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**APPLICATION OF THE SSNIP TEST TO MARKET
DEFINITION:**

**THE EFFECT OF ITS INCLUSION IN THE NEW
ZEALAND BUSINESS ACQUISITION GUIDELINES**

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The text of this paper (excluding contents page, footnotes and bibliography) comprises approximately 11,378 words.

I INTRODUCTION

Competition policy in New Zealand is governed by the Commerce Act 1986. The Act, which is closely based on the Australian Trade Practices Act 1974, aims to prevent the establishment or operation of business arrangements which reduce competition, to prevent firms possessing market power from using that market power for an anticompetitive purpose and to provide for the scrutiny of mergers and takeovers to prevent undesirable

The aim of this paper is to examine the implications of the implementation of the 'ssnip' test for market definition in competition analysis in New Zealand, subsequent to its inclusion in the New Zealand Business Acquisition Guidelines released by the Commerce Commission in October 1996. The 'ssnip' test defines a market as that in which a hypothetical monopolist of a product could impose a small yet significant non-transitory increase in price without losing its customers to substitute products. As the ssnip test is originally derived from the United States, this paper seeks to determine whether it is an appropriate test for the notably different New Zealand markets. The paper raises potential criticisms of the ssnip test regarding the size and the duration of the hypothetical price increase, which price level from which to hypothesise a price increase, whether the ssnip test necessitates supply side considerations in market definition and the effect of price discrimination. The Business Acquisition Guidelines address each of these issues and comparisons are made with other jurisdictions who employ the ssnip test, in determining the adequacy of the Guidelines' coverage.

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acquisitions of market power.¹ The Commerce Act is enforced by the Commerce Commission ("the Commission") and the courts.² In October 1996 the Commission released its first Business Acquisition Guidelines ("the Guidelines")³ outlining the approach the Commission will undertake in assessing the competition implications of proposed business acquisitions. As in any competition analysis, the first step in such assessment is definition of the relevant market to provide the context in which those competition implications will be relevant.⁴ The Guidelines have adopted the use of the "ssnip" test to define the relevant market as the smallest space within which a hypothetical profit-maximising sole supplier of a good or service would impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant.⁵ This means that if a hypothetical monopolist of a product (or service) could increase the price of that product by five percent without losing its customers to substitute products then the market will be defined as consisting solely of that product. If customers did switch to substitute products or services, the market would be broadened to include the products or services that were switched to.

¹ RJ Ahdar (ed) *Competition Law and Policy in New Zealand* (The Law Book Co Ltd, Sydney, 1991), 22.

² See Part I of the Commerce Act 1986. The Commission is a body corporate. Van Roy describes its main functions as determining applications for authorisations of certain restrictive trade practices which would otherwise be prohibited, determining applications for clearances and authorisations of proposed business acquisitions, authorising prices for goods and services which have been placed under price control and taking enforcement proceedings in respect of contraventions of certain provisions of the Act. See page 8.

³The Commerce Commission "Business Acquisition Guidelines 1996".

⁴ An accurate definition of the relevant market is considered the essential and principal prerequisite to the resolution of any competition law dispute.

⁵Above n 3, 14.

The 'ssnip' test was pioneered by the United States Department of Justice when it was included in the 1982 Merger Guidelines⁶ and has now become a world-wide standard for defining antitrust markets.⁷ This paper will consider whether or not the formal implementation of the snip test into New Zealand competition law analysis is appropriate given New Zealand's unique economical and geographic position, with small populations markets. The paper will provide an explanation of how the snip test is applied under the Guidelines and how this approach compares with judicial market definition prior to the release of the Guidelines and how it compares with that of other jurisdictions which have adopted the snip test. Potential criticisms of the elements of the test will be discussed and reference will be made to how other jurisdictions have addressed such issues. Such discussion will include the difference between competitive and current price levels, the size and time period of the price increase, price discrimination and product differentiation, and whether supply side considerations should be included in the market definition process.

It should be noted that although the snip test can be used to define a relevant market for any sort of competition analysis, this paper will mostly focus on the Guidelines use of the test in defining a market for the purpose of analysing a business acquisition.

⁶US Department of Justice and Federal Trade Commission *Horizontal Merger Guidelines*, 1992 The snip test was also included in the 1984 and 1992 United States Guidelines

⁷See *Consumer And Corporate Affairs Canada (Director of Investigation and Research - Competition Act) Merger Enforcement Guidelines*, 1991; *Australian Competition & Consumer Commission Merger Guidelines*, 1996; *European Draft Notice on Market Definition 1997* and *Nestle/Perrier*.

II MARKET DEFINITION FOR BUSINESS ACQUISITION ANALYSIS

A *Business Acquisitions and the Commerce Act 1986*

Prior to the Commerce Amendment Act 1990 parties to a merger or takeover were required to seek clearance or authorisation from the Commission.⁸ Under the new provisions, parties to the acquisition can elect whether or not to seek clearance from the Commission before implementation. However, the Commission can challenge any non-notified proposal which it considers has been, or is about to be, implemented in breach of the dominance rules in section 47 of the Commerce Act 1986. That section provides:

(1) No person shall acquire the assets of a business or shares if, as a result of the acquisition,-

- (a) The person or another person would be, or would be likely to be, in a dominant position in a market; or
- (b) That person's or another person's dominant position in a market would be, or would be likely to be, strengthened.

The Commission has described the concept of a "dominant position" as:⁹

A person can be considered to have a dominant position in a market when that person is able to make significant business decisions, particularly those relating to price and supply, without regard to the competitors, suppliers or customers of that person. ... it may

⁸ Acquisitions which were prima facie anticompetitive could be authorised by the Commission if they were in the "public interest". See s 66-69 prior to amendment in 1990.

⁹ *News Ltd/Independent Newspapers Ltd* (1986) 6 NZAR 47.

reasonably be inferred that this ability to act independently is presumed to arise only in markets where there is an absence of competition.

The Business Acquisition Guidelines set out the Commission's approach to assessing whether or not the acquisition will result in, or be likely to result in, a dominant position in a market or strengthening of a dominant position. They serve as a guide to the business community and its advisors of the circumstances where the Commission may be concerned about a business acquisition and may seek to prevent it. This insight into the internal decision-making of the Commission is of considerable assistance under the new voluntary pre-merger notification regime.¹⁰

B Market Definition Prior to the Business Acquisition Guidelines

The initial step in examining whether a firm would acquire or strengthen a dominant position in a market is definition of the relevant market. Market definition gives an indication of the market in which the undertaking is operating and provides a framework in which the competition implications of an application can be analysed. The larger the relevant market, the less likely the parties to the acquisition will be in a dominant position. If the market is defined too broadly, consumers may be forced to consider goods that are not really adequate substitutes for the goods they desire. On the other hand, if the market is defined too narrowly, a trader may be penalised for conduct which, although harms a

¹⁰ Parties to business acquisition proposals can elect to seek clearance from the Commission before implementation. The Commission can challenge any non-notified proposal which it considers has been, or is about to be, implemented in breach of the dominance rule. See ss 66 and 83 to 85 of the Commerce Act 1986.

competitor, does not really affect the market or harm consumers.¹¹ This is not what the Commerce Act seeks to do. The Commerce Act defines a market as:¹²

the term 'market' is a reference to a market in New Zealand for goods and services as well as other goods and services that, as a matter of good commercial common sense, are substitutable for them.

