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The Efficiencies Defence in Merger Analysis: A New Zealand Perspective

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New Zealand's current competition laws, like Canada's, are comparatively new. The Commerce Act (the "Act") and Canada's Competition Act were both passed in 1986. The New Zealand Act, in essence, recognises the efficiencies defence. Where a merger is likely to result in the acquisition of a dominant position in a market, it is open to the merger parties to apply to the Commerce Commission (the "Commission") under section 67 for authorisation prior to implementation. This process requires the Commission to identify and weigh the detriments likely to flow from the acquiring of a dominant position in the relevant markets, and to balance those against the public benefits likely to flow from the acquisition as a whole. Since 1990, there has been explicit statutory guidance under section 3A that efficiencies must be taken into account in assessing public benefits. If the Commission is satisfied that the benefits outweigh the detriments, the proposed merger will be authorised.

Thus, there are striking similarities between the New Zealand position, section 96 of the Canadian Competition Act and the US governmental guidelines described in Professor Mathewson's paper.[1] What follows is an outline of the Commission's

[1] See paper entitled The Efficiencies Defense in Merger Analysis in Canada and the USA by Frank Mathewson, Professor (Economics), Director of the Institute for Policy Analysis (University of Toronto), and Senior Consultant, Charles River Associates, available on ISCR website.

approach in New Zealand. This outline reflects a more tolerant approach than is apparently the case in Canada. Indeed, seven mergers raising dominance concerns have already been authorised on public benefit grounds.

The Commission considers that a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. The formerly contentious issue in the early 1990s of how changes in the distribution of income were to be treated has been resolved in favour of neutrality, so that situations where one group gains while another simultaneously loses are viewed as not being directly irrelevant in the efficiency framework. However, it is recognised that income transfers do provide margins which could be absorbed by the production inefficiencies discussed below. For example, these could provide a wide scope for rent-seeking behaviour by managers and others in the merged entity, leading to the dissipation of rents through inflated costs. Similarly, because of the New Zealand focus required by the Act, profits repatriated overseas (less local taxes paid) are apt to be regarded as a welfare loss unless it leads to subsequent actions by those investors which would advantage New Zealand public benefit.

Since the *Air New Zealand/Ansett* decision of 1996 the Commission, mindful of the observations of Richardson J in *Telecom v Commerce Commission* on the Commission's responsibility to attempt to quantify benefits and detriments where feasible, has attempted to do so rather than rely on purely intuitive judgement.

Critical to the assessment of benefits and detriments is the establishment of an appropriate counterfactual. This specifies what might otherwise happen in the future in the absence of the acquisition. Thus, a comparison has to be made between two hypothetical future situations, one with the acquisition and one without. The differences between these two scenarios can then be attributed to the impact of the acquisition in question. This provides one mechanism for helping to ensure that the benefits claimed are intrinsic to the acquisition, and could not be gained by any other means. The counterfactual is not necessarily a continuation of the status quo, as the industry and relevant markets may continue to evolve in the absence of the acquisition. In framing a suitable counterfactual, the Commission bases its view on a pragmatic and commercial assessment of what is likely to occur in the absence of the acquisition.

In all cases, because of the uncertainties involved in making future predictions, the emphasis is on establishing a range within which each of the detriment and benefit categories in annual terms are likely to fall, and the greater the uncertainty faced, the wider the ranges used. The Commissioners are then left ultimately to determine where in those ranges they believe the actual outcome will lie, and thus to make their authorisation determination accordingly. Time scales of up to five years ahead have been used. Applicants' claims for benefits often step upwards for a few years following the merger; the Commission has tended to assume that detriments follow similar trends, as it is expected that inefficiencies may take some time to take hold.

In assessing the magnitude of the potential detriments, the Commission normally conducts its analysis under three headings: allocative inefficiency, productive

inefficiency and dynamic inefficiency. With regard to allocative efficiency, the aim is to quantify the size of this "deadweight loss triangle", which depends upon estimates of the price elasticity of market demand and of supply (i.e., the responsiveness of the buyer and of suppliers respectively to changes in price); the anticipated size of the price rise post-acquisition; and the size of the market measured by the total outlay. The estimates used are intended to reflect the structure of the market in question as far as information permits. For example, in some cases econometric estimates of demand elasticity may be available, but in others reliance may have to be placed on "educated assessments" based on an appraisal of the economic characteristics of the product. Applicants often argue for an inelastic demand as this serves to reduce the size of the loss. However, the nature of the triangle is such that the allocative loss rarely contributes much to the overall size of the detriment.

Productive inefficiency is considered likely to arise when a firm acquires a dominant position in a market because it lacks the competitive pressures to remain efficient in production, even when it is a profit-seeking entity. Organisational slack may creep into its operations, salaries and benefits of management staff may become inflated, and costs in general may increase, because a satisfactory level of profit is assured even when the firm is less than fully efficient. Principal-agent problems, in which principals can neither fully control nor monitor their subordinates, may allow middle managers scope for opportunistic or self-serving behaviour. The increase in costs is a measure of the value of the resources being wasted, which in turn indicates the value of the output foregone by the economy as a whole from those resources not being employed productively elsewhere.

