

COMPETITION ALERT

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THE HIGH COURT - WHERE EVERYONE GETS A CLEARANCE?

The High Court recently released its decision¹ in respect of Woolworths and Foodstuffs' appeal against the Commission's refusal to grant them each clearance to acquire all the shares in The Warehouse Group Limited ("The Warehouse")². In its judgment, the High Court ruled in favour of the two supermarket chains, allowing them to expand their respective 10% stakes in The Warehouse. The judgment's release has sparked a substantial amount of commentary in the media. This special edition of Alert summarises the High Court's findings, responds to recent media coverage, and offers some perspectives on the judgment.

Findings of the Court

The High Court hearing occupied two weeks, during which Justice Mallon and Professor King (sitting as a lay member of the Court) heard a significant amount of evidence from all parties, including evidence which was not available at the time the Commission reached its decision declining to grant clearance to the supermarkets. Key to the Court's conclusion that the acquisition by either of the supermarkets of The Warehouse was not likely to substantially lessen competition were the findings set out below:

- **The Warehouse is unlikely to continue in the market:** The High Court considered that The Warehouse was not likely to continue the Extra concept, with Justice Mallon noting "there is the real prospect that The Warehouse Extra will be trialed for a further period and then abandoned without any further stores rolled out". It was not considered likely (that is to say, only a remote possibility) that the Extra concept would continue long enough for the 'halo' concept to take hold. The 'halo' concept is central to The Warehouse's strategy of entering groceries, as it seeks to increase general merchandise sales by drawing grocery customers into stores.
- **Impact of the acquisition on price level likely to be minimal:** The High Court held that even when compared to a scenario of The Warehouse completing a full roll out of 15 Extra stores, the acquisition's impact on competition would be limited. The Court considered on the evidence before it that The Warehouse would continue to focus its business principally on general merchandise. Accordingly, although the High Court considered that market prices might increase in the factual scenario (with the acquisition), any increase was likely to be *de minimus*. The Court agreed with the Commission's submission that the traditional SSNIP test³ barometer of a 4-5% increase in price as an indicator of decreased competition was not an automatic materiality threshold. The Court agreed that a smaller increase would be sufficient in the groceries market,⁴ perhaps as low as 2%, rejecting the evidence advanced by

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1. A copy of the decision is available at: <http://do.justice.govt.nz/do/GetJudgment/?judgmentID=132268>.

2. Decision 606: Foodstuffs (Auckland) Ltd, Foodstuffs (Wellington) Co-operative Society Ltd and Foodstuffs (South Island) Ltd / the Warehouse Group Limited, and, Decision 607: Woolworths Limited / The Warehouse Group Limited. A copy of the decision is available at: <http://www.comcom.govt.nz/publicregisters/contentfiles/documents/public%20version%20decision%20606%20and%206070.pdf>. For a summary of the Commission's decision, see <http://www.russellmcveagh.com/doclibrary/public/CompetitionLaw/ComplawJul07b.pdf>.

3. A small yet significant non-transitory increase in price. This test is used by the Commission to ascertain whether an acquisition is likely to give rise to market power which would permit the merged entity to raise prices usually by 5-10%, without suffering any competitive backlash.

4. A consequence of low margins and the high percentage of weekly income groceries represent.

the Commission's expert, Dr Hausman, that a SSNIP as low as 1% might be appropriate. Ultimately, the Court was satisfied that an increase in price of this magnitude was not likely to take place in the factual.

- **The Warehouse as a 'Maverick':** The High Court rejected the Commerce Commission's characterisation of The Warehouse as a 'Maverick' competitor, capable of exerting competitive influence disproportionate to its market share.⁵ While supercentres had proven capable of exerting intense competitive pressure internationally, the Court disregarded this evidence as indicating that The Warehouse Extra would be successful and provide a material constraint on Foodstuffs and Woolworths. Unlike overseas supercentres such as Walmart, on The Warehouse's own evidence, it was not ever planning to operate as a 'market leader'.
- **Real and substantial possibilities to be considered separately:** The High Court rejected Woolworths' submission that in the case of multiple counterfactuals, a weighing exercise should be undertaken, considering both the likelihood of that counterfactual scenario occurring and what it would mean for competition. Instead, the Court considered all real and substantial possibilities individually. Justice Mallon and Professor King described the test in the following, clear, way:

"Where there is more than one real prospect as to what may occur, each of those real prospects must be considered. **If any of these real prospects are likely to substantially lessen competition then a clearance is to be declined** even if there is also a real prospect that competition will not be substantially lessened."

- **The High Court's pragmatic approach to evidence:** The High Court focused little on the question of burden of proof, preferring a robust and pragmatic approach. Justice Mallon and Professor King considered it "unhelpful to focus on the burden of proof," and cast the test as "whether the Commission is satisfied or not satisfied on the evidence from whatever source it has come." The High Court was also somewhat critical of what it perceived as an excessive emphasis by the Commission on potential future developments, noting that it was not open to the Commission to require further time to pass before it could be satisfied as to the future state of competition in the market. The High Court took a reasonably commercial stance reducing the evidential question to whether, on the evidence before it, the proposed acquisition would not be likely to have the effect of substantially lessening competition.
- **A reasonable degree of competition exists in the supermarket market:** Justice Mallon and Professor King noted the Commerce Commission's dismissive attitude towards the degree of competition existing in the market. However, they agreed that, while the 2002 acquisition of Woolworths by Progressive had resulted in a duopoly, this was held to have resulted in, at worst, a small effect on supermarket prices, certainly not of a degree sufficient to have substantially lessened competition in the market. The High Court viewed Woolworths and Foodstuffs as being involved in reasonably vigorous and workable competition, rejecting the Commission's concerns around tacit coordination. In addition, the Court noted that the large size of the two firms resulted in savings as a result of economies of scale, and that non-supermarket price constraints (like petrol stations and butchers) also exist.