This definition stems from the following passage in *Edmonds Food Industries/WF Tucker & Co Ltd*:¹³

In delineating the relevant market in any particular case there is a value judgement which must be made which involves, for example, an assessment of pertinent market realities such as technology, distance, cost and price incentives; an assessment of the degree of substitutability of a product; an appreciation of the fact that a market is dynamic and that potential competition is relevant; and an evaluation of industry viewpoints and public tastes and attitudes. Particularly important in this process is industry recognition (both by suppliers and purchasers) and recognition by the consumer. Ultimately the judgement as to the appropriate market - and its delineation by function, product and area - is a question of fact which must be made on the basis of commercial commonsense in the circumstances of each case.

Although the concept of substitutability was not included in the Commerce Act's definition of a market until 1990, it is clear that the Commission and the courts had

¹¹ Y Van Roy *Guidebook to New Zealand Competition Laws* (CCH NZ Ltd, Auckland, 1991), 61.

¹² Section 3(1A) of the Commerce Act 1986.

¹³ Commerce Commission Decision No 84 (21 June 1984), para 7.

previously recognised the importance of the concept.¹⁴ Judge Barker in *Auckland Regional Authority v Mutual Rental Cars (Auckland Airport) Lt* stated:¹⁵

...one must take the goods or services relevant to the inquiry and identify the area of close rivalry or competition, seeking the boundaries by examination of the ready availability or interchangeability of substitute services in response to economic incentives of demand or supply; in other words, to use 'economists' speak, one must identify cross-elasticity of demand and cross-elasticity of supply.

Cross-elasticity of demand refers to the change in demand in response to a change in price.¹⁶ Thus the concept of measuring substitutability in response to an increase in price is not new. As the High Court stated in *Telecom Corporation of New Zealand Ltd. v Commerce Commission*¹⁷, "the mental test that prompts a summary evaluation of the evidence is to ask how buyers and sellers would likely react to a notional small percentage increase in price of the products of interest".

An economically meaningful market will include everything that offers substitution for the products or services at issue for significant numbers of consumers and will exclude from the market all those things that are not realistic substitutes. The ssnip test is a convenient

¹⁴ Substitutability was introduced into the Commerce Act's definition of market through the Commerce Amendment Act 1990 which brought the definition more in line with the Australian definition. Prior to the change, the market was defined as "Market' means a market for goods or services within New Zealand that may be distinguished as a matter of fact and commercial common sense."

¹⁵ [1987] 2 NZLR 647. See also *Tooth & Co Ltd and Tooheys Ltd, In re* (1979) 39 FLR 1 and *Tru Tone Ltd v Festival Records Retailing Marketing Ltd* [1988] 2 NZLR 352; (1988) 2 TCLR 542 (CA).

¹⁶ Elasticity of demand is discussed in part II D2 of this paper.

¹⁷ (1991) 4 TCLR 473, 501.

way to define a market in terms of the goods or services supplied or purchased (the product/service dimension) and the geographic areas from which the goods or services are obtained or within which the goods or services are supplied (the geographic dimension).¹⁸

C *The Ssnip Test*

The Guidelines define the relevant market as the smallest space within which a hypothetical profit-maximising sole supplier of a good or service would impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant.¹⁹ The Commission will generally consider a ssnip to involve a five percent increase in price for a period of a minimum of one year.²⁰ When using the test In *Goodman Fielder* the Commission posed the question as:²¹

If the price of the product were to be raised by a hypothetical monopolist by a ssnip (say, five percent), above the competitive level for at least a year, would so many buyers switch to buying alternative products (demand-side substitutability), or would so much additional supply be added by new suppliers switching their production to the product in question (supply-side substitutability), that the price rise would not be profitable?

¹⁸The Commerce Commission will also seek to define the relevant market in terms of functional level (level in the distribution chain) and time but the ssnip test is not relevant to such analysis.

¹⁹ Above n 3, p14.

²⁰ Above n 3, 15.

²¹ Commerce Commission Decision No 289 *Goodman Fielder Limited; and Defiance Mills Limited* 14 April 1997, 9-10.

Market definition and the ssnip approach is to be distinguished from assessing whether a business acquisition will lead to the strengthening of a dominant position. Market definition is a hypothetical exercise to estimate buyer reaction to a price increase. This process does not presuppose that a ssnip would result from the actual acquisition. That is to be evaluated once the terms of the relevant market have been identified.²²

D The Product Market

1 Introduction

The relevant product market refers to what products are sufficiently close substitutes to compete effectively in each other's market. Definition of the product market plays an important part in the outcome of the case which will often depend on how willing the Commission or the court is to accept a wider range of goods as plausible substitutes.²³ Initially markets are defined narrowly as consisting of the product or service produced by two or more of the parties to the acquisition. If, in response to the imposition of a ssnip, profits would be unlikely to increase for a hypothetical monopolist of those products because buyers switch to substitute products, then the next best substitute product or service will be added to the initial market definition and the ssnip test repeated. The process continues until no significant switching occurs in response to the increase in price and the combination of products or services is found where a ssnip would be profitable.

²² Above n 3, 15.

²³ Above n 11.

2 Economic evidence

The Guidelines state that the key determinant of the product or service dimension of a market is substitutability in demand. Ideally, the substitutability of one product or service for another is determined by reference to the cross-elasticity of demand between them.²⁴

The importance of elasticity in market definition was emphasised by Dawson J in *Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Co Ltd & Anor*²⁵

The basic test involves the ascertainment of the cross-elasticities of both supply and demand, that is to say, the extent to which the supply of or demand for the product responds to a change in the price of another product. Cross-elasticities of supply and demand reveal the degree to which one product may be substituted for another, an important consideration in any definition of a market.

An elasticity test has the advantage that it does not rely on any intuition to determine the substitutability, since it is a purely scientific test based on established data. However, there are limitations to the use of this test. The reliability of cross-elasticity results rests with the choice of products to include in the tests. Where it is difficult to select the correct products for inclusion, the conclusions will differ dramatically in the ultimate market shares given.²⁶ Important as they are, elasticities and the notion of substitution

²⁴ Cross-elasticity of demand refers to the extent to which the physical characteristics, properties or performance of the product concerned are different from those of other products in the market.

²⁵ (1989) ATPR 40-925, 50-014.

²⁶ P Crowther "Product Market Definition in EC Competition Law: The Compatibility of Legal And Economic Approaches" [1996] JBL 177, 186.

provide no complete solution to the definition of a market. A question of degree is involved - at what point do different goods become closely enough linked in supply or demand to be included in the one market. The answer to such a question precludes any dogmatic answer. Although the economic logic of the SSNIP test is clear, implementing the test is not always simple. Information on cross-elasticity of demand will rarely be available and in most circumstances the Commission will need to rely on the next best evidence.²⁷

3 *Consumer behaviour*

The Commission recognises that the approach to defining a market as described in the Guidelines is more of a framework within which case by case judgements can be made, rather than a precise and scientific exercise. Whether a SSNIP could be profitably imposed arguably calls for a speculative prediction of future conduct (namely, whether the acquirer will be able to increase prices) which may be influenced by a variety of factors that are impossible, or at least difficult, to measure.

For every product available for each different location, different buyers or groups of buyers will react differently to price changes. When the products are not identical or the products to which buyers switch are not the same, the relevant market definition rests on the aggregate decisions of different classes of customers. Each have different attitudes toward the importance of price and product characteristics in deciding whether to

²⁷ Above n 3, 15, para3.5.

substitute or not. Even if consumer response cannot be measured directly, certain assumptions about consumer behaviour can generate fairly safe conclusion. For example, it is generally assumed that consumers "maximise" in the sense that they are constantly on the lookout for the product that best meets their needs at the lowest possible prices. This rationality assumption may generate appropriate market definitions even if the assumptions cannot be empirically verified.²⁸

The Guidelines state that the Commission will consider the views, marketing and sales strategies and behaviour of buyers, and analyses of historical and likely future trends in buyer behaviour, in order to estimate buyer willingness to substitute other products or services as prices rise.²⁹ The Canadian Guidelines highlight such buyer information as one of the most important sources of information to consider:

What buyers state they are likely to do, what they have done in the past, and their strategic business plans, often provide a reliable indication of whether the postulated price increase is likely to be imposed and sustained. Where buyers have not substituted product B for product A in the past, and indicate that they would not likely do so in the event of the price increase, it may be inappropriate to conclude, on the basis of hypothetical considerations, that those products compete in the same relevant market.