In assessing such potential losses, the Commission focuses upon those costs of the merged entity which are likely to be susceptible to inefficiency. For example, the costs of bought-in raw materials are much less likely to be affected by market power than those related to its own manufacturing and distribution operations. The Commission broadly proceeds by applying different ranges of percentage increases to different cost categories which reflect their assessed susceptibility to cost inflation. Maximum percentage increases of up to ten per cent have been used, which seem conservative in the light of overseas evidence, although perhaps not over the relatively short to medium time frames used by the Commission. Applicants often argue various reasons why there industry would be less prone to productive inefficiency, such as an export orientation, the constraints posed by a co-operative form of organisation, or peripheral competition from other products which are not quite close enough substitutes to be included in the original market definition.

Dynamic efficiency is concerned with the speed with which an industry adopts superior new technology and produces improved new products, the first through advances in productivity allowing costs of supply to be reduced, and the second bringing the benefit of meeting buyer wants more fully. In broad terms, product innovation would be reflected in a rightward shift of the demand curve, indicating a buyer switch to the improved products of the innovating company or industry, whilst the lower costs associated with production innovation would be revealed by a downward shift in the supply (or unit cost) curve.

Competition is generally considered to act as a stimulus to dynamic efficiency, and market power as a retardant. It is generally believed that in an industry which has a

significant scope for technological advance, the potential losses associated with market power are likely to be greater in the longer term in respect of dynamic inefficiency than they are in respect of the static (allocative and productive) forms of inefficiency. This is because of the loss of the compounding effect of the improvements over time.

In assessing the possible losses from reduced dynamic efficiency, the Commission takes into account the degree of intrinsic dynamism in the industry as a whole, both in terms of advances in technology and in products; the sources of that dynamism (whether internally or externally generated); and indicators such as the frequency of product innovation and the level of research intensity (sums spent on research and development). These have to be put in the New Zealand context where R&D spending appears to be relatively low by international standards. The Commission, although recognising that such predictions are notoriously difficult to make, and hence a relatively wide range in the possible outcomes is necessary, has attempted to estimate possible losses of dynamic efficiency with respect to both a decline in product and production innovation. The latter is generally measured as a loss of productivity growth which would have reduced unit cost by a given (small) annual percentage amount.

The onus is upon the applicants to establish that their proposed acquisitions will generate a net public benefit, and hence much space in applications is generally devoted to laying out benefit claims, usually supported by the work of independent economic experts. One suspects that a variety of factors are at work: the pressure on applicants to prove benefits; the fact that even they – for all their knowledge of their

business - lack a perfect crystal ball; and a natural tendency to over-state in the expectation that over-exuberant claims are likely to be pegged back. Hence, a reasonable expectation is that benefit claims are likely to be over-stated, the difficulties of obtaining them understated, and the scope for making similar gains in the absence of the proposal ignored. While this may have happened to some extent in the past, some more recent applications appear if anything to have moved in the opposite direction, putting forward allegedly "conservative" estimates of benefits. Nonetheless, the Commission has always taken a sceptical stance towards benefit claims, such that to be acceptable, claims must be plausible and generally supported by quite detailed evidence.

It is here in particular that substantial and knowledgeable opponents of the acquisition can play an important role in testing the robustness of the applicant's benefit claims, a role which has to be fulfilled in their absence by Commission staff. This is because many claimed benefits require a detailed knowledge of a firm's operations which are not readily grasped by outside observers. However, a problem with the dominance threshold in the Act is that an acquisition leading to dominance is likely to leave few, if any, competitors of any size in the market who could act as opponents. Exceptions may occur where the market is a regional geographic one with opponents operating in other geographic markets, or where an acquisition has both domestic and international implications, with overseas companies potentially able and interested in fulfilling the "complaining rival" role.

While the Commission is prepared to entertain a wide variety of benefit claims, a critical issue with benefits is that there has to be a nexus between those claimed and

the proposed merger. The Commission has expressed scepticism where substantial benefits are claimed to appear immediately, when it is evident that they could only be achieved gradually and at some cost and effort. Claimed benefits often overlook the difficulties that many mergers experience in trying to integrate the disparate activities of two firms with different cultures, especially where one firm is being acquired rather than being an equal merger partner. There may be too many issues for management to deal with simultaneously. Also, the benefits must be 'real' rather than 'pecuniary' ones, that is, they must lead to savings in inputs used, rather than merely reflect the superior buying power of the merged entity.

In some instances, benefits may be claimed where detriments have been found, such as in dynamic efficiency and research and development. This is part of a wider issue raised by the implementation of the authorisation process, namely the potential consistency issue between the accepting of claimed efficiency gains on the one hand, and the expectation of efficiency detriments on the other. If the latter arise through organisational slack, should this be taken to reflect poorly on the entity's ability to realise claimed efficiency gains? Each component of benefit and detriment tends to be treated separately, rather than within the context of an overall 'market model' which might allow the varying cost and price effects to be integrated within a consistent whole. However, this would probably too difficult to do given the time and information limitation on the process.

The above outline reflects the significant complexities and uncertainties which surround the application of an efficiencies defence. Nonetheless, in accordance with the spirit of the Act, authorisation of an otherwise unlawful merger on efficiency grounds is a distinct possibility in New Zealand.