



Review of the Commerce Commission's Draft Determination to Authorise the Acquisition of New Zealand Wool Services International by Cavalier Wool Holdings

27 April 2011

1 Introduction

We have been asked to comment on the Commerce Commission's draft determination to authorise Cavalier Wool Holdings' (CWH's) application to acquire New Zealand Wool Services International (WSI).

Overall, the Commission's finding that the public benefits of the proposed acquisition are likely to outweigh the detriments by a small amount relies on three key building blocks:

- The analysis of competitive detriments in the market for wool scouring services captures all relevant downstream effects
- The incentives to innovate in wool scouring will remain after the acquisition, meaning that dynamic inefficiency losses in the market for wool scouring services will be negligible, and
- The productive efficiency benefits of the acquisition are certain because they come from the business case analysis, while the detriments of the acquisition are uncertain.

In this submission, we argue that these three building blocks do not provide a convincing basis for approving the proposed acquisition:

- There are significant competitive detriments in downstream markets (such as carpet manufacturing) that are not captured simply by considering impacts in the market for wool scouring services (Section 2)
- The Commission's analysis of dynamic inefficiency in the market for wool scouring services understates the likely effects (Section 3)
- There is a strong history of merger synergies not living up to expectations. International literature and empirical evidence on the impacts of previous mergers and acquisitions illustrates that efficiency benefits claimed in business cases are far from certain (Section 4).

A more realistic treatment of the likely dynamic inefficiencies, both in the market for wool scouring services and in downstream markets, together with an appropriate level of caution about claimed merger benefits, results in the detriments of the proposed acquisition outweighing the benefits.

2 Effects in the Downstream Markets

The Commission's analysis in the Draft Determination is based on a simple story-line: because most of New Zealand's wool is exported either in greasy or scoured form predominantly to China, any change from scouring wool in New Zealand and shipping clean wool to China, to shipping greasy wool and scouring in China, is unlikely to have significant market impacts. Although the option of scouring in China could lead to slightly higher prices for clean wool, this detriment is considered to be static. The competitive threat from scours in China will ensure that the single wool scour remaining in New Zealand after the acquisition is under pressure to continue innovating.

This logic requires the Commission to treat the 30 percent of New Zealand wool used for domestic manufacturing in exactly the same way as it treats the 52 percent of wool scoured and exported as clean wool, and the 18 percent of wool dumped and exported as greasy wool. In principle, this common treatment of different end uses could be justified under three restrictive conditions:

- If there is little difference between import parity and the cost of offshore processing for export. In other words, if the price effects of the proposed acquisition on New Zealand-based manufacturers who use scoured wool are substantially the same as the effects on wool traders, and
- If any effects of the proposed acquisition on New Zealand-based manufacturers that use scoured wool are solely caused by higher prices, with no further anti-competitive consequences in downstream markets, and
- If New Zealand-based manufacturers who use scoured wool are protected from the effects of the acquisition through long-term contracts.

None of these conditions hold in this case. Accordingly, an analytical approach that ignores the effects of the proposed acquisition on downstream markets in New Zealand will substantially under-estimate likely competitive detriments. Below, we explain why the relevant conditions do not hold. We also consider the impacts on dynamic efficiency in the key downstream market—the market for woollen carpet manufacturing in New Zealand.

Import parity is substantially higher than the cost of offshore processing for export

Godfrey Hirst has provided us with an estimate of the costs it would face in contracting with a Chinese alternative to CWH's domestic scouring monopoly after the proposed acquisition. This cost build up is an estimate of the import parity price: the price it would face if greasy wool was shipped to China for scouring, with the clean coarse wool then shipped back to New Zealand to manufacture carpet. A monopoly scour in New Zealand would be able to increase its prices to domestic manufacturers to this level of import parity.

Table 2.1 shows how the import parity estimate is derived. We also compare this import parity estimate to current prices. This suggests that a scour monopoly has the potential to increase prices to domestic users by approximately [], primarily due to the increased cost of shipping greasy wool to China for scouring and then re-shipping the clean wool back to New Zealand.

