Merger Review: An overview of the analytical framework utilised in South Africa

Background

The South African Competition Act came into force in September 1999. Prior to this South Africa had a very weak merger review system – notification was not required and the decisions of the Competition Board had the status of advisory opinions to the responsible Minister (the Minister of Trade and Industry).

The Competition Act of 1999 has introduced a considerably strengthened merger review system. Prior notification of all mergers beyond a specified threshold is obligatory and mergers may not be implemented until they have been approved by the Commission (if 'intermediate mergers'), or the Tribunal (if 'large mergers'). Mergers which fall below the notification threshold ('small mergers') are nevertheless still subject to the jurisdiction of the Competition Act – that is, while they do not have to be notified, the Commission may nevertheless elect to investigate a 'small merger' and, in the event that the transaction fails the tests specified in the Act, the Commission may approve, prohibit or impose conditions on the transaction. If parties to a small merger wish to have their merger cleared prior to implementation then they may voluntarily notify their transaction to the competition authorities.

Note that mergers falling above the specified threshold for compulsory notification are notified to the Competition Commission – the investigative and prosecutorial wing of the triad of authorities established by the Competition Act. Those mergers that fall below a second specified threshold – 'intermediate mergers' - are investigated by the Commission that may then elect to prohibit the merger or to approve it with our without conditions. The decision of the Commission may be appealed to the Competition Tribunal. However, in the case of mergers that exceed this second specified threshold – 'large mergers' – the result of the Commission's investigation takes the form of a recommendation to the Tribunal that may accept, reject or amend the recommendations of the Commission. In other words the Commission may recommend approval of the transaction but this recommendation may not pass muster with the Tribunal that may then either impose conditions on the transaction or prohibit it outright. By the same token the Commission may recommend the prohibition of the transaction while the Tribunal may decide to approve it. Hence in the case of small and intermediate mergers the Tribunal acts as an appeal body; in the case of large mergers the Tribunal is the original decision-making body. Decisions of the Tribunal – in respect of all categories of merger – may be appealed to the Competition Appeal Court, a special division of the High Court. In marked contrast with the previous regime, there is no ministerial override of decisions of the competition authorities.

Substantive Tests

Section 12 of the Competition Act provides three broad tests that the investigative and adjudicative authorities must administer when considering a merger.

Section 12A(1) provides:

12A. Consideration of Mergers

(1) Whenever required to consider a merger, the Competition Commission or Competition Tribunal must initially determine whether or not the merger is likely to substantially prevent or lessen competition, by assessing the factors set out in subsection (2), and—

(a) if it appears that the merger is likely to substantially prevent or lessen competition, then determine—

(i) whether or not the merger is likely to result in any technological, efficiency or other pro-competitive gain which will be greater than, and offset, the effects of any prevention or lessening of competition, that may result or is likely to result from the merger, and would not likely be obtained if the merger is prevented; and

(ii) whether the merger can or cannot be justified on substantial public interest grounds by assessing the factors set out in subsection (3); or

(b) otherwise, determine whether the merger can or cannot be justified on substantial public interest grounds by assessing the factors set out in subsection (3).

In summary, the authorities must determine:

- First, whether or not the merger is likely to *substantially prevent or lessen competition*;
- Second, if it is decided that the merger *will* lessen competition, then it much be decided whether or not the merger will result in *'technological, efficiency or other pro-competitive gains'* that will outweigh the anti-competitive effects of the merger;
- Third, and regardless of the outcome of the evaluation of the competition impact of the merger, a *public interest* test must be administered. In other words, even if the merger passes muster on the competition evaluation, it will still have to be assessed on public interest grounds.

The Competition Test

Section 12A(2) provides

12A. Consideration of Mergers

(2) When determining whether or not a merger is likely to substantially prevent or lessen competition, the Competition Commission or Competition Tribunal must assess the strength of competition in the relevant market, and the probability that the firms in the market after the merger will behave competitively or co-operatively, taking into account any factor that is relevant to competition in that market, including—

(a) the actual and potential level of import competition in the market;

(b) the ease of entry into the market, including tariff and regulatory barriers;

(c) the level and trends of concentration, and history of collusion, in the market;

(d) the degree of countervailing power in the market;

(e) the dynamic characteristics of the market, including growth, innovation, and product differentiation;

(f) the nature and extent of vertical integration in the market;

(g) whether the business or part of the business of a party to the merger or proposed merger has failed or is likely to fail; and

(h) whether the merger will result in the removal of an effective competitor.