The Commission will assess the technical viability of one product or service as replacement for another and will also have regard to relative prices, quality, and

²⁸ H Hovenkamp *Federal Antitrust: The Law of Competition and its Practiced* (West Publishing Co, Minnesota, 1994), 89.

²⁹ Above n 3, 13.

performance when assessing whether in fact they are substitutes.³⁰ Those judgements will involve consideration of a range of evidence including price trend data, consumer surveys, and observation and informed opinion.

4 *Price-trend data*

Price trend data measures price trends of products thought to be in the same market. If products are competing in the same market, then the prices are likely to move in a similar fashion due to similar supply and demand conditions. If product B is an effective substitute for product A then a rise in the price of product A will result in a rise in demand for product B. If price movements of groups of products do not correlate with price movements of other products it is unlikely that they are in the same relevant market. Strong price correlation between products that are superficially substitutable may constitute an indicator that the products are in the same market but it may also be due to other external factors such as price changes in common inputs, inflation, pricing policies of multi-product firms or duties on products such as cigarettes. It is imperative to filter out these extraneous factors which may have a common effect on the price of products making it appear as if their price evolution is related.

³⁰ Above n 3, 13

5 *Observation and informed opinion*

The issue of future price moves and future reactions to price moves usually will be examined through the expert testimony of economic experts and the testimony of interested witnesses such as executives of the defendant, suppliers, customers or the defendant's competitors. Given the uncertainty of hypothetical shifts in the future, a witness can testify in support of almost any conclusion without the fear of effective contradiction. The Guidelines state that information obtained from independent experts and which predates contemplation of the business acquisition under consideration may be more persuasive than that produced specifically for the purposes of a proposal.³¹ This is not to say that future hypothetical price reactions should be ignored. There will be some situations in which reliable evidence of future pricing is available.

Economists are able to assist the court in relation to economic principles. But once the relevant principles are expounded their application to the facts of the case is a matter for the court. The definition of a market is entirely a matter of fact, the determination of which ought not to be made more protracted and expensive by the adduction of unnecessary expert evidence.³²

³¹ Above n 3, 13, para 3.1

³² Wilcox J in *Trade Practices Commission v Australian Meatholdings Pty Ltd* (1988) 10 ATPR 40-876, 49-479.

In *Goodman Fielder*³³, which was concerned with proposed acquisition of baking and milling operations, the Commission staff discussed the proposal with a range of parties with an interest in the relevant industries.³⁴ These included farmers, flour millers, bread bakers, bakery ingredient suppliers, bakery product manufacturers and supermarkets. Written submissions were received from various parties and additional information was sought and obtained for the parties to the proposed acquisition.

6 Consumer surveys

Consumer surveys are listed as a relevant consideration in the process of defining markets. A good example of where consumer questionnaires have been used was in the soft drink merger in the United States.³⁵ Pepsi-Cola, the second largest producer of carbonated soft drinks in the United States proposed to acquire 7-Up, the fourth largest producer of soft drinks. Coca-Cola, the largest producer of soft drinks, proposed to acquire Dr Pepper, the fourth largest producer. Royal Crown, the fifth largest producer, opposed the mergers on the ground that smaller producers' costs would rise at the bottling stage of production because the bottler network would no longer be able to bottle 7-Up and Dr Pepper along with the smaller brands. The predominant issue in the litigation that followed became the definition of the relevant product market. The plaintiff wanted the market to be confined to soft drinks. A number of alternative product market definitions could have been

³³ Above n 21.

³⁴ These included wheat, flour, stock feed, bakery ingredients and baked goods industries. See *Goodman Fielder Limited*, above n 21, 2.

³⁵ D Bull "Implementing Department of Justice Merger Guidelines" (1996) 41 Antitrust Bulletin, 678.

adopted without causing concentration levels to fall sufficiently low to warrant approval of the mergers. Thus an important issue in this case was the degree of substitution of other beverages for soft drinks. An estimate of the price elasticity of demand for carbonated soft drinks became essential as an inelastic demand for a product is a sufficient (but not necessary) condition for demonstrating a relevant antitrust market. No prior estimates of the price elasticity of demand or data for estimating demand elasticity for soft drinks or for performing the relevant price correlation with other beverages alleged to be part of the market could be found. In a somewhat novel approach to measuring demand elasticity, consumers were directly questioned.

Consumers were asked about the consumption pattern of carbonated soft beverages, the quantities bought, the dollars spent on them, and the types of stores in which they are purchased and then they were led to focus on the type and size most frequently purchased and the price paid for it. Half of the sample were asked:

Suppose you found out that the price of carbonated soft drinks had gone down permanently by about 5 percent, this means you would pay ... cents less for the (insert modal buy) for which you now pay... cents. Would you and your family drink more of these beverages or would you continue to buy the same amount you drink now?

The other half of the sample was asked a corresponding question about a permanent price *increase*, followed by the inquiry whether it would *reduce* consumption. A continuation of the questions asked interviewees how much more they would buy; either spending the

same amount of money (price elasticity of one), or buying more soft drinks (price elasticity greater than one), or buying the same amount of soft drinks (price elasticity of zero). Following hypothetical calculation (using increase or decrease of 10 or 15 percent consumption) all four elasticity estimates fell within the inelastic region of demand. Therefore, the results supported the notion that soft drinks form a relevant antitrust market.

The consumers who revealed a price elasticity of demand for soft drinks that was greater than zero were asked whether they would consume more or less of some other beverages if they bought less or more of the soft drinks. If so, what would those beverages be. The results showed that although consumers will substitute certain other beverages for soft drinks, the degree of substitutability is sufficiently low to treat soft drinks as a relevant antitrust market (as opposed to the defendant's proposition that the relevant market was "all beverages"). The use of the consumer survey allowed clear ranking of the substitutes that emerged, which would have been much less apparent under the more traditional approaches to market definition.

A consumer survey approach has two major advantages in market definition. The Guidelines are concerned with a *hypothetical* price change from *current* levels as the determinative factor to consider. Such as standard is forward looking. A well designed survey instrument can provide a reliable measure of demand side product and/or geographic substitutability and can be used to assess, at least, the likely future response of

consumers to a change in price. A second advantage is that a survey can be designed to yield information about the alternative products or geographic areas that consumers view as substitutes for the set being considered under the provisional market definition.³⁶

However, consumer surveys are not without their disadvantages. As the Guidelines specify that the response to a hypothetical price change from current levels be considered the determinative issue, the ideal question would ask 'what did you do...?', rather than, 'what would you do if...?'. However, such hypothetical questions are the standard form in public opinion polling. Questionnaires which ask consumers to state their response to price increases of the product in question may be addressing the issue in an erroneous manner. Most consumers are not likely to be able to predict what their response to a hypothetical situation would be. Although the survey methodology is useful in addressing demand-side substitutability, it is less well suited to dealing with the question of supply-side substitutes across product geographic space. As a result, the demand elasticity estimates that emerge will generally fail to reflect the impact of the supply response of outside firms.

