

Copyright is owned by the Author of the thesis. Permission is given for a copy to be downloaded by an individual for the purpose of research and private study only. The thesis may not be reproduced elsewhere without the permission of the Author.

**AN ANALYSIS OF THE
PRACTICALITY OF USING THE
PUBLIC BENEFIT TEST IN
BUSINESS ACQUISITIONS AND
RESTRICTIVE TRADE
PRACTICES**

**A thesis presented in partial fulfillment
of the requirements of the degree of
Master in Applied Economics
at Massey University**

**ANDREA JANELLE LEASK
1998**

Abstract

The objective of this research was to examine the efficacy of the 'public benefit test' to authorise anti-competitive practices and acquisitions in New Zealand, as applied by the Commerce Commission, under the *Commerce Act 1986*. In particular, the study established whether, and to what extent, companies granted authorisation had successfully achieved the benefits claimed, in comparison to what might have been achieved without authorisation - the counterfactual. No such study has been performed in New Zealand, despite the potentially significant cost to society if anti-competitive acquisitions and trade practices are habitually unable to achieve benefits claimed.

The approach adopted was to compare expectations of benefits held by the Commission and the applicants at the time of merger, with actual achievements. Actual results were also compared with the counterfactual. The case study approach was embraced to accomplish this as it permits an in-depth examination of the issues related to each determination. Questionnaires completed by company representatives of the firms granted authorisation were the primary source of information. Interviews were also held with company representatives to clarify outstanding issues.

Nine authorisations were identified which met a set of criteria developed by the researcher, involving four industries: meat processing, dairy processing, gas, and telecommunications.

One authorisation studied, involving Telecom and the cellphone services market, surpassed expectations of benefits resulting from authorisation, while another, involving a joint venture gas retailing operation in Hamilton, overestimated gains from merger, and thus, benefits have not been achieved. All other authorisations studied, fell somewhere in between these extremes.

The major conclusion of this study appears to be that the Commerce Commission's ability to predict the size, magnitude, and probability of benefits being realised, is poor. This result is attributable to the multitude of factors affecting firms' operations, rather than an oversight by the Commission. In each of the four industries there have been major changes in market conditions, mostly attributable to deregulation, and ensuing competition. The poor predictability of the public benefit test brings into question its usefulness as a major competition policy tool. The major weakness of the public benefit test is its inability to provide an incentive for companies granted authorisation to ensure efficiency gains and other benefits are realised.

Acknowledgments

Thanks go first to my supervisors, Dr Robert Alexander, and Dr Michael Pickford. To Rob, I thank you for your encouragement and support, your enthusiasm was ceaseless and your door always open. To Mike, I thank you for your expertise and kind nature. Your invaluable comments and guidance significantly contributed to the success of this research. This was a big learning process for me, and you were both teachers, in the true sense of the word.

I am indebted to Commerce Commission staff for their assistance, in providing information and answering questions. I would especially like to thank Dick Adam for the time and effort he put into this research.

Thanks also go to all those company representatives that filled in the questionnaires and made themselves available for interviews. This was a long, laborious task, and their contribution was valuable to this research. My appreciation also goes to all those 'experts' that were prepared to answer questions and provide information on each of the four industries studied.

I am eternally grateful for the financial support donated by The New Zealand Association of Economists (Education Trust), The New Zealand Federation of University Women, Massey University (Masterate Scholarship), and Massey University (Graduate Research Fund). This research could not have been completed without their assistance.

Thank you to my friends and colleagues in the Department of Applied and International Economics. Special thanks go to my kind friend Leanne Smith.

A personal thanks goes to those who love me, my friends and family. Thank you Blair, Karena, Gran, Poppa, Nan, Grandad, Cameron, Karen, and Steve for helping me keep my personal life fulfilling and happy, and for your support and tolerance.

And finally, all thanks and gratitude go to my parents. Their enduring support and strength pulled me through when the times got rough, and enabled me to fulfill my hopes and dreams. I love you both.