In the main, the competition evaluation is working effectively. Although our abuse of dominance provisions do specify a market share test for establishing dominance, merger assessment uses a 'substantial lessening of competition' test. This has enabled the authorities to take an appropriately flexible approach in their evaluation of mergers. However, the flexibility implicit in the 'substantial lessening of competition' test has not generated uncertainty. In particular, the explicit listing in the act of the key criteria that must be factored into the competition evaluation has aided both merging parties and the competition authorities in focusing their enquiry and in injecting a requisite degree of certainty into an evaluation mechanism that must allow for flexibility.[1]

The competition test traverses fairly standard terrain. The authority is required to evaluate the present strength of competition in the market and then to ask itself whether the transaction will lessen that competition. The competition analysis is then preceded by an identification of the relevant market. This stage of the analysis then naturally reveals market share and allows for the use of standard empirical measures of concentration. The authorities use these as indicative measures of the transaction's impact on competition.

Having defined the relevant market and, in the process, arrived at indicative estimates of the merger's impact on concentration, the authorities are then required to do the competition evaluation. In undertaking this evaluation the authority is guided by a non-exhaustive list of factors that must be considered. These include all the usual suspects – barriers to entry, import competition, history of collusion, vertical integration, etc. Of some interest is the inclusion of the 'failing firm' argument in the competition assessment.[2]

In South Africa's 30 months experience of merger evaluation the competition assessment has tended to determine the outcome of the investigation. That is, where a merger has been found to lessen competition it has either been prohibited or it has had conditions imposed upon it that are designed to ameliorate the negative impact on competition; where the merger has been found to be pro-competitive (that is, to have no negative impact on competition), the merger has been approved. In one instance, the Tribunal found that pro-competitive gains arising from the merger countervailed a lessening of competition and the merger was approved.[3] In several instances a pro-competitive merger has been approved with conditions designed to ameliorate negative impacts on the public interest.

As noted, in several instances the anti-competitive consequences of a merger have been ameliorated by the imposition of conditions. These again have been standard conditions – either an instruction to divest specified assets or to license specified trademarks or other intellectual property. In rare cases

[1] The criteria listed in Section 12A(2) perform a function similar to a set of guidelines albeit at a high level of generality. Once the Commission has the requisite experience it will undoubtedly publish more detailed guidelines – it already uses an internal guideline in its investigative activity.

[2] In other words possible failure, unlike 'efficiency', is not a defence but is rather part of the substantive competition evaluation. The 'failing firm' issue has reared its head in several important decisions. See Schumann Sasol (S A) (Pty) Ltd and Price's Daelite (Pty) Ltd case no.: 23/LM/May01 where the transaction was prohibited despite assertions by the part that the target firm was failing – this decision is presently on appeal to the Competition Appeal Court. See also ISCOR Limited & Saldanha Steel (Pty) Ltd case no.: 67/LM/Dec01 where a large steel merger was approved largely because the Tribunal accepted that, absent the merger, the target firm would fail.

[3] Trident Steel (Pty) Ltd and Dorbyl Limited case no.: 89/LM/Oct00

behavioural conditions have been imposed – for example, a requirement to deal in a non-discriminatory manner.[4]

The Efficiency Test

Section 12A(1)(a)(i) (see above) provides that where the relevant competition authority decides that a merger is likely to substantially prevent or lessen competition it must then determine whether or not the transaction will result in any efficiency gains. In other words, merging parties may successfully defend an anti-competitive merger by demonstrating countervailing gains in efficiency.

The standard efficiency claims presented by merging parties to the authorities relate to cost savings derived from rationalisation of certain services, frequently managerial, administrative or distribution services. The authorities have tended to accord a low weight to these claims – the evidence is usually scant and highly speculative. Efficiencies are also often conflated with claimed gains projected in international competitiveness which are proxied by an enhanced ability, post merger, to penetrate international markets. This – see below – is actually one of the public interest defences that may be mounted in defence of an anti-competitive merger. Accordingly, merging parties sometimes take three bites at the efficiency cherry – first, in the substantive competition analysis where the competition authorities are obliged to consider 'the dynamic characteristics of the market, including growth, innovation and product differentiation; second, in the efficiency defence itself; and third in the consideration of the public interest evaluation.

