



Competition law and the cattle supply chain

Guidance for market participants

July 2015

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1. Executive summary

The cattle supply chain is important to the Australian agricultural sector and the Australian economy generally. While Australia has natural advantages in the production of cattle and beef products, geographic variations and constantly changing climate conditions give rise to a complex industry in which the needs of market participants are constantly changing.

Competition laws are also complex involving legal and economic concepts that are designed to be flexible enough to be applied to the broadest range of industries. The result is that the intent and operation of competition laws are not always clearly understood by market participants, making the outcome of competition issues appear to be unpredictable.

This report seeks to enhance market participants' understanding of competition issues by both demonstrating the circumstances in which market practices are likely to raise competition issues and where conduct may be beyond the scope of the key competition law provisions.

The key observations arising from this analysis are that:

- a) the current prohibition on misuse of market power relates to a relatively narrow concept. It is designed to protect the competitive process and not particular competitors. Conduct of concern should be tested against the criteria of whether the market participant engaging the conduct has a substantial market power and has taken advantage of that market power for a specified anti-competitive purpose;
- b) merger analysis will significantly influenced by the practical alternatives that are available to market participants. Where market participants would have very limited alternatives to dealing with the merged entity, it is important that information and data is provided to the ACCC to explain the reasons why this is the case; and
- c) cartel conduct cannot take place without communications between potential competitors and is very difficult to establish without evidence of those communications. Where market participants are concerned that cartel conduct may have been engaged in, they should report it to the ACCC and provide the relevant information to enable the ACCC to commence an investigation.

These observations are particularly relevant in the context of the Government's recently released Agriculture White Paper (White Paper). The White Paper calls for increased scrutiny of the agriculture supply chain by the ACCC, including through the appointment of an Agriculture Commissioner and increased funding to enable the ACCC to observe market practices. This process will only be effective to the extent that market participants are able to engage with the competition laws and provide relevant information in support of any concerns they have to the ACCC for further investigation.

In terms of legislative reform of competition laws, this has traditionally been a slow process. The legal framework has recently been the subject of the Competition Policy Review resulting in a recommendation to amend the current prohibition on misuse of market power to include a substantial lessening of competition effects test. It is unlikely there will be changes to the

mergers and cartel conduct provisions that significantly alter their operation in the short to medium term.

Market participants that have more urgent concerns may wish to consider whether an industry code of conduct could assist in addressing market practices that are both within and beyond the scope of the competition law. An industry code would provide the ability to target specific conduct that has arisen in the context of unequal bargaining power between market participants and has detrimental impacts on the efficient operation of the cattle supply chain.

2. Introduction to this report

2.1 Objectives

The Cattle Council of Australia has requested Baker & McKenzie prepare a report addressing the operation of Australian competition laws in the context of the cattle supply chain in Australia (Report) with the objective of:

- a) enhancing market participants' understanding of the nature and scope of competition law protections;
- b) ensuring market participants are aware of the avenues and information required to explore any competition concerns they have identified; and
- c) identifying the limits of relevant competition laws and potential reforms that could be considered.

2.2 Overview

This Report has been prepared with reference to the objectives outlined above and is intended to be most useful to market participants that do not have substantial experience in the application of Australian competition laws.

Section 3 of this Report provides a high level overview of the cattle supply chain to enable particular competition laws to be considered in context.

Section 4 of this Report provides an introduction to the key competition provisions (being misuse of market power, merger control provisions and cartel conduct) which are relevant to issues that have been raised in the context of the cattle supply chain.

Section 5 of this Report addresses these key competition provisions in the context of the cattle supply chain by demonstrating:

- a) the intent and scope of those provisions;
- b) the appropriate framework that concerns arising in relation to conduct and consolidation in the cattle supply chain should be tested against; and
- c) the evidence required to demonstrate that a contravention has taken place.

Section 6 outlines potential options for reform that may be pursued to address concerns that have arisen in relation to the cattle supply chain, including current legislative reform proposals and the development and operation of industry codes.

Through this approach, this Report provides a framework for the consideration of competition issues arising in the cattle supply chain. It is intended that this Report will be of assistance to market participants in the cattle supply chain to determine which concerns, if any, warrant scrutiny under existing competition laws or potential reforms.

2.3 Reliance

This Report has been prepared for the sole benefit of Cattle Council of Australia and may only be used by Cattle Council of Australia for the purpose identified in section 2.1 above. We have sought to raise key issues of relevance to market participants in the cattle supply chain as identified by Cattle Council of Australia. We have not addressed or considered additional matters (if any) which may be relevant to any other current or potential market participant.

Further, we have not reached conclusions in relation to any matter and this Report should not be regarded as legal advice or a substitute for legal advice. To the fullest extent allowed by law, Baker & McKenzie excludes all liability (whether arising in contract, negligence or otherwise) in respect of all and each part of this Report, including without limitation, any errors or omissions. The contents of this Report may contain copyright.

3. The cattle supply chain in Australia

Overview

The beef industry is a major industry in Australia with a herd of approximately 28 million cattle and production value of approximately \$7 billion. Approximately two thirds of cattle produced are ultimately exported.

