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Proposed changes to the SLC test

Economic considerations

RBB Economics[1]

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1 Summary

RBB Economics welcomes the opportunity to make this submission in response to the release by Treasury on 24 July 2024 of the exposure draft of the *Treasury Laws Amendment Bill 2024: Acquisitions* along with Exposure Draft Explanatory Materials (referred to here as "the EM"). It supports the stated goal of ensuring that explicit emphasis is placed on economic methodology and competitive effects when assessing mergers. In our view, such emphasis will help deliver the Government's overriding policy objective of making our merger approval system faster, stronger, simpler, more targeted and more transparent.

If implemented, the range of procedural and substantive changes set out in the Bill would represent a major overhaul of our merger approval system. Notably, the proposed legislation dispenses with the existing framework for merger review and replaces it with a single mandatory and suspensory administrative system for acquisitions, with the Australian Competition and Consumer Commission (ACCC) as the first instance administrative decision-maker.[2] It also proposes amending the meaning of the substantial lessening of competition (SLC) test that lies at the heart of the Competition and Consumer Act 2010 (CCA) and replacing the existing merger factors in section 50(3) of the CCA, which list the matters that must be taken into account when assessing the competitive effects of a merger, with a new set of what are described as Relevant Matters.

[1] RBB Economics advises a number of digital platform service providers but is not advising them on any issues relating to the proposed changes to the merger laws in Australia. The views in this submission are the independent views of RBB Economics.

[2] EM, para 1.0.

This submission focuses on three economic aspects of the proposed amendments to the SLC test and the introduction of the Relevant Matters. Those comments are summarised below and expanded on in the remainder of this submission.

- First, without providing any evidence that the existing SLC test is no longer fit for purpose, the Bill proposes altering the test to explicitly include the creation, strengthening or entrenching of a substantial degree of market power.[3] While couched as a mere clarification, the proposed amendment may have unintended consequences and may create an irresistible temptation for the ACCC to focus on structural features and (preexisting) market power, rather than to engage in a proper competitive assessment that enquires into whether the competitive process will actually be adversely affected as a result of the merger. This risks creating a per se prohibition on any acquisition by a dominant firm and signal an unwelcome intention to move back towards a focus on purely structural features. While this may be Treasury's intention, it is inconsistent with its objective of placing explicit emphasis on competitive effects. We expand on these risks in section 2 of this submission.

  And while the meaning of terms such as "creating" or "strengthening" may be familiar to all of us who are old enough to remember the criteria that applied to mergers before the SLC test was introduced, the meaning of "entrenching" is less clear. Recent experience in Australia (in the context of digital platforms), the United States, and Europe suggests that the term "entrenching" is intended to capture scenarios when a particular acquisition might be aimed at ensuring that the market power that a firm holds endures; that is, it allows the firm to remain insulated from competitive constraints. While such a merger could certainly harm the competitive process and prevent prices returning to competitive levels, that harm should already be captured by the existing test and risks setting a much lower intervention threshold for mergers (particularly for some types of non-horizontal mergers) than is the case under the current interpretation of the SLC test. This could prevent pro-competitive acquisitions being put in effect simply because they make life harder for rivals.

- Second, we argue in section 3 that there are considerable further risks in extending the broader definition of SLC to other parts of the CCA, including to the Misuse of Market Power prohibition. One of the perceived risks is that it could make winning on merit a misuse of market power simply because it makes it harder for rivals to compete.

- Third, section 4 argues that the wholesale replacement of the existing merger factors with a new set of unclear and untested Relevant Matters, imported from other jurisdictions, should be deferred to a later stage when consultation on detailed guidelines can also be undertaken. That would allow a holistic view about the matters that the ACCC should consider when exercising its discretion to be set out clearly and explained through detailed guidance.

2 Creating, strengthening or entrenching market power

Consideration of the phrase "creating, strengthening or entrenching" substantial market power benefits from a very brief recapitulation of reasons for the move away from a dominance test in Australia and the European Union (EU) (to an SLC test, or a significant impediment to effective competition or SIEC test in the EU).