7 *European approach*

Prior to the European Commission's Draft notice on the Definition of the Relevant Market, produced in 1997, the European Community had no specific test for market definition. However, the case law in the Community had developed to the point where

³⁶ Above n 35., 689.

some general guidelines could be identified. Products would be regarded as interchangeable by reason of the product's characteristics, functionality, prices and intended use. In some cases, a comparison of physical characteristics and functionality will be sufficient to achieve a workable product market definition and more sophisticated evidence and complex economic analysis may not be necessary. Physical characteristics may include the speed of operation, level of performance, diversity of application, and other factors which buyers would regard as important parameters of functionality to fulfil their needs.

However, the Draft Notice states that "product characteristics and intended use are insufficient to conclude whether two products are demand substitutes. The functional interchangeability of product does "not provide ... sufficient criteria (for market definition) because the responsiveness of customers to relative price changes may be determined by other considerations also". The notice states that the existence of groups of captive consumers will not of itself define a market unless those consumers can be price discriminated against effectively.³⁷ Here the Commission, in effect, says it is going to ignore the reasoning of the European Court of Justice in *United Brands*.³⁸ The Draft Notice specifically mentions elasticity estimates, correlation studies, Granger causality calculation, price consequence tests and trade flow tests. However, the most emphasis is

³⁷ Captive consumers are those who are unable, or unwilling, to switch to substitute products.

³⁸ *United Brands Co v EC Commission* [1978]1 CMLR 429. The court concluded that bananas had certain special features which were sufficiently distinctive for it be regarded as representative of a relevant product market (as opposed to a market for fresh fruit in general). These special features included year round availability and the ability to satisfy the constant needs of an important part of the population (consisting of the very young, the old and the sick).

given to shock analysis which refers to the analysis of evidence relating to past events or shocks. When available, this sort of information will normally be fundamental for market definition. This approach is similar to the emphasis on historical and likely future buyer behaviour in the New Zealand and Canadian Guidelines.

E The Geographic Market

1 Introduction

The relevant geographic market refers to what firms are sufficiently proximate to others in spatial terms to compete effectively. The Australian Trade Practices Tribunal in *Tooth*³⁹ stated:

The market should comprehend the maximum range of business activities and the widest geographic area within which, if given sufficient economic incentive, buyers can switch to a substantial extent from one source of supply to another and sellers can switch to a substantial extent from one production plan to another.

The ssnip test is applied to the geographic market by initially identifying the overlapping geographic areas of operation of the parties to the merger. If a hypothetical monopolist of the products in that area imposed a ssnip and customers switched to products outside that area, so that the price increase would be unprofitable, this would be an indication that

³⁹ *Tooth & Co Ltd and Tooheys Ltd, In re 1979) 39 FLR 1.*

suppliers in other areas could provide products which were effective substitutes and the geographic extent of the market is broader than the area initially specified. If that is the case the market would be broadened until the switching in response to the price increase stopped. The Commission will seek to define the geographical dimension of a relevant market on evidence of past and forecast buyer and seller behaviour. When two groups of sellers engage in the same advertising or marketing efforts in the same geographic areas, there is strong evidence that each is part of a single geographic market. Similarly if buyers seek price data from two different sets of sellers of similar products that is evidence that both groups of products are in the same relevant market.

The United States Guidelines state that the Agency will consider evidence that buyers have shifted or have considered shifting purchases between different geographic locations in response to relative changes in price or other competitive variables; evidence that sellers base business decisions of the prospect of buyer substitution between geographic locations in response to relative changes in price or their competitive variables; the influence of downstream competition faced by buyers in their output markets; and the timing and costs of switching suppliers.

F The Place of Imports in Market Definition

The deregulation of the New Zealand economy has resulted in imported goods playing a significant part in many New Zealand markets. In a number of markets, the behaviour of

New Zealand resident suppliers is constrained by the nature, availability and prices of imported products. Despite New Zealand's geographic isolation, economies of scale achieved by overseas firms compared to domestic firms often provide them with a cost advantage. As the Commerce Act defines a market to be a "market in New Zealand" the Commission will adopt a national market. However, under section 3(3) appropriate overseas suppliers can and should be considered as providing effective competition in New Zealand, exercising a similar constraint to domestic suppliers.

Under the Guidelines the Commission will generally consider actual competition from imported products to be equivalent to that from domestic supply. Imports and potential imports will be considered as part of the assessment of the constraint from market entry. However, the examination of a number of factors suggests that the Commission will be cautious in assessing import competition.⁴⁰ These factors include the existence of any limits on quantities of imported products and the effects of tariffs, transport costs, international price movements and changing exchange rates on trade.⁴¹

The Commission should have regard to whether existing import supplies could accommodate a significant expansion of supply without the need to invest in sunk costs of distribution, advertising and promoting; whether changes to tariff levels and other forms of production are likely to occur over the next two to three years and information that overseas corporations have concrete plans to enter the Australian market.

⁴⁰ MN Berry "The Commerce Commission's First Business Acquisitions Guidelines: A Comment" (1997) 3 NZBLQ 75.

⁴¹ Above n 3, 16.

III COMPETITIVE OR CURRENT PRICE LEVELS?

The purpose of the snip test is to predict the consequences of an increase in price. However, that prediction may differ depending on whether the proposed increase originates from current price levels or from competitive levels. If the firms selling the product in question are already charging a higher than competitive price, customers of that product are likely to be more willing to switch to substitute products in response to a price increase. Those products that were switched to will be included in the relevant market, thus expanding the market and lessening market power.

The effect of imposing a snip from higher than competitive prices was evidenced in the infamous *Cellophane*⁴² case. du Pont was charged with monopolising the manufacture and sale of cellophane. The government argued that the relevant market was cellophane whereas du Pont argued that the relevant market was all flexible wrapping materials.⁴³ The court concluded that the proper market included all flexible packaging materials on the grounds that a slight increase or decrease in the price of cellophane caused "considerable numbers of customers of other flexible wrappings to switch" demonstrating that the products competed in the same market. The majority reached this conclusion despite the findings that cellophane had significant differences from other flexible packaging materials, cost two or three times as much per surface measure as its chief

⁴² *United States v EI du Pont de Nemous & Co* 351 US 377 (1956).

⁴³ Such as wax paper, glassine, pliofilm and saran wrap

competitors and was the only flexible packaging material suitable to the needs of certain users (particularly cigarette manufacturers). The dissenters emphasised that du Pont's profits on cellophane were unusually high. Accordingly, it is likely that various classes of customers of cellophane were willing to switch to substitute products if du Pont raised its price. The fact that du Pont earned profits substantially above average is direct and more reliable evidence of the fact that it did enjoy market power.⁴⁴

The '*cellophane* fallacy' is addressed by the approach in the New Zealand Guidelines which is concerned with substitutability at competitive market prices. Where the Commission considers that prices in a given market are significantly different from competitive levels it may be necessary to hypothesise as to the effect of a snip from competitive price levels, so that appropriate substitutes are considered.⁴⁵ The 1992 United States Guidelines have a similar approach by stating that prevailing prices will be used unless coordinated interaction among firms in the provisional market is observed already to be occurring the agency will not use the current prices as a starting point, but rather "a price more reflective of the competitive price."⁴⁶

Neither the New Zealand nor the United States Guidelines say how to determine whether the price is non-competitive or when to make that determination or how to identify the competitive price. An absence of such information may lead to some uncertainty. The

⁴⁴ R Pitofsky "New Definitions of Relevant Market and the Assault on Antitrust (1990) Columbia Law Review 1805, 1814.

⁴⁵ Above n 3, 15.

⁴⁶ Above n 6, para 1.11.

1982 and 1984 United States Guidelines noted the administration burdens of hypothesising a price increase from competitive levels, rather than from the actually observed price level. A comparison of price to marginal cost, demonstrating the magnitude of the price/cost differential is the most accurate indicator of market power. However, since marginal cost is unknown to most firms, it is not a practicable alternative. Pitofsky suggests that a more manageable approach would be to measure "profit". However, the common measure in financial statements is accounting profit, rather than economic profit.⁴⁷ Ultimately however, the issue is not measuring profit, but rather determining whether profits over a long period of the time are exceptionally high compared to similar product lines or industries.