Table 2.1: Import Parity Build-up

Item	Cost CWH (NZc/kg)	Cost China (NZc/kg)	Comment
NZ dumping cost	0.00	9.01	Source: CWH Application (page 21), plus freight to port @ \$150
Freight NZ-China (return)	0.00	32.12	\$1,500 NZ-China, \$3,500 return, 16.5 tonnes clean per container
Scouring	[]	13.00	Source: Chinese scouring cost from CWH Application (page 21)
HD packing	7.35	5.00	Service possibly unavailable in China, assumed 5 cents
Finance costs	0.05	0.13	Assuming \$7.50/kg @ 7 per cent x 3 months
Total	[]	59.26	[] difference in price of clean wool to New Zealand manufacturer

Source: Godfrey Hirst

In addition to being concerned about the additional cost of scouring in China, we understand that Godfrey Hirst has doubts about the current capability of wool scours in China to clean course wool. The import parity estimate presented in Table 2.1 does not include the search costs and expenses that would be incurred in trying to maintain product and processing quality in Chinese wool scours. Given the high standards of scouring in New Zealand, the certification requirements on end-product qualities, and the unknown Chinese capability in coarse wool scouring, these costs have the potential to further increase the import parity price.

Even excluding search costs, there is clearly a significant gap between import parity and the cost of offshore processing for export. This means that the effect of the proposed acquisition is likely to be significantly greater on New Zealand-based manufacturers than on wool exporters. Accordingly, the Commission's estimates of the allocative inefficiency resulting from the proposed acquisition—based on the likely price impacts faced by wool merchants—under-estimates the overall market detriment, when 30 percent of wool is used for manufacturing in New Zealand.

Non-price effects in downstream markets are significant

The proposed acquisition does not simply create a monopolist wool scour in New Zealand. It creates a vertically-integrated monopolist, with important downstream interests in the market for manufacturing wool carpets. Economic theory and commercial practice clearly identify the incentive and ability that upstream monopolists have to use non-price discrimination to increase revenues in downstream markets.¹

These non-price strategies were discussed at a high level in our original submission to the Commerce Commission on the proposed acquisition. An upstream monopolist can increase its competitors' costs, reduce competitors' operating efficiencies, and reduce the quality of the product offered to downstream competitors by:

¹ Economides, N. (1998) "The Incentive for Non-Price Discrimination by an Input Monopolist," *International Journal of Industrial Organization* 16 271–284

- **Adopting discretionary queuing processes.** CWH could force its competitors (including Godfrey Hirst) to hold more inventories, for instance by prioritising the processing of wool that is destined for CWH manufacturing
- **Setting restrictive product or process specification.** CWH could set scour line specifications to make it more difficult to produce the wool blend qualities required by Godfrey Hirst, and
- **Altering the timing of service provision.** CWH could process its own wool at the times preferred for its downstream operation, even when competitors place a higher value on priority service.

These potential anti-competitive effects of the proposed acquisition in downstream markets would not be captured in an analysis of the allocative inefficiencies caused by higher wool scouring prices (even assuming a realistic estimate of the potential price increases for domestic manufacturers). The competitive detriments caused by the incentives on a vertically integrated monopolist to benefit its downstream operations are additional to any price effects, and have to be estimated separately.

Godfrey Hirst's contract offers little protection from the effects of the acquisition

The Draft Determination places emphasis on the scouring contract that exists between CWH and Godfrey Hirst to protect Godfrey Hirst from any anti-competitive effects of the proposed acquisition. However, any reliance on the scouring agreement to provide protection against the anti-competitive effects is misplaced for two reasons.

First, the agreement does not protect Godfrey Hirst from the forms of non-price discrimination in scouring discussed above. CWH will be able to adopt strategies such as queuing or blend specifications to increase its rivals' costs in manufacturing carpet.

Second, there is a significant risk that CWH will gain an advantage in the carpet manufacturing by having access to information about Godfrey Hirst's scouring requirements. This will make any attempts to innovate obvious to Godfrey Hirst's largest competitor, significantly reducing the incentives to innovate. In the counterfactual (and in its current operations), Godfrey Hirst can use an alternative wool scour to test new blending configurations. This ability to innovate without revealing plans to its competitor in the downstream market will not be possible after the proposed acquisition.

Dynamic efficiency detriments from anti-competitive vertical conduct

New Zealand accounts for 8 percent of global wool production, but 26 percent of global strong wool production and 45 percent of global woollen carpet production.