The cattle supply chain in Australia is complex with significant volatility in the production process and multiple paths to various markets. This volatility is primarily driven by:

- a) variations in the availability of native pasture due to short and long term climate change;
- b) a long production process resulting in delays in responding to market conditions;
- c) geographic remoteness of production areas making it practically difficult to switch between marketing options; and
- d) international market and currency fluctuations.

Across the supply chain, value is primarily added in the three broad stages of production, processing and retailing which are addressed below. Buying and selling agents, cattle breeders, intermediate producers (backgrounders) and finishers, wholesalers, exporters and importers also participate at various stages of the supply chain.

Production

There are approximately 70,000 cattle producers operating in Australia ranging from a small number of very large cattle stations and a large number of smaller 'family farm' producers. Beef production in Australia is divided between the following regions:

- a) Queensland, Northern Territory and northern Western Australia (Northern Region) which is characterised by extensive but lower quality native pastures, large cattle stations and lower stocking density. Due to their resistance to the extreme weather and pests, slower growing *bos indicus* cattle are predominantly produced in the Northern Region with the majority of production being directed to live export; and
- b) New South Wales, South Australia, Victoria, Tasmania and southern Western Australia (Southern Region) which is characterised by smaller farms, high quality pastures and higher stocking density. Faster growing *bos taurus* cattle are predominantly produced which are processed and directed to domestic and export markets.

Most producers breed cattle and grow stock on pasture until they are 'fat cattle' ready for slaughter or export. Producers may also adjust stock levels by:

- a) buying calves from breeders or feeder cattle from backgrounders; or
- b) selling feeder cattle to backgrounders or grain feedlots for further fattening.

The primary means by which cattle are sold by producers are as follows:

- a) by public auction at saleyards, where price is determined by the market based on live-weight cents per kilogram;
- b) 'over the hook', where cattle is delivered directly from producer to the processor pursuant to a supply agreement, including forward contracts. Price will generally be determined according to a processor 'price grid', with penalties and other discounts imposed on the basis of the quality of beef produced; and
- c) less commonly, 'from the paddock' sales from a producer directly to a buyer or agent, where prices may be determined per head or by weight and are frequently purchased on the basis of forward contracts to secure supply.

The prices available to producers through over the hook and paddock sales may differ depending upon the time between sale and processing and the extent to which agents are involved but are generally benchmarked on traditional saleyard sales.

Processing

Fat cattle are transported to abattoirs for slaughter and processing into beef products. Carcasses may be processed by a 'cold bone' method, whereby refrigeration assists in producing cuts of superior quality, or 'hot bone' method without refrigeration which is generally used for lower quality cattle and produces lower quality cuts of beef such as mince or inputs to processed food.

Cattle are processed pursuant to domestic or export standards. Export standards, which are a requirement of overseas markets, are generally higher and require significant investments by processors with a consequent increase in processing costs.

Compared to the producer sector, Australia's cattle processing sector is relatively consolidated with a small number of very large processors having over 50% of processing capacity and throughput. There are also a significant number of small processors. Options available to particular producers will depend upon the facilities located in their region as it is generally prohibitive to transport cattle over very large distances due to transport costs and the impact of transport on the quality (condition) of the cattle.

A number of processors, including major processors, are vertically integrated and acquire cattle 'over the hook' as an input to their own wholesaling and retailing operations. Processors also provide consignment /service kill services to third parties that have significant supply requirements, such as Australian supermarket operators, or producers that seek direct access to wholesale and retail markets.

Marketing options

The options for marketing beef products include:

- a) domestic markets which are primarily the supermarket, butcher and food service sectors;
- b) export markets, including major markets such as the United States and Japan to which producers and processors may be accredited to supply;
- c) live export markets including major markets for which there is substantial demand and limited domestic production such as Indonesia and the Middle East; and
- d) niche markets which are generally higher value added domestic or export markets including for branded or high specification beef products. Niche markets are necessarily small compared to commodity markets but deliver higher returns and are growing faster than commodity markets.

The size and quality of the animal will influence whether it is slaughtered for export or domestic markets, with larger animals customarily being directed for export (subject to export price and currency fluctuations).

4. Key competition laws

4.1 Australian competition law

Overview

Australian competition laws are set out in Part IV of the Competition and Consumer Act 2010 (Cth) (CCA). Part IV of the CCA is aimed at protecting the competition process by prohibiting anti-competitive agreements and conduct.

Part IV of the CCA consists of three divisions:

- a) Division 1, which contains criminal and civil prohibitions on cartel conduct;
- b) Division 1A, which contains prohibitions against anti-competitive price signalling and other information disclosures in certain prescribed markets (which presently only apply to the banking sector); and
- c) Division 2, which contains prohibitions against a range of anti-competitive conduct, including:
 - i) agreements containing an exclusionary provision (also referred to as collective boycotts);
 - ii) resale price maintenance;
 - iii) third line forcing;
 - iv) anti-competitive agreements;
 - v) anti-competitive secondary boycotts;
 - vi) anti-competitive exclusive dealing;
 - vii) misuse of market power; and
 - viii) anti-competitive mergers and acquisitions.

The CCA is administered and enforced by the Australian Competition and Consumer Commission (ACCC). The ACCC has extensive powers to investigate anti-competitive conduct, including powers to require persons to furnish information, produce documents and attend examinations and the power to obtain search warrants. In addition to its investigation and enforcement role, the ACCC has responsibilities in relation to merger clearances and the granting of authorisations and notifications, which provide an exemption from certain prohibitions.