In one instance the Tribunal has permitted a merger that it found to lessen competition on the grounds that it nevertheless promoted efficiency. Here, on an unusual set of facts, the merging firms were able to show that with the merger they could re-organise the manner in which both used existing plant capacity that brought down production costs significantly and that this could not have been achieved by either firm in the absence of the merger. It was thus both a merger specific and a dynamic efficiency. The Tribunal held that it was not necessary for the parties to show that the efficiency gains be passed on to consumers. The Tribunal suggested, without deciding this point, that where the efficiencies were static efficiencies then evidence of pass-through might be necessary for them to be cognisable.

The balancing of competition and efficiency has created considerable conceptual difficulty largely because a substantial lessening of competition is resisted precisely because of its negative impact on efficiency – the competition/efficiency balance thus seems to imply the balancing of one sort of efficiency against another. The nature of these different types of efficiency is, of course, not clarified by the Act. It appears that the distinction cannot simply be conflated with the distinction between static, allocative efficiency

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[4] There are numerous examples – see <u>Unilever Plc & Robertsons Foods (Pty) Ltd case no.: 55/LM/Sep01</u> for example of structural conditions and <u>Astral Foods Ltd and National Chick Limited case no.: 69/AM/Dec01</u> for example of behavioural conditions.

(compromised by a substantial lessening of competition) versus dynamic, productive efficiency (promoted by certain mergers). As noted the authorities are clearly required to include an assessment of the dynamic consequences of the merger in our substantive competition evaluation.

The upshot is that the competition authorities have tended to adopt a cautious, sceptical approach to efficiency claims – they are effectively most receptive to claims that a merger will promote dynamic efficiency, that the merger will, for example, boost R&D and result in the introduction of new products or processes. We should add that foreign jurisprudence – including that emanating from Canada, from whom we lifted our efficiency defence – has not helped us any.

We understand that in certain jurisdictions – the USA, for example – the analysis of efficiencies is incorporated into the competition analysis. As noted, our efficiency analysis is undertaken in the form of an assessment of a defence to an anti-competitive merger. Although, on the face of it, there does appear to be a significant difference between the two approaches, our task would probably be eased by incorporating the analysis of efficiencies into the substantive competition evaluation where they would have the status of one of a number of factors to be considered in the competition evaluation rather than that of a defence to be considered in relation to the outcome of the entire competition evaluation.

Public Interest

The authorities are then required to assess the transaction's impact on specified elements of public interest. The public interest evaluation must be undertaken regardless of the outcome of the competition evaluation – that is, regardless of whether or not the merger is found to lessen competition.

Section 12A(3) specifies the public interest test:

12A. Consideration of Mergers

(3) When determining whether a merger can or cannot be justified on public interest grounds, the Competition Commission or the Competition Tribunal must consider the effect that the merger will have on—

(a) a particular industrial sector or region;

(b) employment;

(c) the ability of small businesses, or firms controlled or owned by historically disadvantaged persons, to become competitive; and

(d) *the ability of national industries to compete in international markets*.

The South African legislation on public interest is unusual in certain key respects:

- First, the inclusion of a public interest test is unusually explicit and, simultaneously, confined by Section 12A(3) to a set of specific criteria;
- Second it may, and in the case of the employment considerations, is manifestly intended to, give the competition authorities the power to prohibit or impose conditions upon a merger that passes muster on competition grounds;[5]
- Third, it is the competition authorities – rather than a Minister or some other representative of the public – that is required to make the public interest judgment. Note however, that the Act does require that the Minister of Trade and Industry (or, in particular cases, other directly affected Ministers) be served with a copy of the merger notification in order to enable them to plead their case before the competition authorities.

Again the authorities have tended to take a cautious approach to public interest pleas. The view of the Tribunal – articulated in two recent mergers – is that each public interest afforded protection in the Competition Act is more comprehensively protected through other statutory and regulatory instruments. Accordingly, in enforcing the public interest factors stipulated in the act, the competition authorities should seek to complement the range of other interventions principally tasked with underpinning a given public interest. Hence in one matter the Tribunal, in response to an intervention by a trade union representing workers whose jobs were under threat, imposed a condition that the parties and the unions negotiate the employment consequences of the merger thus lending the Competition Act's weight to the protections afforded by the Labour Relations Act and private collective bargaining agreements.