It is widely accepted that competition stimulates dynamic efficiency while market power retards innovation—most Commission decisions support this presumption. Although monopolists often have the resources to invest in research and development and innovate (and are well-placed to appropriate the gains from innovation due to a lack of imitating rivals), the lack of any competitive impetus to trade short-term costs for risky longer-term gains dampens innovation.² The literature provides support for an inverted-U shape relationship between market concentration and innovation, where innovation is lowest for very low and very high levels of market concentration.³

² Para 1168 in *Air NZ/Qantas* for example

³ Aghion, P., Bloom, N., Blundell, R., Griffith, R., and Howitt, P. (2005) "Competition And Innovation: An Inverted-U Relationship," *Quarterly Journal of Economics*, vol.120, 701-728

The Commission has previously considered that the dynamic detriments of proposed mergers and acquisitions are likely to result from reductions in:

- **Product innovation**, where consumers switch to improved products of innovating companies or industries, and
- **Production (or process) innovation**, where lower costs associated with improving production and organisational processes are not explored.

Estimating these dynamic inefficiencies is difficult. However, the Commission has applied a fairly consistent approach in past decisions to ensure that these detriments are counted. While the exact calculation has varied, depending on the expected level of product and process innovations in each market, the important point is that these detriments cannot be ignored.

In Ravensdown Corporation Limited and SouthFert Co-operative Limited (Decision 279), the loss in innovation efficiency was assessed at 0.5 to 1.5 percent of sales. In its 1997 consideration of the PowerCo and Egmont application for an authorisation (Decision 302), the Commission applied an upper bound of one percent of costs. In the PowerCo/Egmont case, neither company expended a significant amount on research and development. Rather, a tendency existed to follow others in the field, and the Commission considered the detriment arising from a loss of innovative efficiency to be small.

In the NewCo Dairy Mega-Merger draft determination, the Commission formed the preliminary view that the potential loss of dynamic efficiency arising from the proposed merger could be significant. However, given the uncertainty, it considered a relatively wide range in the possible outcomes, finding that dynamic inefficiency could reduce market output by between 1 and 5 percent.

In considering the application of TeamTalk to acquire Telecom's "Fleetlink" trunked mobile radio business in 2000 (Decision 393), the Commission assessed dynamic efficiency losses at 0 to 3 percent of the claimed combined revenue base. In Air New Zealand Ltd/Ansett Holdings Ltd and Bodas Pty Ltd (Decision 278), the Commission considered the airline industry to be a relatively dynamic industry. In that case, the Commission considered that loss of competition could possibly result in a loss of productivity growth of between 1 to 2.5 percent a year.⁴

In its submission supporting the CWH application for merger authorisation, NERA applied the reasoning from the Commission's consideration of the 2003 application by Air New Zealand and Qantas. In respect of general dynamic efficiency, losses were estimated by assuming that annual costs would be 0.5 to 1.5 percent higher than they would otherwise have been.

Overall, we consider that using a range of 0.5 to 1.5 percent of sales provides a conservative estimate of dynamic efficiency losses in the downstream market for woollen carpet manufacturing in this case. While we acknowledge the difficulty of calculating the effects which are difficult to observe, such an estimate would be consistent with the usual practice adopted in the Commission's previous considerations. We are not aware of any reasons why the analysis in this case should be radically different. On this basis, the effects of the proposed acquisition on the downstream markets in New Zealand will lead to detriments of between [] million to [] million.

⁴ Para 1181, Air NZ/Qantas

3 The Proposed Acquisition will Result in Less Product Innovation

The Draft Determination states that there will be no decline in innovation, and hence almost no dynamic efficiency detriment in the market for wool scouring services. The Commission finds that competitive pressure from China will maintain current incentives to innovate. As mentioned above, this conclusion is a substantial departure from the Commission's usual approach to treating the losses in dynamic efficiency in its analysis of other mergers and acquisitions.

A departure from the Commission's usual approach could be justified if the unique features of the market for wool scouring services mean that the acquisition will not reduce incentives to innovate. However, the evidence suggest that the loss in innovation would likely be greater in the market for wool scouring services than in the other markets previously analysed by the Commission.

The Commission's conclusions appear to be derived from a presumption that the relevant innovation in the market for wool scouring services relates to finding a way to run scouring lines at the lowest possible cost. The Commission concludes that the pressure from China will deliver the incentive to innovate in this regard.