If the ACCC considers there has been a contravention of Part IV of the CCA, it can bring proceedings in the Federal Court of Australia seeking penalties and other remedies against the primary contravener and other persons involved in the contravention.

Serious penalties apply for contraventions of Part IV of the CCA including up to ten years imprisonment for individuals found to have engaged in criminal cartel conduct.

4.2 Key provisions

Misuse of market power

The CCA prohibits corporations with 'a substantial degree of power in a market' from 'taking advantage' of that power in that or any other market for particular prohibited purposes. These purposes are eliminating or damaging a competitor, preventing market entry, or deterring or preventing a person from engaging in competitive conduct in that or any other market.

There is no specified market share threshold that establishes market power. The courts have defined market power as the ability to act free from the constraints of competition, in particular, in relation to price. The CCA contains a non-exhaustive list of factors that a court may consider in determining whether a corporation has taken advantage of its market power.

Establishing a prohibited purpose is essential in determining whether or not a corporation has misused its market power. The prohibited purpose need not be the only motivating purpose to constitute a breach but it must be a substantial purpose. Purpose is most clearly evidenced by subjective evidence but may also be inferred from conduct and the surrounding circumstances.

There is also a specific prohibition on predatory pricing by corporations with a substantial share of a market. Under this prohibition, a corporation that has a 'substantial share of a market' must not supply, or offer to supply, goods or services for a 'sustained period' at a price that is 'less than the relevant cost' of supplying the goods or services for a prohibited purpose (being the same purposes as the general misuse of market power prohibition referred to above).

Merger regulation

The CCA prohibits the acquisition of shares or assets if that acquisition would have the effect, or likely effect, of substantially lessening competition in any market for goods or services in Australia. There are no mandatory notification requirements. However, the ACCC's Merger Guidelines 2008 indicate that the ACCC will want to examine a merger where the products of the merger parties are either substitutes or complements and the merged firm will have a post-merger market share of greater than 20 percent in the relevant market/s.

There are three types of voluntary notification:

- a) informal clearance, which is by far the most common option and encouraged by the ACCC. This process is operated by the ACCC pursuant to its Merger Review Process Guideline 2013 and is usually the fastest and most confidential process for obtaining merger clearance;
- b) formal clearance, which was introduced in 2007 but has not yet been applied; and
- c) an application to the Australian Competition Tribunal (Tribunal) for merger authorisation. The Tribunal has power to authorise a potentially anti-competitive merger where it is satisfied that the merger would result in such a countervailing benefit to the public that it should be allowed to proceed.

The substantial lessening of competition test is a relatively high threshold, recognising that all mergers will result in a lessening of competition and it is only those that are likely to result in the absence of an effective competitive constraint on the merged entity that should be prohibited. The test is forward looking in that it involves a comparison of the future with and without the proposed acquisition. This necessarily requires the identification of the appropriate product, geographic and functional market in which the impact of the proposed acquisition should be considered.

Cartel conduct

Cartel conduct relates to formal or informal agreements between competitors to act together instead of competing with one another. A 'cartel provision' is a provision of a contract, arrangement or understanding between competitors that has:

- a) the purpose or likely effect of fixing prices;
- b) the purpose of restricting outputs;
- c) the purpose of allocating customers, suppliers or territories; and/or
- d) the purpose of rigging bids or tenders.

There are defences to the prohibitions on cartel provisions, including a defence for joint ventures.

In July 2009, cartel conduct was criminalised in Australia and there are now parallel criminal and civil offences for making or giving effect to a contract, arrangement or understanding that contains a cartel provision.

The cartel regime overlaps with the prohibition on agreements containing an exclusionary provision in the CCA but we have not sought to address the distinction between these provisions in this Report.

4.3 Authorisations and notifications

A corporation may apply to the ACCC for an authorisation in relation to proposed conduct which would otherwise breach Part IV of the CCA. Authorisation may not be obtained for conduct which constitutes a misuse of market power. The ACCC may grant authorisation and thereby immunity for the conduct where the benefit to the public arising from the conduct outweighs the anti-competitive detriment. The ACCC is required to consult publicly in relation to its decision and must make a final decision within six months of receiving an application.

In addition, immunity may be obtained through an ACCC notification process for exclusive dealing conduct and certain forms of collective bargaining conduct. Collective bargaining is an arrangement where competitors collectively negotiate with a supplier or a customer. The immunity provided by a collective bargaining notification applies automatically 14 days after the notification is lodged, unless the ACCC objects to the notification within or after that time.

Public benefits in the context of the authorisation and notification processes have been given a broad meaning to include any contribution to the aims of society including the achievement of the economic goals of efficiency and progress from the perspective of society as a whole.

5. Competition laws in context

5.1 Misuse of market power

The prohibition on misuse of market power has been the subject of debate and controversy in recent years. In the context of the number of concentrated markets in Australia and the sense of unfairness that arises in circumstances where market power is used, small business groups have argued that the current prohibition is ineffective in protecting the competitive process. As would be expected, part of the debate has included confusion regarding the intended and actual scope of the provision.

