitive; and precisely because it is, serious analysis of the shape and content of merger policy is to be welcomed. Unfortunately, the Industry Commission's Information Paper adds little to the debate. It contains no empirical analysis; its discussion of the literature is at best very incomplete; its recommendations seem

---

[55] Tertiary legislation are rules which although they are not directly enforceable, produce indirect legal effects through their impact on the administration of primary and secondary (delegated) legislation. A particularly useful review is in Baldwin Rules and Government (1995) Oxford: Clarendon Socio-Legal Studies at 80-85.

[56] There is an obvious parallel here to stare decisis, and to Lord Devlin's statement that: "The principle of stare decisis does not apply only to good decisions; if it did, it would have neither value nor meaning. It is only if a [prior] decision is doubtful that the principle has to be invoked" Jones v. DPP [1962] AC 635, 711. If certainty is highly valued, and is seen as providing a compelling rationale for simple rules, then there can be no place for the dictum "Cessante ratione, cessat ipse lex". See generally Schauer "Exceptions" 58 The University of Chicago Law Review (1991) 871.

poorly thought through, conflict with the literature it claims to survey, and could only be implemented at the cost of substantial inefficiency.

This is a wasted opportunity. In effect, over the next decade, merger policy in Australia will face new challenges, especially as a result of privatisation and the opening to competition of hitherto protected markets in the public utilities, the primary sector, and the professional services. Exposed to the disciplines of the market, producers in all of these areas will be tempted to seek refuge in mergers, joint ventures and agreements which confer market power. Allowing such an outcome would negate the goals central to the national competition policy.

The ACCC's Merger Guidelines have much to say about how proposed mergers should be assessed in this new context. But it needs to be recognised that the Guidelines too must be responsive to the circumstances of the industries now being exposed, for the first time, to competitive forces. Adapting merger analysis to this purpose is a major task ahead.