Table of Contents

ABSTRACT	i
ACKNOWLEDGMENTS	ii
TABLE OF CONTENTS	iii
LIST OF TABLES	vi
LIST OF FIGURES	vii
 <u>1. INTRODUCTION</u>	 <u>1</u>
 <u>2. AN OVERVIEW OF NEW ZEALAND COMPETITION LAW</u>	 <u>8</u>
2.1. INTRODUCTION	8
2.2. STRUCTURE OF THE ACT	9
2.3. THE PUBLIC BENEFIT TEST	15
2.4. INTERNATIONAL COMPARISON	17
 <u>3. LITERATURE REVIEW</u>	 <u>ERROR! BOOKMARK NOT DEFINED.</u>
3.1. INTRODUCTION	21
3.2. THE GOALS OF COMPETITION POLICY	22
3.2.1. COMPETITION GOAL	22
3.2.2. EFFICIENCY GOAL	24
3.2.3. CONSUMER WELFARE GOAL	26
3.2.4. OTHER GOALS	27
3.2.5. DISCUSSION	28
3.3. SUCCESS OF MERGERS	28
3.4. THE WILLIAMSON MERGER TRADEOFF MODEL	31
3.5. PROBLEMS APPLYING THE MODEL	35
3.5.1. STATIC NATURE OF THE MODEL	35
3.5.2. PARTIAL EQUILIBRIUM NATURE OF THE MODEL	38
3.5.3. INFERENCE AND ENFORCEMENT COSTS	39
3.5.4. INCIPIENCY AND SECOND-BEST CONSIDERATIONS	39
3.5.5. PRE-EXISTING MARKET POWER	40
3.5.6. INCOME DISTRIBUTION, EXTRA-ECONOMIC POLITICAL OBJECTIVES, AND MANAGERIAL DISCRETION CONSIDERATIONS	41
3.6. CONCLUSIONS	43
 <u>4. DATA AND METHODOLOGY</u>	 <u>44</u>
4.1. INTRODUCTION	44
4.2. CASES TO BE EXAMINED	44
4.3. CASE STUDY APPROACH	47

4.4. SOURCES OF INFORMATION	51
4.5. CONCLUSION	58
<u>5. MEAT PROCESSING INDUSTRY</u>	<u>60</u>
5.1. INTRODUCTION	60
5.2. INDUSTRY BACKGROUND	61
5.3. WHAKATU DECISION : DETERMINED 22 JULY 1987	66
5.3.1. SURVEY RESULTS – WHAKATU DECISION	70
5.4. WEDDEL DECISION : DETERMINED 2 FEB 1995	74
5.4.1. SURVEY RESULTS – WEDDEL DECISION	78
5.5. CONCLUSION	86
<u>6. DAIRY PROCESSING INDUSTRY</u>	<u>88</u>
6.1. INTRODUCTION	88
6.2. INDUSTRY BACKGROUND	89
6.3. NZDG - ACMP DECISION : DETERMINED 26 APRIL 1988	92
6.3.1. SURVEY RESULTS – NZDG - ACMP DECISION	97
6.4. NZDG – WAIKATO VALLEY DECISION : DETERMINED 7 JUNE 1991	103
6.4.1. SURVEY RESULTS – NZDG – WAIKATO VALLEY DECISION	105
6.5. CONCLUSION	111
<u>7. NATURAL GAS INDUSTRY</u>	<u>113</u>
7.1. INTRODUCTION	113
7.2. INDUSTRY BACKGROUND	114
7.3. NATURAL GAS WAIKATO DECISION: DETERMINED 24 MAY 1988	118
7.3.1. SURVEY RESULTS - NATURAL GAS WAIKATO DECISION	119
7.4. WANGANUI GAS DECISION: DETERMINED 29 OCTOBER 1992	124
7.4.1. SURVEY RESULTS - WANGANUI GAS DECISION	126
7.5. ENERCO PROGAS DECISION: DETERMINED 22 DECEMBER 1993	129
7.5.1. SURVEY RESULTS - ENERCO PROGAS DECISION	132
7.6. CONCLUSION	137
<u>8. TELECOMMUNICATIONS INDUSTRY</u>	<u>139</u>
8.1. INTRODUCTION	139
8.2. INDUSTRY BACKGROUND	140
8.3. TELECOM AMPS DECISION: DETERMINED 17 OCTOBER 1990	143
8.3.1. SURVEY RESULTS - TELECOM AMPS DECISION	149
8.4. CONCLUSIONS	155
<u>9. SUMMARY AND CONCLUSIONS</u>	<u>158</u>
<u>10. APPENDICES</u>	<u>167</u>