It is not the intention or effect of the competition law to make having or using market power illegal. In contrast, the competitive process that underpins deregulated economies encourages business to strive for competitive advantages through, for example, innovation or improvements in efficiency. Such incentives are only meaningful where those businesses are permitted to benefit from their efforts and the competition law does not seek to limit the extent of any benefit obtained.

Instead, competition law seeks to ensure that market power is not used to undermine the competitive process. In this sense, the current misuse of market power prohibition can be seen as protecting competition and not particular competitors. This is achieved by only applying the misuse of market power prohibition to:

- a) firms that have a substantial degree of market power, as against any form of market power;
- b) conduct of those firms that uses their market power, as against conduct that could be engaged in in the absence of market power;
- c) conduct that is engaged in for particular purposes, as against conduct that has a particular effect; and
- d) specified purposes, which are limited to three forms of conduct that would undermine the competitive process.

The narrow scope of the prohibition on misuse of market power is a bitter pill to swallow for any market participant that has been subjected to the use of market power as the practical impact can be financially disastrous irrespective of the application of the competition law. The sense that the current law may be too narrow, coupled with practical difficulties faced by the ACCC in establishing contraventions in court, have led to reform proposals to introduce an effects test to the misuse of market power prohibition. These reforms are addressed in detail in section 6.1 below.

Pending reform of the misuse of market power prohibition, a clear understanding of the current law is useful for market participants in the cattle supply chain that are concerned they may have been subjected to a misuse of market power. While there are a number of concerns that have been raised over time regarding conduct in the cattle supply chain, they may be broadly categorised as:

- a) unilateral conduct which impacts returns to market participants; and
- b) difficulties in obtaining access to services.

Relevant evidence of unilateral conduct

Smaller market participants, generally cattle producers, have expressed concerns over the level of control and transparency they have over the value they receive for their products. These concerns have arisen in the context of average returns to producers declining over time at a higher rate than can be observed in other countries and increased concentration in downstream processing and retailing sectors.

For example, producers have expressed concerns that approaches to grading of beef, weighing cattle, carcass trimming, the use of beef by-products and quality penalty discounts have been subjectively applied in a manner which significantly impacts upon the value they receive for fat cattle. The issue of misuse of market power is enlivened by a perception there is a lack of realistic alternatives in response to dissatisfaction with the practices of particular market participants and as a result, significant inequality in the bargaining power across the cattle supply chain.

In order for concerns of this nature to be the subject of a misuse of market power allegation, it would be necessary to gather evidence to demonstrate that the market participant engaging in such practices has:

- a) a substantial degree of market power. This would include details of market shares in the relevant market and the extent to which there are effective competitive constraints imposed on the market participant through, for example, alternative suppliers and new entry or expansion. These concepts are discussed in more detail in section 5.2 below;
- b) used any substantial market power to engage in the conduct and, relevantly, could not have engaged in the conduct without having substantial market power; and
- c) engaged in the practice for a specified purpose of undermining the competitive process.

Given the relatively high level of concentration in the cattle processing and retailing sectors, it is possible that some market participants could have a substantial degree of market power in particular regions. It is also possible that grading, weighing, trimming, the use of by-products or discounting practices could be applied in a way that requires substantial market power.

However, in most cases, these practices will not be engaged in for the purpose of undermining the competitive process. Instead, it is more likely that practices that seek to transfer value from

one level in the supply chain to another are simply a use of market power, which is not captured by the prohibition on misuse of market power.

The fact that market practices may fall outside the scope of the prohibition on misuse of market power does not necessarily mean they are beyond the scope of the CCA. In certain circumstances, conduct that seeks to transfer value from one market participant to another may constitute unconscionable conduct under the Australian Consumer Law in Schedule 2 and 3 of the CCA. There are examples of the ACCC bringing successful unconscionable conduct enforcement proceedings in circumstances where the conduct was of a nature that had been the subject of misuse of market power concerns for some time. These include the recent Federal Court proceedings commenced by the ACCC against Coles relating to unconscionable conduct in dealings with suppliers.

Unconscionable conduct is conduct that is considered to be against good conscience as judged by the norms of society. This requires conduct that is more than just unfair and will generally relate to only the most serious cases of the use of market power or bargaining position. Relevant evidence that market participants should look to in seeking to explore whether market conduct may be unconscionable include:

- a) the relative bargaining strength of the parties;
- b) whether any market practices of the stronger party were necessary to protect their interests;
- c) the willingness of the stronger party to negotiate;
- d) the extent to which the parties acted in good faith; and
- e) the requirements of applicable industry codes.

Finally, even where market practices fall beyond the scope of both the prohibitions on misuse of market power and unconscionable conduct, they may still be relevant to market analysis in the context of mergers in the cattle supply chain. These issues are discussed in detail in section 5.2 below.

Relevant evidence regarding access to services

A rational response to any market participant experiencing declining average returns is to seek to vertically integrate into other higher value functional levels of the supply chain. This has been an aspect of the cattle supply chain for some time with market participants seeking to take ownership of products at various points in the supply chain. For instance:

- a) producers have sought to enhance their returns by retaining ownership of cattle products beyond the processing stage to provide direct access to wholesale and retail markets; and
- b) retailers have sought to manage their risks with respect to quality and certainty of supply by taking ownership of cattle 'from the paddock' before the processing stage.