Perspectives on the High Court judgment

The Commerce Commission is currently considering whether to appeal the decision. Given the Commission's apparent dissatisfaction with the duopolistic nature of the supermarket industry, the Commission will no doubt giving careful consideration to its decision. However, the High Court's judgment is well-reasoned and will likely be difficult to successfully appeal. It should be noted also that the decision is one of only a few where the appeal was heard before a judge of the High Court whose experience as practitioner was predominantly in the competition law

5. Envisaged to be around 3% nationally in the event of a full roll out.

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field. That experience, coupled with Professor King's expertise as a current Commissioner of the Australian Competition and Consumer Commission, made for a formidable bench, who produced a well articulated judgment.

A vast amount of commentary, both derisive and supportive of the judgment, has been published. Consideration is given below to some of the more salient comments published to date:

- **The Warehouse is not likely to ever be a meaningful competitive force in the supermarket sector:** A number of commentators have attacked the Court's conclusion that The Warehouse will never be a competitive force in the supermarket sector. However, on the evidence before the Court, it appears that it was entirely justified in reaching this conclusion. By The Warehouse's own evidence, it never anticipated attaining a market share (nationally) greater than 3 percent. On the one hand, this illustrates the judgment's tendency to consider interchangeably competition in the local markets identified for the purposes of the application, with that of a national market, but it also provides support for the conclusion that The Warehouse would never exercise more than minimal competitive constraint as against the two incumbents. Put simply, it is wrong to assume that The Warehouse Extra intended or would be able to compete in groceries as it does in general merchandise.

In response to arguments that The Warehouse is already a competitive force in three locations, this ignores the evidence before the Court indicating that it was neither the price-leader in these specific geographic markets, and also the fact that the establishment of the Extra stores had not provoked a competitive response from neighbouring supermarkets. Moreover, the finding is consistent with Commission's analytical framework⁶ which requires the overall assessment to be based on a comparison of competition in the factual with that in the counterfactual. The Court's treatment of the issue also picks up on a subtle shift in the Commission's approach to markets towards utilising them as an analytical tool rather than an absolute vacuum in which competitive effects are to be assessed. The Court's judgment impliedly sanctions this form of analysis, a signal that practitioners ought to place less reliance on market definition than in the past. The key is to focus on the competitive effects of the acquisition.

- **Criticisms that the The Warehouse Extra will not continue in the future:** Some commentary has also suggested that the Court's conclusion that The Warehouse Extra concept is not likely to continue in the future as akin to a 'leap of faith by the Court.' However, given that the Court did in fact consider what effect The Warehouse might have were it to reach its target 3 percent market share (nationally) - and it concluded that it would not provide any real competitive constraint, the conclusion is of little import. The Court also gave careful consideration to the likelihood of The Warehouse Extra achieving the required 'halo' effect for it to succeed. With the benefit of expert economic evidence, heard in closed Court, it was entirely open to the Court to conclude that the 'halo' effect was not **likely** to ever transpire. In addition, the Court had access to updating evidence given by The Warehouse's Chief Executive, Mr Morrice, which the Commission did not have when reaching its decision.
- **Burden of proof and standard of proof:** It is clear that over the course of the two week trial, the Court preferred the majority of the evidence put forward by the supermarkets, to that of the Commission. Nonetheless, criticisms that the High Court uncritically adopted the evidence put forward by the supermarkets cannot on the face of it be sustained. As a starting point, much of the two week hearing was heard in closed court with much of the corresponding information in the judgment redacted for reasons of confidentiality. As such, it is not appropriate to second guess the Court's approach to evidence. In addition, given that The Warehouse provided some evidence in support of that advanced by the supermarkets, it would have been a dramatic outcome for the Court to decline to entertain evidence

6. Commerce Commission, Mergers and Acquisitions Guidelines, 1 January 2004.

advanced by the only three market participants in New Zealand and prefer the Commission's evidence, much of which was coloured by the peculiar dynamics of overseas supermarket industries.

This point also strikes at the heart of a key issue - who the burden of proof should lie with in assessing whether an acquisition is likely to substantially lessen competition. Given the voluntary nature of New Zealand's merger control regime under the Commerce Act, the onus must surely fall to the Commission. This ensures an approach consistent with enforcement proceedings taken by the Commission under section 47 of the Act, where it is clear that the onus falls on the Commission to prove in Court that the acquisition is likely to result in a substantial lessening of competition. As the Court astutely noted, it is not open to the Commission to deny clearance because it cannot make up its mind. Rather, the Commission must be able to show that it is likely that the acquisition will substantially lessen competition. Without this approach, there remains the risk that the clearance regime will fail to provide the certainty and business efficacy required of it.

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The final word?

As noted above it is not yet known whether the High Court's judgment will be the final say on the matter. Certainly, as the appropriate 25 percent jump in price of shares in The Warehouse shows, a lot rides on the decision's implications for the future direction of all parties. While the judgment provides timely guidance from the Court on a number of issues relevant to the merger control context, most significantly, it stands out as a well reasoned and robust judgment. If given the opportunity, the Court of Appeal ought to think long and hard before disturbing it.