The Act's public interest defences have been subject to predictable criticism by anti-trust practitioners. However, their inclusion has to be seen in the specific context of the society out of which this act emerges. Employment and Black economic empowerment represent major societal concerns and national policy objectives. It is unthinkable that reference to these key concerns would have been omitted from a piece of socio-economic legislation as significant as the Competition Act. Their inclusion and the willingness of the competition authorities to grapple with the difficult balance between public interest and competition has added considerable credibility to the act and the institutions that it has created. That the competition authorities are seen as institutions intent upon promoting participation in the economic life of the nation is strengthened by the explicit inclusion of these public interest considerations.

[5] Or, of course, a merger which fails the competition test but falls to be approved because it has passed the efficiency test, may nevertheless be prohibited because it falls short on public interest.

That having been said, the South African Competition Act is structured in a way that ensures that when public interest considerations are factored into a merger evaluation, this is always done through the filter of the competition analysis – the mere sequencing of the evaluation, with the authority required to make a finding first on competition grounds, promotes this. This may explain why, to date, public interest factors have not, on their own, determined the outcome of a merger evaluation. The overall outcome has, without exception, been determined by the competition analysis (or, in the one case, by efficiency considerations) with public interest considerations occasionally informing conditions attached to an approval.

The fact that a single agency – the competition agency – is responsible for balancing the competition and public interest factors also underpins the centrality accorded competition factors in the authorities' decisions. During the drafting of the Act there was active public debate regarding the locus of decision making with respect to public interest. It was resolved to locate all decision making in the competition authority.

At the same time the Act provides that the Minister of Trade and Industry and the representative trades union in the affected workplaces are provided with notice of any proposed transaction specifically to enhance their ability to present public interest arguments to the competition authorities. Other interested parties are entitled to apply to 'intervene' in merger proceedings before the Tribunal. In the case of large mergers – or appeals from decisions of intermediate mergers – the arguments are ventilated at public hearings and the decisions, with full reasons, are published. This ensures that the competition authorities actually confront the public interest factors – while competition may well be the primary filter in any decision, the process ensures that the competition authorities do not remove the public interest considerations from the frame. The upshot is a public better informed about competition considerations, rather than, as many feared, a competition authority that has abandoned competition considerations in favour of an ill-defined public interest. We are persuaded that this will lay the foundations for the development of a credible competition regime and a public that will, largely through the space made for it to participate in competition decisions, come to appreciate that employment growth, increased participation in the economy and export competitiveness (that is, the 'public interest' as defined) is best secured through enhanced competition.

Above all, the South African competition regime is well served by the <u>explicit</u> introduction of public interest factors and by its limited definition. This ensures that while there is no room to hide from the difficult task of investigating and adjudicating public interest claims, there is equally no incentive to clothe a public interest decision in the garb of competition analysis. It appears to us that many regimes, certainly enforcement agencies and even courts, that claim to uphold a 'pure' competition analysis respond to overwhelming public interest by tailoring a competition analysis to support a decision that has actually been made on public interest grounds. There is no necessity to engage in this kind of obfuscation in a regime in which the competition authorities are explicitly required to consider public interest.

At the same time, the drafters elected to limit the range of factors that may be claimed under public interest. This avoids the major pitfall in most public interest analyses – its content is usually in the eye of the beholder whereas in the South African legislation its scope is limited to four clearly stated grounds. Accordingly, in South Africa an interest group that wishes to invoke public interest must demonstrate that the merger compromises the four stated criteria contained in the Act – that authorities do not have to assess anew each time whether a claimed interest is indeed public interest or merely self-interest.

Analytical Steps

In doing the competition analysis the Commission will initially seek to determine whether the transaction raises any competition issues that require further scrutiny and investigation. If this question is answered in the negative, the investigation is terminated without any further investigation. Such a case would fall under the Commission's fast-track procedures. The Commission has identified following eight categories of cases as falling under the fast-track framework:

- Property transactions.
- Transactions involving failing firms
- Transactions where one of the parties is a new entrant into the market. Justification for this proposal lies in the fact that the transaction would normally represent the replacement of one participant by another.
- Management buy-out transactions are similar to new entrant cases and should therefore be treated as fast track cases
- No product overlap in respect of the product market and no vertical concerns.
- Where the parties to the merger are not in the same geographic market.
- Where the investigator has determined that the parties are in the same relevant market both in terms of the product and geographic markets, but the combined market share post merger is less than fifteen per sent (15%).
- Where the parties are in the same relevant market and their combined market shares are above 15%, but:
    - The post-acquisition HHI is below 1000 points.
    - Where the post-merger HHI is between 1000 – 1800 but the increase in HHI is below 100 points.
    - Where the post-merger HHI is above 1800 but the increase thereof is less than 50 points.