However, the key concern in the wool industry is about product innovation—wool blending and wool applications. This is a central theme of the 2010 Wool Taskforce Report.⁵ The Draft Determination does not address product innovation, and overstates the effect of Chinese processors on process innovation.

The pressure for process innovation from China is overstated

The innovative threat of Chinese scours to NZ is overestimated by the Commission, particularly in relation to coarse wools. A report by CSIRO Textile and Fibre Technology into the treatment of wool scouring effluents in Australia, China, and India, found that many Chinese scours are not operating optimally, and as a result are not making the most of the scouring operation. Chinese scours were found to generally have very poor or no dirt-recovery systems, be highly unsafe, and reluctant to change their practices despite evidence showing clear benefits in cost reductions. In contrast, technologies for improved processing performance in terms of water use, chemical use and productivity were already in place as a result of close contact between CSIRO and wool scours in Australia over many years.⁶

Similarly, scouring in New Zealand meets very high standards. While new regulations or consumer requirements may lead to improvements in Chinese processes, the need to catch up to New Zealand standards will mean that such improvements do not place additional pressure on the remaining New Zealand scour. Catching up to New Zealand standards will reduce the cost differential between scouring in New Zealand and in China, reducing the pressure to innovate.

Chinese scouring will not lead to product innovation

The Wool Taskforce noted in its report that the central challenge for the New Zealand wool industry is to raise demand, primarily through raising demand for products made from strong wool. The Taskforce identified the interaction between growers,

⁵ Wool Taskforce (2010) *Restoring Profitability to the Strong Wool Sector*, Ministry of Agriculture and Forestry, Wellington

⁶ Christoe, J. (1997) *The Treatment of Wool Scouring Effluents in Australia, China and India*, CSIRO Textile and Fibre Technology, available online at <http://aciar.gov.au/files/node/9074/AS%2003-04%20AS1-1997-069.pdf>

manufacturers, and consumers as the key driver of innovation, which requires transparency and accountability in the supply chain and market-led research and development. Specific quality enhancements such as sheep genetics, optimal wool blends, flammability and humidity performance for different applications benefit from a 'line of sight' connection between growers and processors.

Many actual and potential innovations include quality and product attributes, but also reflect growing sustainability concerns in consumer demand, particularly in developed markets such as Europe. Ethical, social, and environment production, including water-use, ecological foot-printing, life-cycle analysis, and other health and environmental standards pose significant opportunities for the attractiveness of wool products to overseas consumers, but to be applied to New Zealand production systems requires information and coordination of effort, as well as proximity to growers and exporters.

Lost proximity to growers and exporters has significant innovation detriments

Scouring in New Zealand has been highly successful and is at the leading edge of innovative wool processing and usage. This success relies on the incentives of competing scouring operations and on close proximity to growers and exporters, including spinning and carpet manufacturing.

The Draft Determination notes that the wool industry has a long history of incremental product and process innovation, with many improvements occurring through input from associated research companies based in New Zealand, close to the resource base. By contrast, relying on China for competition will separate scours from New Zealand wool growers and users, significantly reducing the opportunities for innovation. Scouring is a crucial element in the supply of final wool products—an element that downstream wool processors can leverage to create further value in better and new products. The 'line of sight' between producers and consumers identified by the Taskforce would be lost if scouring shifts to China, or is motivated only by a competitive threat from China.

A strong message in the Taskforce report is that the generic marketing of plain wool fibre is not the direction for a high-value wool sector. Failing to capitalise on New Zealand's potential to expand beyond plain wool fibre is a cost to New Zealand. In our view, the economics literature and the facts of this case strongly support the view expressed in the Futures submission (on behalf of WSI) that the dynamic detriments of the proposed acquisition are likely to dwarf the allocative and productive detriments by at least an order of magnitude.⁷

The Draft Determination notes the difference between merchant and commission scouring models, but concludes that the competitive tension between the two is not strong. We believe the evidence does not support this conclusion. However, we also consider that the fact that WSI is both a merchant and commission scour provides a competitive option for other merchants and for carpet manufacturers, such as Godfrey Hirst, to explore new scouring and blending techniques without revealing information to CWH. It is competition between WSI and CWH that creates an incentive to invest in product innovations, such as wool blending techniques, in close collaboration with growers, downstream manufacturers and exporters.