2.1 Moving from dominance to SLC (and SIEC)

In Australia, although an SLC test was used to assess mergers when the CCA (or the then Trade Practices Act) was enacted in 1974, it was changed in 1977 to a dominance test. The reason for that was to allow

[3] A "substantial degree of power in the market" is referred to simply as "market power" for the purpose of brevity in this submission.

more mergers to take place, so that Australian firms could achieve economies of scale and improve international competitiveness.[4]

Under a dominance test, mergers were only prohibited where they resulted in or substantially strengthened a 'position to control or dominate a market'. A former Chair of the ACCC, Allan Fels, explained that, in Australia at least, the dominance test, by only prohibiting mergers that created or enhanced dominance, failed to prevent a significant category of mergers that were likely to substantially lessen competition, namely those that raised issues regarding coordinated effects.[5] As a result, in 1993, the merger test in Australia changed back from "dominance" to "SLC". The effect of that was to widen the scope of the test to capture not only those mergers that created a clear position of dominance, but also those that gave rise to anti-competitive effects through coordinated effects as well as those that substantially lessened competition as a result of what economists refer to as "non-collusive oligopolies" (that is, mergers that led to unilateral effects concerns that could apply even when the merging firm would not achieve a clear position of dominance).

In the EU, the move from a dominance test to a significant impediment to effective competition or SIEC test occurred in 2004 as part of the EU's attempt at instituting a wider set of procedural and substantive reforms. Prior to 2004, the relevant test when assessing mergers in Europe was whether the merger would "create or strengthen a dominant position as a result of which effective competition would be significantly impeded". The question at the time of those reforms in Europe was whether that test gave rise to an enforcement gap in oligopolistic markets. That gap concerned mergers that could result in prices being raised above the pre-merger level even if they do not create a post-merger firm that enjoys a clear position of dominance. The 2004 changes were seen to close that gap.

2.2 Does the SLC already capture "create and strengthen"?

What seems clear is that, both in Australia and in the EU, the relevant test when assessing the competitive effects of mergers initially only captured those mergers that created a post-merger firm that enjoyed a clear position of dominance – that is, those mergers that created or strengthened substantial market power – but was then widened to capture mergers that harmed competition even if the market position of the merged entity fell short of dominance (that is, by including non-collusive oligopolies under both regimes) and, in Australia specifically, by also capturing coordinated effects.[6]

When, for example, discussing its approach to assessing unilateral effects in its Merger Guidelines, the ACCC makes it clear that the existing SLC test should be capable of capturing mergers that create or strengthen a substantial degree of market power as well as cases where the post-merger market shares fall short of the level that would create a clear dominant position. It states, for example, that the most obvious way for unilateral effects to arise is when a merger creates a dominant firm (a merger to monopoly),[7] but then adopts language that could be applied to capture mergers that create a firm that does not meet the threshold of dominance. For example:

- in markets involving homogeneous products with no dominant firm, competition analysis focuses not just on the market shares of the merging firms and the extent to which those shares exceed a particular concentration threshold but also on the strategic interaction between rivals competing on output or capacity. In that context, unilateral effects may arise where the merged firm sets it post-merger output

[4] Fels, Allan, "The change from a dominance to a substantial lessening of competition test in Australia's merger law", 2002 Fordham Corporate Law Institute Conference, 2002, p. 8.

[5] Mergers can give rise to coordinated effects when they assist firms in the market in implicitly or explicitly coordinating their pricing, output or related commercial decisions – see ACCC Merger Guidelines, para 6.1.

[6] Coordinated effects were captured in the EU even before the 2004 reforms.

[7] Merger Guidelines, para 5.6.

level significantly below the level of output that would have prevailed absent the merger, and despite the response of competitors, brings about a higher price than would have prevailed absent the merger.[8]

- In markets where competition between firms selling differentiated products is based on price, unilateral effects may arise where a merger between firms previously supplying close substitutes results in an increase in the price of either or both of the close substitutes.[9] In these sorts of markets, unilateral effects are more likely to arise if the merging parties are particularly close competitors, meaning that before the merger a relatively large share of customers would switch from one of the merging parties to another in the event of a price increase.