These arrangements have been largely facilitated by the provision of consignment or service kill services by cattle processors in which cattle are slaughtered and butchered to required specifications by processors pursuant to contracts with third parties.

In the context of consolidation in the processing sector, concerns have been expressed in relation to the extent to which consignment/service kill services are available to third parties. In particular, producers have expressed concerns that they have been unable to obtain consignment/service kill services, making them more reliant on selling cattle through channels available before the processing stage.

While there is no general obligation on market participants to provide services to one another, it is possible that concerns of this nature could be framed in terms of a misuse of market power. As set out above, the prohibition on misuse of market power is narrow in scope and particular circumstances would have to be present before an allegation could be established. As a starting point, this would include where a market participant that is vertically integrated seeks to limit the supply of services to third parties in order to foreclose upstream or downstream competition.

To determine whether conduct of this nature may constitute a misuse of market power, evidence would be required to establish that the market participant limiting or refusing to supply services has:

- a) a substantial degree of market power in the provision of those services. As above, this would include details of market shares in the relevant market and the extent to which there are effective competitive constraints imposed on the market participant through, for example, alternative suppliers and new entry or expansion;
- b) used any substantial market power to engage in the conduct and relevantly, could not have engaged in the conduct without substantial market power; and
- c) engaged in the practice for the purpose of undermining upstream or downstream competition.

As flagged above, it may be possible to establish that some vertically integrated market participants have a substantial degree of market power and that they would require market power in order to refuse to provide services. This bigger challenge is likely to be establishing that the conduct has been engaged in for the purpose of undermining the competitive process. Market participants may have legitimate reasons for limiting or refusing to supply services to third parties including insufficient capacity to meet their own requirements. Third parties impacted by these decisions would need to establish more than just suspicion in relation to purpose in order to provide the ACCC with a basis to commence an investigation.

5.2 Merger regulation

Consolidation in the cattle supply chain

The cattle supply chain is characterised by increasing levels of concentration. Although cattle production remains highly diversified, cattle processing has been the subject of ongoing

consolidation, while beef wholesaling and retailing having been relatively concentrated for some time.

Consolidation necessarily involves a reduction in choice for the customers and suppliers of the merging businesses, a lessening of competition in the market and an increase in the level of market power that the merged business will have. Mergers also lead to benefits in terms of efficiency which, through the competitive process, are made available to consumers through lower prices. The objective of merger regulation is to determine the point at which the lessening of competition is substantial such that the merged business will be in a position to enjoy sustained market power and retain the benefits of any efficiencies.

Given recent consolidation in cattle processing markets, this sector provides a useful illustration of the manner in which merger analysis is conducted and the impact of consolidation on the cattle supply chain. Cattle processing mergers reviewed by the ACCC include the Swift Australia Pty Ltd acquisition of Rockdale Beef Pty Ltd in 2010, the Teys Bros (Holdings) Pty Limited acquisition of Cargill Beef Australia in 2011 and most recently, the JBS USA Holdings Inc acquisition of Australian Consolidated Food Investments Pty Ltd (Primo Smallgoods) in 2015. In each instance, the ACCC granted informal merger clearance on the basis that, amongst other factors, there would be an ongoing effective competitive constraint imposed by alternative cattle processors that remained in each market.

However, some market participants have expressed concerns regarding the impact of consolidation in the processing sector. In particular, market participants have queried whether acquisitions involving particular facilities have the potential to create regional monopolies in which producers have limited practical alternatives to the merged firm. Despite the outcome of the ACCC merger review process for the JBS acquisition of Primo, concerns of this nature resulted in the Treasurer imposing conditions on the Foreign Interest Review Board approval process. These included that the merged entity would not close a particular abattoir and would ensure that part of its capacity would remain open the third parties for consignment/service kill services.

Merger analysis

Merger analysis requires the identification of appropriate economic markets in which a proposed acquisition should be considered and consideration of the characteristics of those markets.

The identification of economic markets is a different exercise to observing markets from a commercial perspective. Often what are considered narrow segments or sub-markets by market participants will be identified as the relevant markets for the purpose of a competition analysis. This is because they are considered to be the most appropriate product, geographic and functional boundaries for considering the impact of a merger on competition.

Despite the conceptual and economic basis, merger analysis is essentially fact based and will be influenced by the ability of interested parties to substantiate concerns or conclusions with market evidence. The breadth of the relevant markets will have a significant impact upon the

outcome of a competition analysis as the impact of a proposed acquisition will naturally be amplified by the adoption of narrower markets.

Market boundaries are determined by the extent to which there is substitutability between products and services, geographic areas or functional levels in the market. In simple terms, this can be expressed as the extent to which market participants have alternatives across each of these market dimensions.

An economic test is applied to determine whether an alternative is a sufficiently good alternative to be considered a competitive constraint. This test explores the market response to a small but significant, non-transitory increase in price (SSNIP). While the appropriate level of price increase considered may differ from market to market, a SSNIP of 5 to 10% is a good starting point for considering whether a market boundary should be identified.