Is a Five Percent Increase Substantial?

The *Cellophane* case was concerned with monopolising the manufacture of cellophane under section 2 of the Sherman Act 1890 rather than a merger under section 7 of the Clayton Act. Merger analysis is concerned with whether the merger would create or enhance market power, rather than whether market power is being exercised. It is arguable that the relevant price level in merger cases is the current price level as merger cases are concerned with the future and whether prices will rise above the current level in the future. Even if a market demonstrates high prevailing prices, section 47 of the Commerce Act may not be violated if the merger does not make the situation worse by strengthening a dominant position in a market. This argument is weak for several reasons. A merger

⁴⁷ For example, a firm in an expanding market may invest heavily in research and development or plant expansion and thereby show little accounting profit, despite its considerable market power. By contrast, a firm in a declining industry or with a declining product may invest little in new facilities in marketing and show considerable "profit" but have little market power.

among the members of a cartel (who are charging less than competitive prices) further lessens competition as it stabilises the agreement. Secondly, sellers or buyers in a highly concentrated market are likely to be able to coordinate more effective strategic behaviour to exclude rivals. Finally an interpretation of section 47 that ignored the *Cellophane* fallacy would lead to absurd results⁴⁸ such as where a totally effective cartel would not be made worse by a merger which seems obviously inconsistent with the aims of Parliament when it passed the Commerce Act.

IV SSNIP TEST FACTORS

A *Is a Five Percent Increase Suitable?*

The Commission will generally consider a ssnip to involve a five percent increase in price for a period of a minimum of one year. This five percent figure appears to have been plucked from the United States Guidelines. Although the word 'generally' implies a degree of flexibility, the New Zealand Guidelines, like their United States counterpart, provide no information as to when that flexibility may be exercised or what percentage change is appropriate. As a lower percentage will generally result in a narrower market, with fewer substitutes, it is possible that a lower percentage would be more appropriate in defining New Zealand markets rather than adopting the same percentage figure as larger jurisdictions.

⁴⁸ Above n 44, 1846,

It has been argued that a five percent test for all markets is flawed. If the parties to the merger were currently selling their products at a depressed price then a price increase following the merger may not cause product switching among buyers because it would simply raise the prices to a competitive level. Similarly, if monopoly prices were already being extracted from the firms, an increase in price following the merger would be more likely to cause product switching.⁴⁹

Secondly, the significance of any percentage increase will vary depending on profit margins in the industry. A five percent increase could lead to a much larger increase in profit.⁵⁰ In an industry with narrow profit margins, such as food retailing, a profitable price increase less than five percent could indicate a great market power. On the other hand, for a high risk industry such as oil drilling, a five percent increase would indicate little about market power even if buyers did not switch to substitute products. The Canadian Guidelines recognise that a larger price threshold may be more appropriate in "situations where a five percent increase involving products purchased by consumers would be measured in cents rather than in dollars".⁵¹ A larger figure may also be more suitable in product differentiated markets. Thus any percentage test should be applied flexibly, taking the nature of the competition in the market into account.⁵²

⁴⁹ See discussion on competitive prices in part III of this paper.

⁵⁰ GJ Werden "Market Delineation" (1993) 38 Antitrust Bulletins 517.

⁵¹ For example, a five percent increase in the price of a chocolate bar would only be approximately five cents.

⁵² Above n 44, 1819.

Despite the United States Guidelines describing a five percent increase, it is commonly understood that a ten percent hypothetical price increase is commonly used by the Commission. It is argued that a smaller figure encourages pursuit of trivial or even desirable market power. A larger figure may seem apt, particularly in product differentiated markets. It is suggested that the fact finder hypothesise a price increase of ten percent above the competitive level and consider the impact of such a price increase on customer demand, competitor supply and entry.

B "Would" Versus "Could"

The New Zealand and American Guidelines require that the hypothetical monopolist "would" impose at least a "small but significant and non-transitory" increase in price. The Canadian Guidelines adopted the word "could" partly to be consistent with the United States 1984 Guidelines and partly because it was thought that use of the word "would" might create an undue burden on the Bureau.⁵³ As it would ordinarily be rational for someone who has the power to raise prices to do so, "could" will usually translate into "would". However, it is the ability of the hypothetical monopolist to raise prices, rather than the demonstration that it "would" (which may sometimes prove difficult) which is important.

⁵³PS Crampton "Canada's New Merger Enforcement Guidelines: A 'Nuts and Bolts' Review" (1993) 38 Antitrust Bulletin 665, 682.

C Period of Increase

The New Zealand Guidelines consider that generally a snip will involve a five percent increase in price for a period of a minimum of one year. The Canadian Guidelines followed the United States 1984 Guidelines by stating that a one year period would in most contexts be used. In the 1992 Guidelines the one-year specification has been replaced with "the foreseeable future" which apparently will vary with the industry involved. United States Federal Agency staff have suggested that one interpretation could be "for one product cycle" or "until the next purchase decision".⁵⁴ The provision clearly grants substantial discretion to the decisionmaker and may give rise to some uncertainty. The Canadian Guidelines explain that a one year period is allowed for response to a price increase because sellers that would require more than this amount of time to respond to an increase in the price of a product generally do not exercise a significant constraint on the price of that product. Suppliers who would take longer than a year to respond to a price increase are considered at the barriers to entry stage. Although the New Zealand Guidelines do not consider supply substitution at the market definition stage, a one year period seems to be a more appropriate approach for the New Zealand Guidelines to follow, as it provides more certainty than the United States period and would, in most cases, encompass "the next purchase decision" interpretation.

⁵⁴ T Calvani and WT Miller "31 Questions" (1993) 38 Antitrust Bulletin 593.

V SUPPLY SIDE CONSIDERATIONS

A *Introduction*

Just as a consumer may consider a particular product a suitable substitute for the product at issue, a producer may regard the production of that product or a substitute product as a viable possibility. Existing firms manufacturing a similar product to the one in question or the same product some distance away will often be able to respond to a price increase rather quickly. If the production process could be redesigned promptly and sharply to produce the second product, then it may be necessary to count that potential "supply substitution" in the product market. It is possible that due to supply side substitutability a monopolist of a relevant market could not raise prices because in response to an attempted price increase, other producers may be able to switch at low cost to producing the product in question, or a suitable substitute. The existence of supply-side substitutability has the effect of enlarging the product market under consideration where the products concerned are not interchangeable in terms of demand.

Supply substitution can come from a series of sources. Excess capacity is a more certain source of supply in the event of a snip than an entirely new entrant and these substitute sources can usually be initiated or diverted to a market within a time period which can be reliably determined. Capacity in production can consist of location, shelf space and technical knowledge. A retailer will be able to switch that capacity to supply varying

merchandise lines and varying quantities of service (such as delivery and advice) in accordance with profit incentives. Captive production which is presently committed to internal use may be diverted to the open market in the event of a snip. Where there are economies of scope, there will normally be an accompanying capacity to take advantage of substitution in production.⁵⁵ However, substitution may be prevented by the potential long-term consequences⁵⁶ of diversion in response to what may be a "non-transitory" but also not permanent increase in price. Other sources include products currently sold outside the market that could be diverted, processes turning out currently non-competitive products that could be adjusted and new entry in the form of expanded entry or grassroots entry.⁵⁷ However, if the supply-side factors are to be taken into account in the market definition the difficulty arises where to draw the line between supply-side substitutes and potential entrants.⁵⁸

B The New Zealand Guidelines

New Zealand's approach is somewhat ambiguous. The Guidelines concentrate on demand side factors in market definition largely to the exclusion of supply-side factors. Supply side factors are considered at a later point when identifying the participants in the relevant market. At this later stage, "near entrants", that is businesses which can and *would*

⁵⁵ Above n 1,134.

