



Recent developments in merger law

An economics perspective

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- Proposition – Court of Appeal decision in *The Warehouse* case has sanctioned an extension of the Commerce Commission’s merger analytical framework
 - It is at least arguable that the Commission’s “traditional” framework would not have captured the Extra situation
 - The extension is an important development



- Outline facts of *The Warehouse* case, and issues
- Describe concept of “real option”
- Describe approach of the High Court and Court of Appeal
- Apply to *NZ Bus*
- Conclusion

Supermarkets in NZ



- Two players
 - Foodstuffs (New World, Pak 'n Save, Four Square)
 - Woolworths (Woolworths, Foodtown and Countdown)
- Markets geographically delineated
 - 5km around Extra stores
- No entry for 20 years
 - Suitable sites
 - Resource consents
 - Economies of scale

The Warehouse Extra



- The Warehouse entered into grocery markets in 2006
 - “Extra”
 - Supercentre concept – groceries and general merchandise
 - Based on anticipated “halo” effect
 - Sylvia Park, Whangarei and Te Rapa
- Viability of model was uncertain
- Both Foodstuffs and Woolworths bought a 10% stake, and applied for clearance to purchase the whole business

Competition problem?



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- Under the status quo, Extra was not having much competitive impact
- Therefore, how could there be a substantial lessening of competition if one of the supermarkets bought The Warehouse?

Commission's Approach



- Essentially the Commission's analysis was based on the *potential* of Extra
 - 3:2 merger with high entry barriers
 - International success of supercentre concept
 - Credibility of The Warehouse
- Declined to clear
- But is this consistent with the Commission's traditional approach to merger analysis?

Commission's “traditional” approach



- Identify whether merger would eliminate a material constraint
- Commission would analyse
 - Constraint from remaining incumbents
 - Constraint from buyer power
 - Constraint from entry
- In respect of entry, LET test
 - Likely
 - Sufficient in **E**xtent
 - **T**imely

Would Extra be caught?



- Insufficient evidence to demonstrate material existing constraint
- To obtain purchasing power (and therefore be viable), would need to roll out further
- Query whether threat posed by Extra would satisfy LET test
 - Likely?
 - Timely?
 - *Can you see the whites of their eyes?*



- Why are firms' internal hurdle rates much higher than their cost of capital?
- If
 - A decision involves irreversibility;
 - There is uncertainty about the payoff; and
 - The decision can be delayed
- Then there is value in waiting until future states of the world are revealed
- Increment on the cost of capital reflects the extinguished option value

Harry Potter and Lord of the Rings



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- Note that the Harry Potter movies were made at separate times
 - Uncertainty about success
 - Value in waiting to judge that success before investing in next movie
- Compare to Lord of the Rings
 - All three movies produced together
 - Extinguished real options, in exchange for economies of scale

Application to The Warehouse



- Clearance (and subsequent merger) is, in effect, an irreversible decision
- There is uncertainty about
 - Whether Extra will succeed
 - If it does, what competitive effects it would have
- Therefore there is option value in delaying decision
 - I.e., decline to clear to gain more information about the success of Extra
- Value is a function of
 - Uncertainty



- Commission and court not entitled to delay decision until new information comes to light
 - Would incentivise avoidance of clearance process; or
 - Would delay mergers (which are often good for the economy)
- Even the loss of a valuable option (slightly different meaning – effectively a beachhead) does not result in a breach of the Act if that option is unlikely to eventuate
 - If the success of Extra is not a “real and substantial possibility”, then it is not a valid counterfactual
- Continuation of Extra and further roll out remote
 - No SLC
 - Clearance



- More structural approach
 - 3 to 2 merger with barriers to entry
 - Empirical evidence insufficient to outweigh concerns about duopoly
- Makes the entrant (option) valuable (particularly when as credible as The Warehouse)
- Does not matter that the existing constraint imposed by Extra is immaterial
 - Too early to tell
 - Substantial possibility of success, and would then materially constrain



- “We see the foreclosure of the one stop shop innovation before it has had a chance to prove itself as a matter for concern, especially as this concept is the only realistic source of ongoing competition to Woolworths and Foodstuffs in the near future.”
(¶205)
- If Commission not sure, can decline clearance



- Real options analysis has a place in merger analysis
 - This is (arguably) an extension to the Commission’s traditional approach
 - Something that is not yet a constraint, and may not satisfy the LET test, can result in an SLC
 - Does “likely” in the LET test have the same meaning as it does in the counterfactual analysis?
 - Miller J in *NZ Bus* (186): “The combination of contract restructuring, bundling of routes, and lead times together contribute to a conclusion that new entry will remain possible but is not likely to occur in an effective and timely way.”
 - Asymmetric treatment of Extra - removal of Extra leads to an SLC; but the addition of Extra would not mitigate an SLC
 - What if Foodstuffs wanted to buy a Woolworths banner in Wellington?



- Will we see more clearance declines, as Commission exercises its option?
 - Will more mergers occur without going to the Commission, to extinguish the Commission's option?
- By cutting off a potential exit strategy, Court of Appeal's approach might reduce entrepreneurship



- *NZ Bus* can perhaps be viewed in the same framework
 - Ex post economics analysis, not legal
- Generally accepted that Stagecoach and Mana do not compete
- Miller J – “tacit understanding”
- Therefore, how can there be a substantial lessening of competition?

- Commission's case was that counterfactual
 - Is not the status quo
 - Is the 74% shareholding being sold to a more aggressive player
 - Mana to then be used as the vehicle for competing with Stagecoach
- But is this an appropriate counterfactual?



- Evidence from large players that they would be interested in the 74% stake
- But “talk is cheap”
- If a third party’s true objective was to compete vigorously with Stagecoach, it would surely be an uncomfortable arrangement to effectively share ownership of Mana with Stagecoach
- As it has turned out, an investment bank bought the stake



- If clearance declined, it might turn out that another player would buy the stake and compete aggressively
 - This is the parallel to Extra succeeding and constraining the supermarket duopoly
- Accordingly there is value in waiting/declining clearance
- There is value in keeping that possibility alive
- Court found:
 - Purchase by overseas player a real and substantial possibility
 - And if that occurred, then there would be an SLC



- If there are impediments to competition in a market, e.g.
 - Duopoly with entry barriers; or
 - Coordination
- Then acquisition of a possible threat will be declined, even if that threat would not meet the LET test



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