10.1. APPENDIX I: AUTHORISATIONS DETERMINED BY THE COMMERCE COMMISSION UNDER THE 1986 ACT, THROUGH TO DECEMBER 31, 1996.	167
10.2. APPENDIX II: SAMPLE QUESTIONNAIRE : COMPLETED BY TELECOM CORPORATION OF NEW ZEALAND	169
<u>11. BIBLIOGRAPHY</u>	<u>180</u>

List of Tables

<u>TABLE 4.1</u>	<u>46</u>
<u>TABLE 4.2</u>	<u>52</u>
<u>TABLE 5.1</u>	<u>65</u>
<u>TABLE 5.2</u>	<u>72</u>
<u>TABLE 5.3</u>	<u>85</u>
<u>TABLE 6.1</u>	<u>98</u>
<u>TABLE 6.2</u>	<u>99</u>
<u>TABLE 6.3</u>	<u>103</u>
<u>TABLE 6.4</u>	<u>108</u>
<u>TABLE 6.5</u>	<u>109</u>
<u>TABLE 7.1</u>	<u>121</u>
<u>TABLE 7.2</u>	<u>122</u>
<u>TABLE 7.3</u>	<u>123</u>
<u>TABLE 7.4</u>	<u>135</u>
<u>TABLE 8.1</u>	<u>151</u>
<u>TABLE 8.2</u>	<u>154</u>
<u>TABLE 8.3</u>	<u>155</u>

List of Figures

FIGURE 3.1	32
FIGURE 3.2	41
FIGURE 4.1	55

1. Introduction

The *Commerce Act 1986* (hereafter 'the Act') is an Act 'to promote competition in markets in New Zealand,' where competition is defined as 'workable' or 'effective' competition. The rationale behind the emphasis on competition in the Act is the belief that "the interaction of competitive forces will yield the best allocation of New Zealand's resources, the lowest prices, the highest quality, and the greatest material progress etc., unless it is shown, for example, that the possession of a dominant position is better able to achieve economic efficiency" (Commerce Commission (CC), 1987a). Thus, although competition is stated as the primary competition goal, it is favoured not as an end in itself, but as a means of promoting efficiency. Where a less competitive outcome is expected to yield greater efficiency, the competition goal is overridden. Hence, the ultimate competition goal of the Act is the promotion of efficiency.

Section 3(A) of the Act upholds this statement. It states that "where the Commission is required under this Act to determine whether or not, or the extent to which, conduct will result ... in a benefit to the public, the Commission shall have regard to any efficiencies that the Commission considers will result ... from that conduct."

Parties to business acquisitions and restrictive trade practices which breach anti-competitive thresholds set out in the Act,¹ may be granted authorisation where the Commission is satisfied that the acquisition or trade practice will result in a benefit to the public which would outweigh the detriment from the lessening in competition. The procedure adopted by the Commission to weigh the effects of market power and efficiency gains arising from a merger or trade practice, is called the 'Public Benefit Test.'

The objective of this research is to examine the practicality of the public benefit test to authorise anti-competitive practices in New Zealand, and to establish whether those applicants granted authorisation have successfully achieved the public benefits claimed compared to what might reasonably have been achieved without authorisation. The study also encompasses those factors which promoted the achievement of benefits; possible difficulties (if any), which delayed or

¹ Practices deemed anti-competitive are those found by the Commission to breach section 47 or sections 27, 28, 29, 37, 38 of the Act which prohibit the acquisition of shares in a business if the acquirer is likely to create or strengthen a dominant position in a market, or in the case of restrictive trade practices, arrangements which substantially lessen competition.

impeded the realisation of benefits; and whether other unforeseen factors arose to divert the company from its original plans. It is hoped that the research demonstrates the accuracy of the Commission's estimates of the magnitude and probability of benefits and detriments made at the time of the decision.

The approach adopted is a comparison of the expected benefits and detriments flowing from a number of authorised acquisitions and restrictive trade practices put forward by the parties and accepted by the Commission, at the time of the Commission's determination, with the actual outcomes. In addition, the research would attempt to compare actual results with those likely to have been achieved without the acquisition or trade practice.

The case study approach is the most approach to assess the extent to which parties granted authorisation under the Act had achieved the benefits claimed given the rarity of authorisations in New Zealand. The case study approach allows an in-depth examination into a wide range of factors peculiar to each case, and the industry setting, and permits each authorisation to be assessed individually, with questionnaires and interviews customised to suit each case. Given the unique circumstances surrounding each authorisation, the case study approach was considered the appropriate investigation method, as it permitted greater flexibility than other methods.