⁵⁶ Such as labour contract, expensive fixed cost considerations, loss of customers of downstream products lost as a result of diverting captive supply, and a reputation for unreliability of switching back and forth between captive and open markets. See discussion in Pitofsky, above n 44, 1851.

⁵⁷ Above n 44.

⁵⁸ The question of whether supply side consideration or "contestability" is more relevant to the market definition process or to the determination of market power is discussed late in Part of this paper.

quickly enter the market in response to an attempt by existing suppliers to raise prices or reduce output, and existing suppliers, are included in the identification of market participants. Such "near entrants" must already possess the facilities and/or the knowledge required to produce the goods or services sold in the relevant market. Entry by such comparisons must result from redeployment of existing capacity or expansion involving minimal sunk costs and minimal delay. Such near entrants should be readily identifiable and their potential to supply product markets should be explicitly recognised.⁵⁹

Despite the detailed description of what constitutes a near entrant at this later stage, the Guidelines later acknowledge that, in practice, consideration of supply side factors has played a greater part in the market definition process in some Commission and court decisions.⁶⁰ The Guidelines further acknowledge the possibility of including supply-side factors in the market definition process by considering that:⁶¹

So long as an appropriate process of market definition and analysis of market participation and entry occurs, that process will generally yield the same conclusions irrespective of whether the emphasis at the market definition stage is limited to demand side factors or expanded to incorporate supply-side factors as well.

⁵⁹ Above n 3, 16. For example, these may be companies which generally export but which could readily divert supply to the domestic market.

⁶⁰ Above n 17: "competition may proceed both through substitution in demand and substitution in supply in response to changing prices". See also the Commission's decision of supply substitutes in Commerce Commission Decision No 279 *Ravensdown Co Limited; and Southfert Cooperative Limited* 21 June 1996 and *Goodman Fielder*, above 21.

⁶¹ Above n 3, 12.

If supply substitutes are already and specifically identifiable it appears likely that the Commission will include such factors in the market definition process. This was the practice prior to the production of the Guidelines, as was made clear in *Telecom*⁶² where it was stated that "competition may proceed both through substitution in demand and substitution supply in response to changing prices". It has also been the practice of the Commission following the introduction of the Guidelines. In *Goodman Fielder*⁶³ the Commission stated that a properly defined market will include those suppliers currently in production who are likely, in the event of a ssnip, to shift promptly to offer a suitable alternative product even though they do not do so currently. Despite recognising that such suppliers have been referred to as "near entrants", as described in the Guidelines at the market participation stage, the Commission appeared to use the term interchangeably with supply substitution at the market definition stage.

Where supply side substitutes are to be included in the process of defining a relevant market, the Commission will consider the technical feasibility of switching production and the associated costs; the marketing effort and expense involved in establishing a credible (and profitable) position as a supplier to the market; and the degree to which any supply side substitution has occurred in the past.⁶⁴

If entry into the market requires no specialised investment and is relatively easy so that barriers are low, it may not be viable to include the potential competition in the relevant

⁶² Above n 17.

⁶³ Above n 21.

⁶⁴ Above n 3, 12.

market. It would be difficult to predict which business would move into the market and what their output would be. By contrast, if the manufacture of two products requires a great deal of specialised machinery but the cost of switching production between the two products is relatively small, barriers to entry from the outside could be quite high. It may be appropriate to include the divertible production⁶⁵ of one in the relevant market of the other.⁶⁶ In close cases evidence that existing suppliers can switch production is usually more convincing than evidence that entry barriers are low.

C The Australian Approach

The Australian New Zealand Closer Economic Relations Trade Agreement (ANZCERTA)⁶⁷ is concerned with the removal of tariffs and quantitative restrictions on trade in goods between Australia and New Zealand. It provides for companies in one country to be able to sell in the other on the basis of their productive efficiency and marketing abilities, free of trade barriers. As part of the review of ANZCERTA, New Zealand and Australia entered into the Memorandum of Understanding Between the Government of New Zealand and the Government of Australia on Harmonisation of Business Law. This Memorandum encourages a harmonisation of commercial statutes and shared interpretation of commercial law.⁶⁸ As market definition is a crucial part of

⁶⁵Divertible production refers to the output of rivals not currently sold in the geographic market.

⁶⁶Above n 28, 107

⁶⁷ Which came into force on 1 January 1983.

⁶⁸ M Brunt "Market Definition' Issues in Australian and New Zealand Trade Practices Litigation" [1990] ABLR 86, 89.

competition analysis, it is imperative that Australia and New Zealand adopt a similar definition process.

Section 4E of the Trade Practices Act 1974 defines a market as "a market for those goods or services and other goods or services that are substitutable for, or otherwise competitive with, the first-mentioned goods or services". Market definition in the 1992 Australian Guidelines is the first of five stages in evaluating whether a particular acquisition will be likely to contravene section 50 of the Trade Practices Act. The explanatory memorandum to the Australian Guidelines states⁶⁹

The availability of substitute products in a market where a merger takes place allows consumers to purchase alternative products if the merged firm seeks to raise its price. Similarly the scope for substitution in production may limit the scope for the merged firm to raise prices.

For example, in response to any attempt to increase prices, manufacturers of other products which use similar processes may be able to switch at low cost to producing the merged firm's product. In such circumstances it is less likely that the merger would substantially lessen competition. Similarly, if new substitutes are likely to be available if the merged firm raises its prices, the merged firm is likely to be constrained in its behaviour, and competition is less likely to be lessened.

⁶⁹At [27].

It is evident that, despite the ANZCERTA agreement, the Australian Guidelines differ from the New Zealand Guidelines by including both demand and supply side substitutes in the market definition process. Supply side substitution which does not require significant new investment in response to a ssnip is included in the definition of the relevant market. Substitution which would require significant investment is defined as market entry. This approach is consistent with past judicial interpretation of the market definition such as in the *Tooth and Tooheys* brewery ties case:⁷⁰

... competition may proceed not just through the substitution of one product for another in use substitution in demand) but also through the substitution of one source of supply for another in production or distribution (substitution in supply). The market should comprehend the maximum range of business activities and the widest geographic area within which, if given a sufficient economic incentive, buyers can switch to a substantial extent from one source of supply to another and sellers can switch to a substantial extent from one production plan to another. In an economist's language, both cross-elasticity of demand and cross-elasticity of supply are relevant.

Every judgement in *Queensland Wire Industries*⁷¹ either implicitly or explicitly affirms the relevance of substitution in supply; "the capacity to alter the range to those products" (Toohey J), it being "relatively easy to convert production from one shape of steel to another" (Mason J and Wilson J).⁷² In considering the possibility of cross-elasticity of supply, the Trade Practices Commission has stated that it will need to be concerned that

⁷⁰ Above n 39, 18,196.

⁷¹ Above n 25.

⁷² Above n 25, 50,010 and 50,022

potential sources of supply *could and would* be likely to rapidly switch their production and distribution facilities to supply a closely substitutable product to the customers of the merged firm, without the need for any significant investment of sunk costs in production, distribution or promotions.⁷³

C The United States Approach

The primary merger control provision in the United States is found in section 7 of the Clayton Act 1914 which provides:

That no person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital ... of another person engaged also in commerce or any activity affecting commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.