In terms of market characteristics, the relevant aspects of markets are based on established economic theory and reflected in the merger factors set out in the CCA. They include the extent of market concentration, alternative suppliers, barriers to entry, countervailing power, import competition and vertical integration. These factors are considered collectively to determine whether a proposed acquisition is likely to have a substantial and lasting impact on competition with reference to the likely future market conditions in the absence of the proposed acquisition. As the same markets are being considered, several of the factual matters identified as relevant to market definition will be important the ultimate competition analysis.

Relevant evidence of substantial lessening of competition

This analytical framework demonstrates that effective engagement with the ACCC in merger review processes requires more than simply expressing concerns regarding a reduction in alternatives arising from a merger. Market participants that have concerns need to gather evidence that goes directly to the issues of market definition and market characteristics. Often, this will involve demonstrating the complexity of market dynamics to provide a clearer indication as to whether alternatives that are apparently available are able to be taken advantage of in practice. In many cases, this will involve demonstrating the complexity of cattle markets and the impact of volatility arising from external factors such as climate conditions.

For the purpose of illustration, these factors can be considered in the context of mergers in cattle processing markets. Relevant evidence could include details of any practical constraints that limit options for other market participants. The ACCC has recently adopted an approach to geographic market definition based on a general rule regarding the distance producers are able to transport cattle for processing. To the extent producers consider this inappropriate, they could gather information regarding the impact of transport costs on profitability to demonstrate that alternatives may be more limited in practice. It may also be useful for this analysis to be conducted in a range of time periods to demonstrate the impact of different climate conditions on the supply chain and producer profitability.

Further, in considering alternatives that may be accessible to market participants, it would be useful to provide evidence regarding the quality of those alternatives. This information would be

relevant to either the boundaries of the relevant markets or the extent of competitive constraints imposed by participants in those markets. For instance, there is the potential for overall processing cattle capacity to be misleading where part of that capacity is either:

- a) customised for particular processing services (such as hot or cold boned processing or export or domestic grade processing) and there are barriers to modifying facilities to provide other processing services; or
- b) substantially contracted such that there is limited spare capacity that can be used by producers looking to switch between alternative processors.

Finally, barriers to entry more generally will be an important aspect of competition analysis and it would be important for market participants to provide details of the costs of establishing new or expanded capacity. This may also include details of any practical obstacles such as the time and costs involved in meeting regulatory and environmental requirements and the ability to obtain supply of cattle to establish operations at a minimum efficient scale. A key issue here would be the extent to which part of these costs are 'sunk' in that they can not be recouped upon exit from the market as this will provide a significant disincentive for potential entrants.

The extent of barriers to entry are also linked to the level of countervailing power in the market. Countervailing power relates to the ability of market participants to by-pass a business, even where it has an apparently strong market position. Where barriers to entry are low, it could be expected that an increase in price would result in market entry or expansion either by new entrants that see an opportunity to compete or through entry or expansion that is sponsored or otherwise encouraged by users of the services.

5.3 Cartel conduct

Cartel conduct is the most serious of the competition laws. It is an enforcement priority for the ACCC, with significant resources allocated to cartel investigation and enforcement activities. However, unlike misuse of market power and mergers regulation, cartel conduct is a strict liability prohibition. This means that it is only necessary to satisfy the elements of the provision for a contravention to be established and broader economic questions of the extent of market power or lessening of competition do not arise.

It is important that all market participants protect themselves from being involved in cartel conduct. Business people are regularly surprised by the breadth of the cartel provisions in three key respects:

- a) the parties to the cartel may be any actual or potential competitors. This is a significantly broader test than the competitors that may be focused on from a business perspective;
- b) the understanding between the parties to the cartel can be highly informal, involving any meeting of the minds between two competitors in which one or more parties intends to rely on the actions of the other; and

- c) the cartel arrangement does not need to be successful, longstanding or lucrative. Even an attempt to arrive at a cartel can form a contravention such that even ill-conceived communications with competitors are high risk.

A famous international cartel in the agricultural sector involved price fixing agreements between global competitors in the supply of the animal feed additive, lysine, which operated for several years. The cartel was successfully prosecuted in the United States resulting in over \$100 million in fines.

Cartel conduct may take place in any market as a result of communications between two individuals representing potential competitors. However, cartel conduct will not always be sustainable as there are usually strong incentives for firms to 'cheat' by taking advantage of the other party's compliance with the cartel make additional sales. This dynamic has arisen in a number of cartel cases, particularly where they have been implemented over a significant period. To the extent the cartel operates successfully, this is usually because one or both parties are able to retaliate to any cheating on the cartel in order to encourage compliance.

In this context, the prospect of sustainable cartel conduct arising is linked to the structure of the market. Cartel conduct is more likely to arise where:

- a) the goods or services are relatively similar, as different products at different prices tends to create uncertainty as to appropriate terms for the cartel;
- b) the cost structures of the firms are relatively similar. Where they are different, the parties may have different incentives regarding participation in the cartel;
- c) there is sufficient transparency such that compliance with the cartel can be observed and any cheating can be met with retaliation; and
- d) there are limited competitive constraints in the market as the presence of effective competitive constraints, for example from alternative suppliers, will undermine the benefit of the cartel.

Relevant evidence of cartel conduct

To date, cartel conduct and allegations have not been a significant aspect of the cattle supply chain or agriculture markets. However, there have been concerns expressed in relation to the conduct of cattle saleyards, the operation of which play an important role in the setting of prices for fat cattle in Australia as there is a relationship between saleyard prices and over the hook sales.