⁷ See for example Solow R. (1957) "Technical Change and the Aggregate Production Function", *Review of Economics and Statistics*, 39(3), 312-320, concluding that 87 per cent of United States 20th century growth could be explained by investment in human capital and research and development—not increases in labour or capital. Romer P. (1994) "New Good, Old Theory, and the Welfare Costs of Trade Restrictions" *Journal of Development Economics*, 43(1), 5-38, finds that dynamic efficiency losses as a result of trade protection measures are more than eight times (and can be up to 20 times) the allocative efficiency detriments.

Economic literature shows the need for link between growers and processors to ensure product innovation. The benefits of locating vertically related industries close to each other arise from clustering and agglomeration spill-overs, which lead to knowledge accumulations and idea diffusion.

Baptista and Swann (1998) provide a good summary of the linkages and analyse whether firms located in strong industrial clusters or regions are more likely to innovate than firms outside these regions. This study looks at the record of innovation at 248 manufacturing firms in the United Kingdom over an 8 year period. The paper concludes that innovation, entry and growth tend to be stronger in clusters.⁸

Clusters of manufacturing innovation continue in spite of increased communications technology. Pavitt (1987) explains that:⁹

“[M]ost technology is specific, complex, often tacit, and cumulative in its development. Such tacit knowledge is much harder, or even impossible, to transfer by wire: it requires geographical proximity and face-to-face contact to maximize knowledge transfer of this sort.”

Knowledge spill-overs in dynamic efficiency, arising from industry specialisation, are known in the economics literature as MAR (Marshall–Arrow–Romer) externalities, restated by Romer (1990)¹⁰. This innovation happens because knowledge accumulated by one firm tends to help the development of similarly focussed firms, which the Wool Taskforce Report emphasises. This is similar to the argument presented by Porter (1990), which also stresses the importance of rivalry between competitors.

Industries that are regionally specialised benefit most from transmission of knowledge within industry and should, therefore, grow faster. By locating near to the source of wool, interaction between growers, merchants, wool scours, processors, and exporters can promote new ideas and iteratively develop improved processes and more significantly, products. Location of competing scours in New Zealand allows for the provision of wool inputs in a greater variety and at a lower cost. Krugman (1991) provides a good commentary recognising the importance of productive location and trade.¹¹

The other major benefit of locating scours close to growers is the reduction of uncertainty. The counterfactual, with merchant scouring located in New Zealand would facilitate collective learning and risk sharing. Technical and commercial outcomes of innovative efforts are uncertain and complex, and proximity enables the exchange of information to reduce uncertainty. Being close to upstream and downstream markets enables firms to exploit developments in production methods or product characteristics quickly and share experience obtained dealing with similar objectives.

Overall, the applicants’ own estimate of the dynamic efficiency loss of [] million to [] million appears to be a more plausible estimate of the likely dynamic inefficiencies than the Commission’s unusually low number used in the Draft Determination. Again, we see no obvious reason—and no reasons were given in the Draft Determination—for the Commission deviating from the approach adopted in its previous decisions.

⁸ Baptista, R. and Swann, P. (1998) “Do firms in clusters innovate more?” *Research Policy* 27 pp525–540

⁹ Pavitt, K. (1987) “The Nature of Technology (The Objectives of Technology Policy,” *Technology, Management and Systems of Innovation*, pp3-14

¹⁰ Romer, P. (1990) “Endogenous Technological Change,” *Journal of Political Economy*, 98, pp71–102

¹¹ Krugman, P. (1991) *Geography and Trade*, MIT Press, Cambridge.

4 Benefits of the Acquisition are Not Certain

The Commission describes the “relatively wide range of estimated detriments” as evidence of their uncertain nature. In contrast, the Commission makes the point that the benefits are highly certain, because they relate to specific cost savings identified by CWH, and that due to the benefits “higher degree of certainty”, they should be accorded a “comparatively greater weighting”.

There is no basis for this certainty. In fact, there is strong support in the economics literature and past experience with mergers and acquisitions for caution in relation to synergies identified pre-integration.