This suggests that including the terms "creating" or "strengthening" into the legislation is both unnecessary and risky. It is unnecessary because the SLC test in Australia (and the SIEC test in the EU) should already be capturing mergers that lead to a clear dominant position. It is risky, because defining SLC to explicitly include those terms may create an irresistible temptation for the ACCC to focus on structural features and (preexisting) market power, rather than to engage in a proper competitive assessment that enquires into whether the competitive process will actually be adversely affected as a result of the merger. This risks creating a per se prohibition on any acquisition by a dominant firm and signal an unwelcome intention to move back towards a focus on purely structural features.

2.3 Is "entrenching" different to "creating" or "strengthening"?

While the terms "creating" and "strengthening" market power can be traced back to the old dominance test and may have been included in the proposed amendment to remind decision-makers that the SLC test is clearly capable of capturing mergers that create a clear dominant position, the term "entrenching" is new and, therefore, less well-understood.

This uncertainly may be caused by a lack of consensus about what the term "entrenching" means. Three recent examples from Australia, the EU and the United States (US) suggest that the proposed amendment may be aimed at addressing a very specific concern.

In September 2023, the ACCC released the seventh interim report in its five-year Digital Platform Services Inquiry. That report considered the expanding ecosystems of providers of digital platform services in Australia. It noted that digital platform service providers such as Alphabet (Google), Amazon, Apple, Meta and Microsoft have "core" services that represent significant sources of revenue or market position and flagged the risk that those firms may expand into services adjacent to or complementary to those core markets.

The ACCC noted that such an expansion into adjacent or complementary markets can provide benefits to consumers. Those benefits include increased convenience and quality improvements. A consumer with an Apple iPhone, for example, may enjoy the ability to send and receive texts and emails on their Apple Watch when they are not able to access their iPhone. However, the ACCC also noted that there was a risk that expansion into those markets may be driven by a desire to protect a position of market power or extend a position of market power into new markets. This could occur by raising barriers to entry and expansion or engaging in other behaviour that could have an exclusionary effect on actual or potential rivals.

[8] Merger Guidelines, para 5.8.
[9] Merger Guidelines, para 5.9.

Despite warning about the potential harm that might arise when digital platform service providers expand into other markets, the ACCC did not make specific findings of anti-competitive conduct, noting instead that:[10]

> *"…when a digital platform service provider has market power in one or more markets, certain behaviours may have a higher risk of harming competition. In particular, there are risks associated with the expanding ecosystems of digital platform service providers, and how barriers to entry and expansion may be increased in core and related markets, ultimately impacting rivals' ability to effectively compete to the detriment of consumers."*

At the same time that the ACCC released its Interim report into the expanding ecosystems of providers of digital platform services, the European Commission prohibited the proposed acquisition of Flugo Group Holdings AB ('eTraveli') by Booking Holdings ('Booking').

Booking and Etraveli operate as online travel agents (OTAs). Booking is focused on accommodation services, whereby it operates a platform connecting hotels that seek to offer rooms to consumers with consumers looking to book hotel rooms. Etraveli provides a similar service in respect of flights, allowing airlines to access travel consumers, and consumers to book flights with airlines. Booking is the leading accommodation OTA in Europe, albeit competing against dozens of rival accommodation OTAs, while Etraveli has a moderate market position in flight OTA amongst a number of similarly sized rivals.

According to the European Commission, the acquisition would have allowed Booking to entrench or strengthen its dominant position on the market for hotel OTAs in the European Economic Area ('EEA').[11] The EC's concern was that:

> *The transaction would have allowed Booking to expand its travel services ecosystem, which revolves around its hotel OTA business. A flight OTA product is a crucial growth avenue in this ecosystem as it would generate significant additional traffic to Booking's platform. This is because, among the different travel OTA services, flights have the highest chance to lead to the cross-selling of accommodation. These would have allowed Booking to benefit from existing customer inertia because a significant share of these additional consumers would have stayed on Booking's platforms. Therefore, the transaction would have made it more difficult for competitors to contest Booking's position in the hotel OTA market.*
>
> *By increasing traffic to and sales by Booking's platforms, the transaction would have reinforced network effects and increased barriers to entry and expansion, making it harder for competing OTAs to develop a customer base capable of supporting a hotel OTA business. OTAs currently on a path to become full-fledged competitors may not be able to do so if the transaction goes ahead.*

Moreover, the revised Merger Guidelines issued by the U.S Department of Justice (DoJ) and the Federal Trade Commission (FTC) include a new guideline which states that mergers can violate the law when they entrench or extend a dominant position. When considering that, the new guideline states that the DoJ and FTC will examine whether one of the merging firms already has a dominant position that the merger may reinforce, thereby tending to create a monopoly. They also examine whether the merger may

[10] ACCC, Ecosystems report (Interim Report 7), p 6.
[11] The European Commission reported that Booking did not offer remedies that were sufficient to address its concerns.

extend that dominant position to substantially lessen competition or tend to create a monopoly in another market. Two specific examples are provided in the revised Merger Guidelines of how a firm may entrench its dominant position.