The 1982 and 1984 United States Guidelines provided that existing production and distribution facilities that could be switched easily and economically so as to produce and sell in a relevant product market within six months (extended to a year in the 1984 Guidelines) would be included but only sales likely to be made or capacity likely to be used would be counted. The 1992 Guidelines, like their New Zealand counterpart, state that market definition focuses solely on demand substitution factors. Supply substitutes

⁷³Australian Draft Merger Guidelines at [2.17].

are considered in the identification of firms that participate in the relevant market and the analysis of entry. Unlike the New Zealand Guidelines, the United States Guidelines use the ssnip test at this later stage. Once the relevant market is defined, firms viewed as participants will include the firms likely to enter rapidly into production or sale of a market product in the market areas in response to a ssnip. A firm, not currently producing or selling the relevant product will be considered a market participant if, in response, to a ssnip, the firm is likely to turn to supplying the market with the relevant product. These supply responses must be likely to occur within one year and without the expenditure of significant sunk costs of entry and exit.⁷⁴ It is interesting to note that these considerations of potential market participants are similar to those in the Australian Guidelines for determination of what supply substitutes will be included in the market definition.

E The European Community Approach

Articles 85 and 86 of the Treaty of Rome address anticompetitive arrangements and abuse of a dominant position respectively but are inadequate to control mergers effectively. Explicit merger control regulation was adopted by the European Community Council in 1989 by regulation 4069/89 on the Control of Concentration Between Undertakings. It focuses entirely on market concentrations and provides that any market concentration that

⁷⁴Sunk costs are the acquisition of costs of tangible and intangible assets that cannot be recovered through the redeployment of those assets outside the relevant market. That is costs uniquely incurred to supply the relevant product and geographic market. a significant sunk cost is one which would not be recouped within one year of the commencement of the supply response.

"strengthens a dominant position as a result of which effective competition would be significantly impeded" is incompatible with the quality of the common market.

In its 1993 Competition Policy Report the Commission stated that supply-side substitutability is normally considered by the Commission under its assessment of possible dominance (that is, potential competition). It is sometimes mentioned under product market definition, but is not generally a sufficient condition for extending the definition of the relevant market.⁷⁵ However cogent evidence on the potential for supply-side substitutability is accepted by the Commission as relevant in determining whether a concentration gives an undertaking the ability to act independently of its competitors. Equally, the complete absence of such material may reinforce a narrow product market definition and a finding of dominance.

In *Continental Can*⁷⁶ it was suggested that supply substitutability exists when the relevant technology is available and when only a minor adjustment into one's production process is necessary to enter the field.⁷⁷ The court recognised that the extent of supply substitutability coming from either captive producers or producers of other types of can was important in determining the relevant market from the point of view of the rules of competition. Difficulties in assessing supply substitutability arise when the relevant technology is not well-developed or where the cost or risk of adaptation is unreasonably

⁷⁵CJ Cook and CS Kerse *EC Merger Control* (Sweet and Maxwell Ltd, London, 1996).

⁷⁶*Continental Can v Commission* [1973] ECR 215.

⁷⁷FL Fine *Mergers and Joint Ventures in Europe: The Law and Policy of the EEC* (2 ed, Members of the Klumer Academic Publishers Group, London, 1994).

large. In *Commercial Solvents*⁷⁸ the court suggested that one product cannot be substitutable for another on the supply side unless the know how necessary to manufacture the former product exists on an industrial scale.

The 1997 Draft Notice states that supply side substitutes whose "effects are equivalent to those of demand substitutes in terms of effectiveness and immediacy" will be included in the market definition. Where supply side substitution is not immediate and would require some additional investment and time, then supply side substitutes will be treated like potential entrants and will not be included in the market definition.

F Supply Side Considerations: Market Definition or Market Power?

Judge Mason and Wilson J claimed in *Queensland Wire* that:⁷⁹

In identifying the relevant market, it must be borne in mind that the object is to discover the degree of the defendant's market power. Defining the market and evaluating the degree of power in that market are part of the same process and it is for the sake of simplicity of analysis that the two are separated.

However, Crowther suggests that the logical approach to take is to define the market on a demand-side basis and consider potential market entrants alongside market incumbents.

⁷⁸ *Istituto Chemioterapico Italiano v Commission* [1974] 1 CMLR 309.

⁷⁹ Above n 25, 50,008. This statement was approved in New Zealand in *Union Shipping NZ Ltd & Anor v Port Nelson Ltd* (1990) 3 NZBLC.

This maintains the strong distinction between actual and potential competition, however quickly the potential competition might be deemed likely to arise. In this way, aspects of potential competition are not subject to the double test of whether they impose an effective restraint or not.⁸⁰

The New Zealand Guidelines appear to adopt this approach by concentrating on demand

From a procedural perspective there are two advantages of a purely demand-side approach. The first is that it allows the initial assessment of competition in a relatively short time span. It is only when demand-substitutes are perceived to be relatively weak or few that one must give consideration to longer term possibilities. Market definition must only be seen as a prelude to a full investigation of the possible costs of acquisition or of the dominance of a particular undertaking.⁸¹ The second advantage from a procedural perspective is that it enables consistency across cases. Where supply-side substitutes are included at the stage of market definition, and then further products are considered in the next stage, (the market participation stage), this means that the market has not been correctly delimited in the first place and may lead to double counting.⁸²

Crowther suggests that a demand-side approach should on the whole give a more useful reflection of the present state of the market. The mere fact that market definition based on demand-side approach does not indicate the true level of substitutability or products in certain circumstances is not a justification for including supply substitutes in every analysis. A manufacturer considering a switch of production techniques to producing a

⁸⁰ Above n 44 181.

⁸¹ Above n 44, 182.

⁸² Above n 44, 182.

new product (or alternatively, entering the market with a new production technique) will need to make the decision very carefully. In particular, it will need to estimate how long the presumed price rise will last.⁸³

The New Zealand Guidelines appear to adopt this approach by concentrating on demand side considerations largely to the exclusion of supply side factors but, at the same time, acknowledging that supply side considerations *may* be included in the market definition process. The Commission in *Goodman Fielder*, in determining a total of 15 relevant markets to the proposed merger, included supply substitution only in the market for the production and acquisition of premium pastry flour market. In most circumstances the amount of product differentiation between types of flour is quite small and the flours could be produced by any of the major millers. However, in the case of premium pastry flour, for which there are no suitable substitutes, and which is more expensive to produce, the number of producers is strictly limited to the current three producers due to the need for a large throughput and modern production techniques.⁸⁴

Crowther suggests that the only justification for including supply side substitutes in the relevant market is the readiness of competition authorities to equate market definition with dominance.⁸⁵ If market definition is to be a useful stage of analysis, it should be

⁸³ Above n 44, 183.

⁸⁴ This flour is milled from the centre of the wheat grain, and so can constitute at most only 8% to 12% of the grain milled.

⁸⁵ This is what Mason J and Wilson J were saying in *Queensland Wire*. See above n 79.

recognised for what it is, namely an initial process of determining what the relevant products for consideration are at the time of analysis. The correct approach to market definition lies in the distinction between actual and potential competition. Any form of supply substitution is an assessment of potential competition, an attempt to determine whether, if (for example) a merger was to go ahead and the merged entity were to start charging monopoly prices, would market forces react to restrict such activity. By contrast, demand substitutability asks the question "what actual products does the customer perceive as being substitutable for the products of the merged entity". The distinction to be made is that by considering demand substitutability one is in effect taking a snapshot of a particular market to determine which existing products are viewed as substitutable at that particular point, whereas if one includes supply-side aspects, one is making predictions as to the way the market is likely to develop, whether in the short, medium or long term.⁸⁶ The New Zealand Guidelines purport to follow Crowther's reasoning. Section 3(9) of the Commerce Act expressly states that when determining whether two or more persons, who are interconnected, are in a position to exercise a dominant influence over the production, acquisition, supply or price of goods or services, regard shall be had to the extent to which they are constrained by potential competitors and suppliers in that market. These are clearly considerations at the later stage of analysis, not at the market definition stage.