In order to substantiate any concerns regarding potential cartel conduct, market participants would require direct or indirect evidence of communications between parties that are potential competitors. This would include being a party to, or informed of:

- a) communications between competitors regarding prices, outputs, markets or bids;
- b) the nature and scope of any understanding arrived at; and

c) instances in which the understanding was given effect to through conduct in the market.

To the extent that such evidence may be available, it is generally not possible to progress the issue further than referring the matter to the ACCC. Unlike market participants, the ACCC has the investigatory powers to obtain details of communications between competitors and test whether they relate to a cartel arrangement. It may also obtain search warrants which are highly effective in obtaining the details of cartels.

While mere suspicion of cartel conduct is generally insufficient, there may be circumstances where observable market conduct can indicate the presence of cartel conduct. These include:

- a) where market conduct would have been unlikely to arise in the absence of communications between competitors; or
- b) where patterns of market conduct can be identified which are inconsistent with normal market operation.

For instance, this could include a boycott of a saleyards or alternate bidding on different saleyard pens which would be difficult to facilitate without an understanding between competitors.

It is also possible that competition issues could arise from the common representation of market participants by agents. This is because of there is a risk that agents could facilitate communications regarding selling or buying strategies between competitors. Even in the absence of cartel conduct, such arrangements have the potential to raise competition concerns where common representation has the effect of further reducing the number of competitors contesting the market.

Again, the best approach for market participants that have concerns in this regard is to collect tangible evidence with as much detail as possible and provide it to the ACCC. As the ACCC does not have the resources available to monitor ongoing conduct, the onus is on market participants to provide sufficient evidence to justify commencing an investigation.

6. Enhancing the effectiveness of competition laws

6.1 Legislative reform proposals

Misuse of market power

Longstanding concerns in relation to the operation of the current prohibition on misuse of market power were an input to the decision of the Government to commission an independent 'root and branch' review of Australia's competition laws and policy. The review was conducted by a panel chaired by Professor Ian Harper (Harper panel) and after substantial consultation delivered its final report on 31 March 2015 (Harper Report).

In the context of the scope of the Harper Review, the prohibition on misuse of market power generated a disproportionate level of debate. Strong views have been expressed that the

current prohibition was either appropriate or inadequate in addressing instances of market failure. In particular, market participants in concentrated industries that had significantly less bargaining power than their customers or suppliers expressed the view that:

- a) the prohibition needed to be expanded to capture not only conduct for which there was a proscribed anti-competitive purpose but also conduct that has an anti-competitive effect; and
- b) the current requirement that there be a direct link between the substantial market power of a business and the conduct was too narrow and permitted firms with substantial market power to unilaterally undermine the competitive process.

In response, the Harper Report proposed that the misuse of market power prohibition be broadened to address conduct that had the purpose or effect of substantially lessening competition and removing the 'taking advantage' element of the prohibition. Treasury is currently consulting on this proposal with the expectation that legislative reform will be progressed in 2016.

While this proposed reform would significantly broaden the scope of the misuse of market power prohibition, it would only result in a subtle change in the range of market conduct that may be legally engaged in by a firm with a substantial degree of market power. This is because:

- a) the proposed amendments do not seek to prohibit the use of market power and, in the majority of cases, the use of market power will continue to be permissible;
- b) a substantial proportion of market conduct is the subject of contractual agreements, such that the substantial lessening of competition test in the general prohibition on anti-competitive agreements may already apply; and
- c) the substantial lessening of competition test remains a relatively high threshold, requiring a lasting impact on extent of competitive constraints imposed in an economic market.

Given the protracted nature of the misuse of market power debate and the work currently being undertaken by Treasury, there would appear to be limited opportunity to address any concerns arising in the cattle supply chain that are significantly beyond the scope of the Harper Report recommendations. However, as noted above, conduct which has been the subject of misuse of market power concerns could still form the basis of an unconscionable conduct claim and these provisions will continue to apply in particular circumstances.

Merger reform

The substantial lessening of competition test for the regulation of mergers has also been the subject of debate in connection with the cattle supply chain. Wherever markets are relatively concentrated, smaller players will feel the impact of uneven bargaining power with larger players and cattle producers have expressed concerns in relation to the impact of retail and processor consolidation in this context.



Some of these concerns have related to the impact of small acquisitions over time which ultimately have a substantial impact on competition (often referred to as creeping acquisitions). The problem of creeping acquisitions has been debated for many years, with proponents for reform identifying the focus of the merger provision in the CCA on a single acquisition as a deficiency in the law.

In response, amendments were made to the CCA in 2011 to clarify that the relevant substantial lessening of competition could arise in any market (as against a particular market) and that this need not be a substantial market. The intention of these reforms was to provide clearer guidance around the extent to which an acquisition which may only affect relatively small markets could be reviewed under the CCA.

There has and will continue to be further debate as to the effectiveness of these reforms and the operation of the merger provisions of the CCA. However, the Harper Report has concluded that the substantial lessening of competition test has broad support and should not be the subject of reforms at this time. As a result, it appears unlikely that there will be reform to merger provisions in the short to medium term. Further, market participants in the cattle supply chain that are concerned as to the impact of a merger should focus on gathering information that goes to the current analytical framework, as discussed in section 5.2 above.