- First, **by creating or enhancing barriers to entry or expansion by rivals that limit the capabilities or competitive incentives of other firms**. The Guidelines suggest that barriers to entry can entrench a dominant position even if the nature of future entry is uncertain, if the identities of future entrants are unknown, or if there is more than one mechanism through which the merged firm might create entry barriers. This may happen by the dominant firm trying to increase switching costs (for example, by reducing interoperability), by interfering with the use of competitive alternatives,[12] or by depriving rivals of scale economies or network effects.
- Second, **by eliminating a nascent competitive threat**. A merger may involve a dominant firm acquiring a nascent competitive threat – namely, a firm that could grow into a significant rival, facilitate other rivals' growth, or otherwise lead to a reduction in its power.

2.4 What mischief is being addressed?

While the discussion above confirms that there has been increased chatter around entrenchment concerns and the related ecosystem theories of harm, there is no consensus yet in Australia around whether these are new or just a slight reframing of existing concerns. That lack of consensus would suggest that there is a need for caution before amending the legislation to explicitly define SLC to include entrenching market power, at least until the issue is better understood.

Those recent cases, inquiries and reviews provide some strands of a theory that can be pulled to together to explain what entrenchment or ecosystem concerns might be. Some of those strands are concerned primarily with the ability of a dominant firm to protect – either by an acquisition or by conduct (discussed in the next section) – its position of dominance. The acquisition or conduct will often happen in an adjacent market. The effect of the acquisition or conduct may be exacerbated by network effects or other characteristics which are commonly found in digital platform markets. And while rivals may struggle to expand or challenge the firm's dominance as a result of the acquisition or conduct, consumers may well benefit following the acquisition or conduct.

An obvious problem when trying to pull together these strands is that the concern may be too wide ranging and any legislation that bluntly defines it as an SLC will intrude on the ability of firms to pursue their legitimate commercial objectives by making products and services that consumers value and which enable them to beat competitors and win market share.

One area in particular that would be worth exploring before rushing to legislation is the extent to which there is actually a gap in the law in addressing these types of concerns. Given that concerns around "entrenchment" typically relate to mergers happening across different markets, the starting point is to consider how authorities assess non-horizontal mergers.

In Australia, for example, the ACCC's Merger Guidelines explain how it approaches non-horizontal mergers, which include vertical mergers and conglomerate mergers. (A reminder: vertical mergers are mergers that involve firms that operate at different stages of a single vertical supply chain (for example, a merger between an upstream manufacturer and downstream distributor); conglomerate mergers, on the other hand, involve firms that interact across several markets.)

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[12] The example provided in the Guidelines is when a dominant position may be threatened by a service that customers use to work with multiple providers of similar or overlapping bundles of products and services. If a dominant firm acquires a service that supports the use of multiple providers, it could degrade its utility or availability or could modify the service to steer customers to its own products, entrenching its dominant position.

The types of concerns discussed in section 2.3 above are more likely to arise in respect of a conglomerate merger which provides a merged firm with the opportunity to bundle or tie products in related or independent markets. While the ACCC in its Guidelines acknowledges that bundling and tying are ubiquitous practices, often with no anti-competitive effects, it notes that such practices may enable the merged firm to alter its operations or product offerings in a way that forecloses the merged firm's rivals and ultimately reduces the competitive constraint they provide. It explains that the merged firm's rivals may be foreclosed if the merged firm chooses to bundle or tie complementary products such that:

- no product can be purchased or used separately;
- at least one product cannot be purchased or used separately; or
- customers receive additional benefits when they purchase or use the merged firm's products together (for example, due to discounts, rebates or design features).[13]

The analytical framework that the ACCC proposes to apply to assess conglomerate effects is to apply a framework based on "ability, incentive and effect" when assessing whether a merger is capable of foreclosing rivals. That is, it assesses whether:

- the merged firm would have market power in the relevant market – including whether the products are considered by customers to be especially important or a "must have" because of factors such as superior functionality – and, as a result, is able to operate free of effective constraints (ability);
- whether it is profitable for the merged firm to engage in a foreclosure strategy (incentive);
- whether the foreclosure of rivals will have a detrimental effect on competition (effect).