Ability to discriminate can arise in a variety of ways. The product may have some special

Ultimately, regardless of whether supply side substitutes are included at the market definition stage or the barriers to entry stage, the result is likely to be the same because of

⁸⁶ Above n 44, 184.

supply elasticity is high under either measure, the merging firms will lack substantial market power. Nevertheless, there are differences in the relevant evidence and perhaps the degree of confidence in the judgements of the Commission.

VI PRICE DISCRIMINATION

The theory of price discrimination enters into market definition when the hypothetical monopolist would have the ability to distinguish customers who continue to purchase the product when the price increases (captive consumers) from customers who stop purchasing or purchase less when the price increases (precarious consumers). If the hypothetical monopolist can discriminate between these customers, for example by their uses or locations, it will have the incentive to charge customers different prices depending on their willingness to pay for the product.

Both the United States and New Zealand Guidelines allow for the examination into the extent of, or potential for, price discrimination within relevant identified markets. The Commission may define smaller relevant markets based on particular uses for a product or service, particular groups of buyers, or buyers in particular geographic regions.⁸⁷

Ability to discriminate can arise in a variety of ways. The product may have some special features that are essential to the purchaser, preventing him or her from switching products. Even when a products or services are identical, a firm's reputation and the reluctance of

⁸⁷Above n 3, 16.

some purchasers to switch from the known and liked, may cause some customers to pay the higher price rather than switch. Ultimately the hypothetical monopolist must be able to identify the customers to whom price can be increased.

If it is simply assumed that a hypothetical monopolist can price discriminate, incorrect conclusions may result. With no price discrimination currently existing, the assumption that a hypothetical monopolist could price discriminate is all the more speculative.⁸⁸ The ability to discriminate will be defeated if customers buying at a lower price engage in arbitrage (buying a product in quantity and reselling it to the other disfavoured consumers. While the ability to discriminate is difficult to prove, it is not impossible to do. However, the Guidelines themselves do not state how the Commission will identify price discrimination.

VII PRODUCT DIFFERENTIATION AND PREMIUM MARKETS

A *Premium Product Markets*

Given that for almost all products there exists a certain amount of brand loyalty, even in a competitive industry there will be a degree of price inelasticity over a certain range of prices. Many manufacturers will have at least a small ability to profit by raising prices above marginal cost. Other imperfections in markets, such as information failures,

⁸⁸ JA Hausner, GL Leonard, CA Veltre "Market Definition Under Price Discrimination" (1996) 64 Antitrust Law Journal 369, 372.

transaction costs, and small geographic market size imply the same result. Small monopoly profits originate from firms sufficiently differentiating themselves from others by making their particular product more attractive to consumers⁸⁹.

Factors to consider in the determination of premium product markets include whether the Merger investigations in the United States suggest that brand reputation and consumer loyalty to brand name products may lead to enforcement agencies recognising either premium product markets or significant entry barriers under the United States Guidelines. In *United States v Gillette Co*⁹⁰, which involved Gillette's proposed takeover of Parker Pen Holdings Ltd, the Justice Department sought a market definition of premium fountain pens, in which the acquisition may substantially lessen competition. Gillette argued that the court could not segregate the market based on price and that the market should include other writing instruments that competed against premium fountain pens. The court ruled that the relevant market consisted of "all premium writing instruments" with retail prices from 40 to 400 dollars.⁹¹ The decision is note-worthy because of the court's willingness to accept a premium product market that excluded lower-priced functional substitutes.

The narrow market approach which results from the step-by-step definition of the market. When determining whether a premium market exists, the existence of different price tiers or price structures among functionally interchangeable products may signal to the enforcement agency that a certain degree of demand inelasticity already exists for the product in the upper price tier. It will then be necessary to assess whether this demand

⁸⁹ Above n 28.

⁹⁰ 828 F Supp 78 (DDC 1993).

⁹¹ Above n 90, 83.

inelasticity is of a degree sufficient to support a "premium" product market definition for the higher price product tier, by applying the ssnip test.⁹²

Factors to consider in the determination of premium product markets include whether the relevant product is a well-established branded product with entrenched consumer recognition; whether significant price differentials between branded and private-label products exist in the market; whether customers face significant switching costs possibly attributable either to actual quality differences or perceived risk in switching to a lesser known brand; whether distributors are reluctant to stock non-established brands; and whether substantial sunk costs in marketing and advertising are necessary to build a competitive brand reputation.⁹³ The presence of these factors in a particular case, of course, must be examined on an individual basis. The Guidelines present a workable framework for identifying and examining them.

B Innovation Issues

The narrow market approach which results from the ssnip test's definition of the "smallest market" in which a hypothetical monopolist could impose a price increase potentially fails to take account of innovative industries. Innovation creates uncertainties about market structure and the course of development. A broader market definition would alleviate the problem of overenforcement by including the spectrum of partial substitutes and emerging

⁹² See discussion in DJ Dadoun and DL Dietrich "After *Gillette*: An Analysis of Premium Product Markets Under the 1992 Merger Guidelines" (1993) 17 *Harvard Journal of Law and Public Policy* 567.

⁹³ Above n 88, 589.

replacements that the "smallest market" approach can ignore. As the ssnip test requires the enforcing agency to begin its investigation by choosing the smallest market in which the firms' products compete it is arguable that the process is biased toward unjustifiably narrow product markets.⁹⁴ Similarly the ssnip test will generally not work for innovation markets because those markets do not have any existing products about which to ask the price increase question.⁹⁵ However, the New Zealand Guidelines state that the Commission will take into account recent developments, and likely future developments, in products and production technology in the process of market definition.

VIII CONCLUSION

The ssnip test was originally a United States test, deriving from a distinct social, commercial and constitutional setting. As such, adaptation into New Zealand competition law should be done with caution. As McGechan J stated "[i]t is the task of this Court to interpret and apply the New Zealand Commerce Act 1986. It is not a matter of importing common law doctrine".⁹⁶ However, the inclusion of the ssnip test in the New Zealand Business Acquisition Guidelines is, in reality, a mere formalisation of a test which was already in use by the Commission and the courts. What the Guidelines do is clarify and harmonise the approach to be taken and provide an insight into Commission practice for

⁹⁴ AC Hruska "A Broad Market Approach to Antitrust Product Market Definition in innovative Industries" 1992) 102 YLJ 305.

⁹⁵ DA Yao and SS Desanti "Innovation Issues Under Merger Guidelines" (1996) 61 Antitrust Law Journal 505, 510.

⁹⁶ *Union Shipping New Zealand Ltd & Anor v Port Nelson Limited* (1990) 3 NZBLC 101,640, 101,645. The statement was made in reference to the essential facilities doctrine.

the business community. The only major variance from past judicial practice is the exclusion of supply side considerations from market definition. Although such a move is justified by separating market definition from market dominance considerations, the Guidelines do not rule out the possibility of including supply side factors in the market definition process if the analysis of the particular market requires a more supply side focus. The fact that the Commission has considered supply side factors in decisions subsequent to the publication of the Guidelines indicates that the Guidelines have, in reality, done little to alter judicial tendency to include supply side factors in the market definition. The Guidelines have allowed considerable flexibility in the application of the ssnip test. Any potential problems which may arise with respect to the size of the hypothetical price increase, the duration of the hypothetical price increase, less than competitive prevailing price levels and price discrimination have been addressed by the Guidelines which allow adaptability to diverse circumstances. In effect, the inclusion of the ssnip test in the Business Acquisition Guidelines has brought New Zealand into line with other major jurisdictions with no significant consequences for current practice in market definition.

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