Cartel provisions

Concerns in relation to cartel conduct have been expressed in relation to the cattle supply chain. These concerns have generally related to particular market practices rather than the operation of the law or the need for reform. This reflects the fact that the cartel provisions are already broad in scope and have been the subject of significant enforcement activity by the ACCC.

The Harper Report did recommend amendments to the cartel prohibitions in the CCA to provide for a simplification of the existing regime and greater clarity in relation to aspects of the regime. These include the jurisdictional reach of the law, the meaning of 'potential' competitors and exceptions relating to the joint ventures and supply agreements. Beyond these refinements, it could be expected that there will not be substantive reforms to the cartel prohibitions in the short to medium term.

However, the Harper Review also concluded that the current prohibition on price signalling in prescribed markets (currently only the banking sector) should be repealed and replaced with a prohibition on concerted practices that have the purpose or likely effect of substantially lessening competition.

Such a provision would address conduct by actual or likely competitors that is jointly arranged, carried out or co-ordinated but falls short of the 'understanding' that must be identified under the cartel prohibition. If this recommendation is adopted and a concerted practices provision is introduced, market participants in the cattle supply chain will be in a position to consider whether any conduct of concern falls within its scope.

6.2 Industry codes of conduct

The competition laws in Part IV of the CCA have proven to be flexible and proportionate in protecting the competitive process across the economy in the vast majority of circumstances. However, it is always possible that circumstances will emerge in which markets fail to operate efficiently due to sustained market power being obtained by particular market participants.

In recognition of this, Part IVB of the CCA relating to industry codes of conduct was introduced to provide an alternative to the competition laws for markets in which minor or major market failure may be identified. Part IVB of the CCA provides for industry codes to be prescribed by the relevant Minister and grants the ACCC and private parties enforcement powers in relation to contraventions of industry codes.

Industry codes involve a set of principles, guidance or obligations that set out minimum standards of conduct in an industry in the context of an identifiable problem. The effect of an industry code being prescribed under the CCA is to broaden the reach of the CCA to scenarios that may or may not have been covered by the competition law. In this sense, industry codes assist in preventing instances of market failure as well as providing a mechanism to address any market failure that may have occurred.

Industry codes may be established on the following bases:

- a) a self-regulatory voluntary code;
- b) a voluntary code prescribed under the CCA; or
- c) a mandatory prescribed code under the CCA.

It is not simply a matter of choice as to which form of industry code is adopted. The Government has provided guidance on the circumstances in which it will prescribe an industry code under the CCA.

A voluntary industry code is the most common form of industry code used in Australia. It involves an industry agreeing some of the key terms upon which market participants will interact and providing for self-regulating industry body to administer the code. This usually involves the operation of dispute resolution procedures. The benefits of voluntary industry codes are that they involve lower compliance costs and are highly flexible, ranging from providing guidance in relation to operational matters to imposing specific obligations for market participants with consequences for non-compliance. Examples relevant to the cattle supply chain include the Australian Code of Practice for the Selling of Livestock.

A voluntary industry code prescribed under the CCA will be considered by the Government where industry consultation demonstrates a compelling case for regulatory intervention to address market failure. The Government will also assess whether alternative options may be available, such as a self-regulatory code or industry specific legislation, and whether the costs of operating the code will be outweighed by the benefits. Voluntary prescribed codes will only be binding upon market participants that agree to comply with the code. Examples relevant to

the cattle supply chain include the Food and Grocery Code of Conduct which has been agreed to by some participants in the grocery sector.

Mandatory industry codes prescribed under the CCA will be considered by the Government where an industry code is considered the most appropriate response to instances of market failure and market participants have proven unable to resolve industry issues on a self-regulatory or voluntary basis. While basic operational issues and general obligations to act in good faith are usually able to be agreed amongst market participants, issues that impact the transfer of value between participants in the supply chain will be hard fought. Where these are issues of significance, it is likely that consensus will not be achievable and that a mandatory prescribed code should be considered. Examples relevant to the cattle supply chain include the Wheat Port Code of Conduct which was introduced in 2014 to replace port access obligations under the *Wheat Export Marketing Act 2008* (Cth).

In the context of these options, market participants may wish to consider whether an industry code would assist in addressing any concerns that have arisen in relation to the cattle supply chain. As industry codes are focused on conduct, the most relevant issues to consider would be those identified as concerns in relation to misuse of market power.

The benefit of a code of conduct would ultimately be determined by its scope. Where an industry code dealt with operational matters and higher level obligations, the cattle supply chain could benefit from greater transparency in relation to interactions between market participants. This could also contribute to greater confidence and potentially investment across the supply chain.

Where appropriate, a code could also include detailed obligations to address any instances of market failure that are capable of being demonstrated. This could include specific unilateral conduct which impacts upon returns to market participants and/or access to services that facilitate greater competition across the supply chain.

Finally, an industry code would also provide a forum in which any concerns arising in relation to the cattle supply chain could be considered and, if substantiated, acted upon in a timely way. Given the protracted process of legislative reform and testing specific conduct through competition enforcement, the ability to resolve any issues in a shorter timeframe is likely to be attractive to market participants and assist the entire cattle supply chain in focusing on opportunities for growth.

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