While a quantitative approach would have provided valuable information to support or refute claims of the extent to which firms have achieved benefits claimed, an insufficient number of authorisations have been granted by the Commission, and in many cases, too little time has elapsed since authorisation was granted, to make valid conclusions from the data. The researcher had envisaged undertaking a comparison of financial data before and after merger, however, only two of the respondents were prepared to make available such information. Much of the financial data supplied was unusable due to its aggregated nature, and lack of comparable data from other industry participants. Thus, informational difficulties played a significant role in determining the method of investigation used.

A number of problems associated with the approach adopted and method of investigation used were foreseen by the researcher. In particular, respondents have no obligation to participate in the study or supply information, therefore availability and access to information was expected to

be a significant factor when drawing reliable conclusions. Furthermore, an asymmetry of information means that caution needed to be observed in relation to data provided by the respondents, as the researcher was, in many cases, unable to validate claims and assertions with other industry participants. These informational difficulties must be borne in mind when results are being considered.

As a consequence of countless internal and external changes, the causal link between the acquisition or restrictive trade practice, and benefits and detriments is often not clear. Additionally, other factors acting on the industry and the firm make it difficult to discern the extent to which the merger influenced the achievement of benefits and detriments, from the influence of other factors. Finally, a counterfactual scenario was used to compare the extent to which benefits and detriments were realised with the merger or trade practice, and without. This requires the respondents to predict the characteristics of the firm and the industry in a hypothetical situation. An exercise such as this is highly speculative and insupportable, thus little reliance can be placed on such forecasts.

Nine authorisations formed the basis of the study. These satisfied a set of criteria developed by the researcher. Authorisations had to have been decided under the 1986 Act, and before January 1, 1996. Also, benefits had to be able to be identified in hindsight, measurement of intangible benefits would prove too difficult. These authorisations involved four industries: meat processing, dairy processing, gas, and telecommunications. Negative responses were received from a number of participants to the authorisations, although only one authorisation (a dairy industry merger between Kiwi Co-operative Dairies Ltd. and Moa-Nui Co-operative Dairies Ltd., CC, 1992a) could not be examined further, as a result of a negative response.

Despite potentially large consequences on society if a significant proportion of parties granted authorisation have not achieved benefits claimed, a study relating to the extent to which parties efficiencies and other benefits are attained following authorisation by the Commission has not before been conducted in New Zealand.

Antitrust authorities and the New Zealand Government have an obligation to New Zealanders to ensure that the laws governing society are appropriate, efficient, and achieve the goal they set out to achieve. They ought to be held accountable for the decisions they make on behalf of New Zealanders. This study attempts to fulfill this obligation to society. The consequences of

erroneous decisions, or inappropriate competition policy are potentially enormous, therefore a study such as this is long overdue.

The literature agree that concentration of market power acquired through merger or other business activity, negatively affects economic growth, and welfare. The absence of competition is believed to lead to a poorer allocation and use of resources, and retarded growth and innovation, since incentives are insufficient to ensure firms strive to gain a competitive advantage over rivals. Thus, firms in possession of market power can afford to sustain slackness, waste, or inefficiencies, without suffering a loss of custom or profitability. The detriment to society arises from efficiency losses due to poor allocation of resources, lost opportunities to introduce productive and dynamic efficiency gains, higher prices, poorer quality, and less goods and services available.

In addition to the acquisition of market power, as a result of a merger or restrictive trade practice, efficiency gains and other benefits may be attained. Productive efficiency gains and cost savings realised through economies of scale or scope, rationalisation of staff, facilities, and expenses, or elimination of duplication, constitute a benefit to society. Innovation or technological improvements may also be accomplished as a result of merger, which were not possible while the two firms operated separately.

Moreover, benefits arising from a merger or restrictive trade practice may accrue to customers, in the form of lower prices; other industry participants or other industries, as cost savings or innovations are imitated or emulated by competitors; other industries may also benefit, as resources are freed for use elsewhere; and society, as scarce resources are being used more productively, using better methods than previously.