The ACCC also discusses an additional factor which it suggests may be relevant in the context of conglomerate mergers, namely:[14]

> *… the proportion of customers likely to purchase the relevant products from the merged firm. This must be sufficiently large to cause independent rivals to face a significant decline in sales, resulting in increased costs. The level of competitive constraint imposed by rivals may be detrimentally affected where economies of scale or network effects are important features of the relevant markets, since foreclosure may prevent the merged firm's rivals from achieving minimum efficient scale.*

What the ACCC's approach suggests is that the concern with conglomerate mergers is often about the extent to which they lead to foreclosure that prevents the merged firm's rivals from effectively competing in the relevant market. For example, suppose a firm that was dominant in the supply of meat pies merged with a firm that supplied tomato sauce and began offering an attractive bundle of pies and tomato sauce to consumers. The ACCC's approach to conglomerate effects would be to first assess whether the supplier of meat pies had a substantial degree of market power, then to consider whether it had the incentive to foreclose third party suppliers of tomato sauce, and finally to consider whether those rival sellers of tomato sauce would be foreclosed from the market and enable the merged firm to increase the price of tomato sauce above the competitive level.

What the case studies presented in section 2.3 of this submission suggest is that the mechanism of harm under an "entrenching market power" theory of harm is different. The concern in the meat pie example is

[13] Merger Guidelines, para 5.26.
[14] Merger Guidelines, para 5.42.

that merger involving the dominant supplier of meat pies is motivated by the view that the dominant supplier of meat pies' integration with a supplier of tomato sauce will make it harder for rival suppliers of meat pies to challenge its dominance in the market for meat pies or by a concern that the supplier of tomato sauce might otherwise have entered the market for the supply of meat pies and challenged its dominance. The risk isn't that the merger harms rival suppliers of tomato sauce but protects or entrenches market power in the market for meat pies.

Whether "entrenchment" theories of harm can be captured by the existing analytical framework used by the ACCC to assess conglomerate effects is an important question that should be answered before changing the definition of the test. That framework should be flexible enough to deal with any potential competition concerns from the hypothetical merger between a supplier of meat pies and a supplier of tomato sauce but may come under strain when dealing with mergers involving strategic behaviour over time. Whether that strain means that the existing regime has reached breaking point and that a new enforcement gap has opened up, meaning that an overly permissive stance is being taken to mergers involving firms with market power, has yet to be definitely proven.

In our view, the question of whether the existing frameworks can handle entrenchment or ecosystem concerns is one that should be allowed to play out in Australia rather than rushing to close an enforcement gap that does not demonstrably exist. It is important, in our view, to reiterate that in its inquiry into digital platform ecosystems, the ACCC did not make a single finding of anti-competitive conduct in its market study of digital ecosystems and simply noted that when a digital platform service provider has market power in one or more markets, certain behaviours *may* have a higher risk of harming competition.

To the extent that "entrenchment" is found to be a separate means to SLC that cannot be captured in the existing framework, an alternative approach to changing the definition of an SLC in the CCA would be to include the risk of "entrenching" market power as one of the merger factors in the CCA.[15] Such an approach would nonetheless first require detailed guidance to be provided in the next iteration of the Merger Guidelines, and for a debate to take place about the existence of an enforcement gap during the consultation on those guidelines. Those guidelines will need to set out how the ACCC will determine which mergers are capable of entrenching market power in a way that prevents other firms from providing a meaningful constraint to the firm with substantial market power in its core market. Importantly those guidelines will also need to set out how the ACCC will balance the pro-competitive benefits of such mergers (such as mergers that lead to product improvements, cost efficiencies and which promote inter-operability of devices that make the consumer's life easier) and the potential harm to competition caused by some rivals finding it harder to compete and grow in the market.