Mergers do not have a strong history of delivering promised benefits

Book and article titles, such as *Reasons for Frequent Failure in Mergers & Acquisitions*¹² and *Beating the Odds of Merger & Acquisition Failure*¹³ highlight the lack of empirical evidence supporting the claimed efficiency effects of mergers and acquisitions. These studies strongly suggest that the control of mergers and acquisitions should not be based on general presumptions of cost savings or efficiency gains. The available evidence does not point to any easily observable conditions where efficiency gains should be expected, and suggests that the Commission is not justified in concluding that the claimed cost saving benefits of the proposed acquisition are certain.¹⁴

While micro-level industrial literature is optimistic about productive synergies, ex-post studies of merger performance (almost exclusively from a financial and economic perspective) overwhelmingly find that the success of mergers and acquisitions is not guaranteed. Indeed, a large proportion of mergers and acquisitions actually increase costs. When adjusted for market effects, the value of both the acquired and the acquiring company tends to fall rather than increase (on average) as a result of merger or acquisition.¹⁵ Many claimed merger efficiencies are never actually realised, meaning that competition authorities are not well placed to predict with any certainty which horizontal integrations will yield benefits.

Röller, Stennek and Verboven (2006) undertake a comprehensive review of the empirical evidence for merger failure. Perhaps the most famous study is Ravenscraft and Scherer (1987), considering a large sample of the pre-merger profitability of 634 merger targets in the United States. All of the companies considered are manufacturers acquired in the 1960s and 1970s, and include small and privately held companies. This study found that merger intensity had a negative effect on profitability.

According to Loughran & Vjih (1997) there are three typical results from numerous previous studies. First, the target firm’s stockholders gained significantly higher abnormal returns from the acquisitions. Second, the acquiring firm’s stockholders gained little or no abnormal returns from all tender offers. Finally, the acquiring firm’s stockholders gained negative abnormal returns from all merger transactions.¹⁶

¹² Straub, T. (2007) *Reasons for Frequent Failure in Mergers and Acquisitions: A Comprehensive Analysis*, DUV, Wiesbaden

¹³ Tetenbaum, T.J. (1999) "Beating the odds of merger and acquisition failure: seven key practices that improve the chance for expected integration and synergies", *Organizational Dynamics*, Autumn, pp. 22-36

¹⁴ Röller, L., Stennek, J and Verboven, F. (2006) “Efficiency Gains from Merger.” In *European Merger Control: Do We Need an Efficiency Defence?* (edited by Ilzkovitz and Meiklejohn), Edward Elgar

¹⁵ Pautler, P.A. (2003) “Evidence on Mergers and Acquisitions,” *The Antitrust Bulletin*. 48 (1), 119-221.

¹⁶ Loughran, T., & Vjih, A.M. (1997) “Do Long-Term Shareholders Benefit From Corporate Acquisitions?” *Journal of Finance*, LII (5), 1765-1790

Alexandridis, Antoniou, and Petmesas (2007) suggest that an optimistic view on synergies from mergers and acquisitions is largely unsupported by observation of prior financial results, when reviewed from a variety of methodological and conceptual perspectives.¹⁷ Newbould, Stray & Wilson (1976)¹⁸, and Lubatkin (1983)¹⁹ also found no relationship between prior acquisition experience and post-acquisition performance.

Management has incentives to over-estimate merger benefits

The benefits of the merger are also difficult to verify and quantify because information on any potential efficiencies is held only by CWH and WSI. The literature from overseas notes that management of firms have strong incentives to promote mergers and acquisitions as being successful, and management will often attempt to create the impression that value has been added. Even where mergers create synergies, the acquiring firm will often lack information for observing or compelling performance with the merged firm's assets. The market eventually realises that value has not been added and the company is often penalised through a reduced share price.²⁰

Scherer (1991) proposes that competition authorities force acquiring parties to be more realistic in their efficiency claims by being subject to continuing review, for instance with trial merger periods.²¹ White (1987) and Fisher (1987) find that efficiencies are easy to claim, but very difficult to prove, arguing in favour of very high standards for proving actual efficiencies. This argument is based on several examples where efficiencies were claimed but did not materialise, or could have been achieved in other ways that did not harm the competitive process.²²

Overseas authorities are sceptical of efficiency benefits from monopolies

There is no consistent approach among competition authorities overseas on how merger efficiencies should be factored into merger review, and how much uncertainty should be tolerated in quantifying the effects of a proposed merger or acquisition. However, scepticism of the claimed efficiency benefits of mergers is universal, particularly where the merger or acquisition results in monopoly.²³