The Williamson merger tradeoff model (Williamson, 1968, 1977) provides the framework with which to identify and balance efficiency gains and losses from mergers and restrictive trade practices. The model applies a static partial equilibrium framework to large scale mergers, and assumes an efficiency objective for competition policy has been adopted. Severe operational difficulties limit application of the model in antitrust cases. Nonetheless, the model offers valuable insight into the implications of antitrust determinations and competition policy.

The implications of the Williamson merger tradeoff model were applied to those authorisations identified for examination in this research, in order to assess the extent to which benefits claimed at the time of the Commission's decision, were achieved. The research presented in the following chapters concludes that the poor ability of the public benefit test to predict the extent to which efficiency gains and other benefits will be achieved brings into question its usefulness as a major competition policy tool. All credit goes to the Commission however, since the multitude of other factors influencing the firms' ability to achieve benefits have a far greater bearing on this conclusion than the Commission's evaluation.

The major implication of this research is that firms granted authorisation lack an incentive to ensure efficiency gains and other benefits are achieved. In the absence of competition, companies need not implement programmes to realise efficiency gains and cost savings, as performance is unaffected.

The research will be presented as follows; Chapter 2 outlines the purpose and workings of the *Commerce Act 1986*, with particular emphasis on the public benefit test, and provides an international comparison of competition policy. New Zealand's public benefit test authorises acquisitions and other trade practices deemed by the Commission anti-competitive, where efficiency gains and other benefits outweigh detriments. Australia's and Canada's competition policies contain a similar test. The United States recognises efficiency gains where there is only a small lessening of competition, and gains are expected to be substantial. Finally, the European Union has no 'efficiency defense.'

Chapter 3 reviews the literature on competition policy goals, provides an explanation for the approach adopted in New Zealand, and summarises the conclusions of previous studies related to the extent to which efficiency gains and other benefits have been achieved. A brief overview of the Williamson model, its implications, limitations, and qualifications is also presented.

Chapter 4 justifies the methodology used to extract information from the companies granted authorisation, and other industry participants. Within the case study framework, questionnaires and interviews were held with parties granted authorisation, and industry experts, in order to gather information on the firm, the industry, and developments, since authorisation.

Chapter 5 discusses the meat processing industry and the two restrictive trade practices granted authorisation by the Commission (CC, 1987b, 1995a). The chapter summarises the characteristics of the meat processing industry, and the issues which arose in relation to these cases. An analysis of the extent to which the respondents have achieved the benefits claimed is also presented. As a result of deregulation and freeing up of New Zealand markets, the meat processing industry has been subject to a number of internal and external factors, which have had a significantly larger impact on the firms' ability to realise cost savings, efficiency gains, and other benefits claimed, than the trade practices.

Similarly, Chapter 6 provides an examination of the background to the dairy industry, and the issues which arose in relation to the two applications for merger (CC, 1988a, 1991). Deregulation of the dairy industry, and ensuing competition between dairy companies, for suppliers and domestic product sales, necessitated rationalisation of the industry. While merger facilitated the transformation from a highly regulated industry to a fully deregulated one, rationalisation would have occurred anyway. The mergers simply accelerated the process and prevented greater suffering.

Chapter 7 summarises the background to the gas industry, and identifies those issues considered relevant to the Commission's investigation at the time of the decisions (CC, 1988b, 1992b, 1993c). Each of these gas company mergers was motivated by the need to prepare for deregulation of the industry. In anticipation of intense competition in gas retail markets, which was expected following deregulation, gas utilities endeavored to establish links with larger retailers and wholesalers, and strengthen market position by purchasing interests in other retailers. Competition between retailers has not yet eventuated, but is expected in the near future. One gas industry merger (CC, 1988b) was not able to achieve any of the benefits claimed, cost savings were grossly overestimated, debt servicing costs were excessively high, and extensive repair work was required, which had not been anticipated. The other two gas industry cases were more successful at achieving benefits claimed.

Chapter 8 also examines the background to the telecommunications industry. In particular, the cellular services market. The issues which arose in relation to the Commission's investigation are also examined. Forecasts of expected growth in cellular services were grossly underestimated, and thus, benefits have exceeded expectations. The application by Telecom to acquire the AMPS-A, band suitable for cellular services, was eventually authorised by the Court of Appeal

almost two years after the Commission declined to authorise the application (CC, 1990b, Court of Appeal (CoA), 1992).

Finally, Chapter 9 offers some conclusions arising from the research, limitations, and possible research extensions.