3 Extending the SLC (with create, strengthen and entrench) to other parts of the Act

Our second comment relates to the proposal to extend that broader definition of SLC across the CCA. This means that provisions such as the misuse of market power provision would be affected. The EM states that:

> *The amendments to section 4G are intended to increase the focus on the market power of the parties to the acquisition and clarify that even an incremental change in market power, may still amount to a substantial lessening of competition if the acquisition (or other act, for*

[15] This could either form part of the existing factors, or following a period of meaningful consultation, a set of new factors or Relevant Matters.

provisions other than the acquisitions provisions) strengthens the acquirer's market power (that is, their ability to act with a degree of freedom from competitive constraints) or protects their market power in an enduring way. In addition, establishing a position of substantial market power in another market that the acquirer (or relevant business) previously did not operate in, may also constitute a substantial lessening of competition depending on the characteristics of the parties involved or nature of the market.

In our view, applying the new definition to all parts of the CCA could fundamentally affect the outcome of the test, particularly with regard to the misuse of market power prohibition and create a chilling effect on competition.

All firms in Australia – even those with a substantial degree of market power – are able to pursue their lawful and legitimate commercial interests. Those interests include engaging in conduct that can grow their market share and capture sales and margins from rivals. That conduct may be developing new products or services that consumers can bundle with existing products or services, or reducing prices to deal with periods of excess capacity. If firms are successful, they will make life harder for their competitors and their position in the market may be "strengthened" or "entrenched".

Including the term "strengthen" or "entrench" explicitly into the definition of SLC and applying it to section 46 risks creating a chilling effect on competition through persuading firms to compete less aggressively for fear of section 46 intervention.

This concern echoes the debate that raged at the time of the proposal to change from the old "take advantage" test for section 46 to the current "effects test". Our position then was to support the introduction of the effects test.

We noted at that time that some of the prominent objections to an effects-based test[16] saw an effects-based test as synonymous with a law that condemns firms with market power whenever they succeed in competition – i.e. when they beat competitors and win market share. We argued that if an effects-based test were interpreted in this way, then that would indeed be a serious problem. But our view was that section 46 exists to prevent the unilateral exercise of market power from leading to anti-competitive outcomes that are inefficient and adversely affect consumer welfare and that an effects-based test – that is, one that focuses on those outcomes and intervenes only where adverse effects arise (or are likely to arise) – could meet this policy objective.

The current proposal risks bringing that problem back to the fore and would risk making winning on merit a misuse of market power simply because it makes it harder for rivals to compete.

In our view, the existing definition of SLC should not be changed, and can continue to apply consistently across the Act. If any change is made, further guidance in the legislation should be provided to make clear that pro-competitive conduct that harms competitors through the superior efficiency of the firm with market power should not be categorised as creating an SLC.

[16] For example, Samuel, G. and King, S. (12 August 2014). The effect of the ACCC's ambitions is dangerous. The Australian Financial Review, p. 47.

4 The need for detailed guidelines to explain the Relevant Matters in the exposure draft

Our final comment relates the replacement of the existing merger factors contained in section 50(3) of the Act with a new set of what are described as Relevant Matters. The EM states that the Relevant Matters are designed to guide the ACCC's discretion when determining whether or not to approve a merger.

We can see the need for some high-level principles to be included in the legislation to guide the ACCC's discretion when determining whether or not to approve a merger. However, it is not clear why the existing merger factors contained in section 50(3), which largely contain terns that have economic meaning, should be entirely discarded and replaced with terms from another jurisdiction, and which lack any clear economic meaning or local context.

If Treasury is serious about introducing the Relevant Matters into the legislation in Australia, then detailed guidelines should have been produced and been exposed to consultation alongside the changes to the legislation discussing how those factors will be given effect in Australia. This would have led to meaningful consultation on the Relevant Matters.

In our opinion, a wholesale replacement of the existing merger factors with a new set of unclear and untested Relevant Matters imported from other jurisdictions without any clear justification should be deferred to a later stage when consultation on the detailed guidelines can also be undertaken. That would allow a holistic view about the matters that the ACCC should consider when exercising its discretion to be set out and clearly explained through detailed guidance.