The United States Merger Guidelines require applicants seeking merger approval to clearly and explicitly substantiate efficiency claims so that the Federal Trade Commission can verify the likelihood and magnitude of each asserted efficiency gain. This evidence needs to include how and when each benefit would be achieved, any costs of achieving the benefits, and how each claimed efficiency gain would enhance the merged firm's

¹⁷ Alexandridis, G., Antoniou, A., and Petmesas, D. (2007) "Divergence of Opinion and Post-Acquisition Performance", *Journal of Business Finance and Accounting*, 34(3 & 4), 439-460.

¹⁸ Newbould, G.D., Stray, S.J., & Wilson, K.W. (1976). Shareholders' Interests and Acquisition Activity, *Accounting and Business Research*, 23, pp. 201-213.

¹⁹ Lubatkin, M. (1983) Mergers and the Performance of the Acquiring Firm, *The Academy of Management Review*, Vol. 8, No. 2, pp. 218-225.

²⁰ Campbell, T.S. and Marino, A.M. (2007) "Synergistic Mergers in an Agency Context: An Illustration of the Interaction of the Observability Problem and Synergistic Merger", *Aggregation, Efficiency, and Measurement*, Springer US, page 45

²¹ Willig R.D., Salop S.C., and Scherer F.M. (1991) Merger Analysis, Industrial Organization Theory, and Merger Guidelines, *Brookings Papers on Economic Activity: Microeconomics*, pp. 281-332

²² White L.J. (1987) Antitrust and Merger Policy: A Review and Critique, *The Journal of Economic Perspectives*, Vol. 1, No. 2, pp. 13-22, Fisher F.M. (1987) Horizontal Mergers: Triage and Treatment, *The Journal of Economic Perspectives* Vol. 1, No. 2, pp. 23-40

²³ Baxt, B., Randall, M., North, A. (2004) *International Competition Network (ICN) Merger Guidelines*, Chapter 6.

ability and incentive to compete.²⁴ In the 2001 *Heinz-Beech-Nut Baby Foods* case in the United States, the Appeals Court concluded that productive efficiency arguments came with a high burden of proof.²⁵

The high market concentration levels present in this case require, in rebuttal, proof of extraordinary efficiencies, which the appellees failed to supply.

Claimed efficiencies will generally be given less weight when the likely adverse competitive effects are substantial—competition authorities in the United States take the position that efficiencies almost never justify a merger to monopoly or near-monopoly. The EU Merger Guidelines contain similar directions.²⁶

Overall, the Commission’s view that the claimed benefits have to be treated with a greater weight than the likely detriments does not appear to be consistent with the economics literature, experience with past mergers and acquisitions, or with the practice of competition regulators overseas.

5 Conclusion

The Draft Determination finds a small net benefit in the proposed acquisition. This finding is not robust because the building blocks that support this finding are unconvincing. The Draft Determination relies on the presumption that there are no competitive detriments in downstream markets, that the effects of lost innovation in the market for wool scouring services will be negligible, and that the productive efficiency benefits from the proposed acquisition are certain.

These presumptions are not consistent with the Commission’s usual approach to analysing these issues, and are at odds with the evidence from the wool industry. The building blocks of the Commission’s Draft Determination also run counter to the economics literature and the experience of competition authorities overseas. Even a very cautious application of the conventional analytical techniques in mergers and acquisitions turns the presumed net benefit into a net detriment.

²⁴ US Department of Justice and the Federal Trade Commission, (2010) Horizontal Merger Guidelines, available on www.ftc.gov website (last accessed 19 April, 2011)

²⁵ *FTC v. H.J. Heinz Co.*, 116 F. Supp. 2d 190 (D.D.C. 2000); reviewed in 246 F.3d 708 (D.C. Cir. 2001).

²⁶ European Union, (2004) *Guidelines on the Assessment of Horizontal Mergers under the Council Regulation on the Control of Concentrations Between Undertakings* at paragraph 84: “It is highly unlikely that a merger leading to a market position approaching that of a monopoly, or leading to a similar level of market power, can be declared compatible with the common market on the ground that efficiency gains would be sufficient to counteract its potential anti-competitive effects.”