It is important to realize that these possibilities do not reflect public interest issues. Consequently, even if a case falls within these categories, the absence of a letter of comfort from the trade unions may hinder the speedy finalisation of the matter as meetings may have to be set with the parties as well as the unions, exchange of documents and additional submissions may also be made to interrogate this issue.

Competition law and jurisprudence is, for the most part, a product of the most advanced industrialised economies and is increasingly formulated in response to sophisticated advances in economic theory as well as detailed and complex empirical analysis. Whilst the former – advances in economic theory – present no particular challenges to developing countries (no greater, at any rate, than they do to developed country regimes), the latter do: data are less readily available and the resources to gather the data are considerably more limited in developing countries than in developed countries. The upshot is that we are, in merger analyses, frequently required to make decisions on a less extensive empirical foundation than that available to our counterparts in developed countries. This is particularly troubling when defining relevant markets.[6]

For the most part our experience is that complex econometrics – even when applied on the more comprehensive empirical foundation available in advanced economies – frequently obscures more than it reveals.[7] However developing countries – particularly those like our own in which the judicial system sets high evidentiary standards – need to be cognisant of this difficulty.

Our response here has been to rely rather more on the views of actual participants in the market – customers, suppliers and, with due regard for their particular interest, competitors - and rather less on sophisticated econometric analysis. In other words we have, without compromising the integrity and standard of our proceedings, attempted to tailor the evidence required to the circumstances of our countries and the resources of our agencies charged with enforcing competition law. At the same time the authorities have attempted to raise the standard of economic evidence relied upon in their decisions. Each of these quests represents a considerable challenge to which an institution like the ICN may have a considerable contribution to make.

Lessons

The major lesson derived from our experience of merger regulation is confirmation of its centrality in a competition law and policy regime, including a developing country regime. Any ‘special’ circumstances that derive from a country’s social and economic status may, in our experience, be incorporated into the merger regulation system – they are not grounds for eschewing

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[6] See JD Group Limited and Ellerine Holdings Limited case no.: 78/LM/Jul00 in which the Tribunal’s decision regarding the relevant market relied largely on the reasoning employed in the US *Staples* case that, in turn, was developed on the basis of a sophisticated econometric analysis.

[7] Unilever Plc & Robertsons Foods (Pty) Ltd case no.: 55/LM/Sep01

merger regulation. Some of the more important lessons learned are referred to above. In summary these are:

- The status accorded by the act to the ‘efficiency defence’ should be reconsidered – efficiency should not be a self-standing defence, but simply one of the factors to determine in undertaking the competition evaluation;
- On the other hand, our task in balancing public interest and competition considerations is probably eased by having public interest evaluated separately from the competition evaluation. It has the effect of making the trade-offs clearer and in avoid the tendency to camouflage public interest decisions by presenting them in the garb of competition analysis;
- The policymakers may, in time, want to reconsider some general aspects of the place of public interest in the merger evaluation – one possibility is that public interest criteria only be considered as a defence to mergers found to be anti-competitive, and not as a possible bar to a merger that passes muster on the competition evaluation;
- By incorporating a non-exhaustive list of review criteria in the Act, we have managed to combine the flexibility of a substantial lessening of competition system with a requisite degree of certainty. The criteria listed in the Act will inevitably be supplemented by guidelines once the system has a wider experience of merger review;
- The structure of our merger regulation system and its transparency holds us in good stead. In particular:

    - Our structure provides for rapid review of the investigative bodies conclusions. Moreover, by distinguishing between intermediate and large mergers, those mergers less likely to raise competition concerns are effectively fast-tracked;
    - Although the reviewing body, the Tribunal, is independent of the investigative body, the Commission, it is a creation of the Competition Act – its procedures and practices are less rule bound than the normal high court system and merger review is, in consequence, both less litigious and formalistic. Our merger review has the character of an enquiry rather than a highly adversarial trial, while deriving the benefit of independent adjudication.
    - The provisions of the Act and the procedural rules governing merger regulation underline a strong respect for transparency. The Tribunal is obliged to publish reasons for all its merger decisions – this requirement is not restricted to mergers that it prohibits or subjects to conditional approval. The procedures provide for relatively easy intervention by parties who may wish to express an opinion or provide information regarding a merger without getting involved in all aspects of the litigation process. This underpins considerable public participation in, and comment upon, merger review. We have been able to ensure transparency and a high level of public participation without compromising high standards of confidentiality.