Competition News

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Towards a fair and efficient economy for all.

IN THIS EDITION

Looking out for cartels

tell-tale signs of price fixing, market divisions and collusive tendering

"People of the same trade seldom meet together, even for merriment or diversion, but the conversation ends in a conspiracy against the public, or in some contravention to raise prices."
Adam Smith, 1776

More than 200 years ago, Adam Smith alluded to the possible harm that people of the same trade, or competitors, can cause when they decide to co-operate rather than compete.

This tendency for competitors to conspire (or collude), is driven by the increased profits that follow from colluding rather than competing. Posing as competitors, cartel members destroy competition and cause serious harm to economies and

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consumers. Collusion enables competitors to charge monopoly prices and make monopoly profits. In its 2000 *Report on Hard Core Cartels* the Organisation for Economic Co-operation and Development shows that price fixing leads to an average increase of 10 percent of the selling price, with a corresponding reduction in output as high as 20 percent.

In South Africa, price fixing and the fixing of trading conditions, market division, and collusive tendering are seen as so anti-competitive that under the Competition Act (Act 89 of 1998) it is a *per se* contravention and thus cannot be justified by any means (S4(1)(b)).

Price fixing and the fixing of trading conditions

Price fixing agreements and the fixing of trading conditions can take many forms. Essentially, they are agreements not to compete on price and other services rendered by suppliers and include, but are not limited to:

- Price fixing, a fixed formula for price calculations and minimum prices
- Fixed discounts, credit and payment terms and conditions
- Fixed price differentials between different products.

Market division

Market division occurs when firms agree not to compete with each other in specific markets. This type of collusion has firms allocate customers amongst each other and divide products and territories. The agreement not to compete with each other for customers or in certain product or geographic markets essentially establishes each member of the cartel with their own monopoly and the opportunity to extract monopolistic profits.

Collusive tendering

Collusive tendering (or bid rigging as it is known in the United States of America) is where conspiring competitors agree in advance who will submit the winning (lowest price) bid. There are four main methods of collusive tendering, used either individually or in combination by cartels. These are:

- Bid suppression: certain companies agree to refrain or withdraw from the tender procedure
- Complementary bidding: certain members of the cartel agree to submit high bids to give an appearance of competition
- Bid rotation: all the members submit tenders, but take turns to be the lowest and winning tender
- Sub-contracting: the winning company spreads some of the spoils, by sub-contracting part of the work to losing bidders.

Cartels are highly profitable arrangements for their members. The incentive for cartelisation is high, but so is the incentive for cartel members to cheat and make even more profit. Cartelisation requires a method to easily establish and maintain consensus amongst members.

Favourable conditions for collusive activity/ cartels

Some market structures and product and sector characteristics create circumstances that are more conducive to cartel activity.

Market structure. Few sellers, or a concentrated industry, allows for easier co-operation between cartel members. The fewer the players, the easier it is to communicate with each other; to get agreement on prices, quotas and markets, and to police members' behaviour.

Markets with high barriers to entry make it difficult for new entrants to react to higher prices and profit opportunities.

Product type. Markets in products with low levels of differentiation, or that are standardized, facilitate easy collusion.

Furthermore, cartels favour stable sectors in the economy and are found where mature technologies are employed, i.e. cartels do not have to react fast to external influences. Member firms of cartels generally have similar cost structures.

An important part in the process of collusion is the channel of communication between, and policing of, cartel members. Information is vital to the execution of collusion. This process of information sharing often happens through the use of trade associations, particularly when there are larger numbers of operators. Collusion is sometimes also a natural progression when competitors know each other well and meet regularly.

Tell-tale signs of cartels/ collusive activity

Cartels are by their very nature secretive and difficult to detect. Competition policy and the successes in enforcement by authorities worldwide have forced cartels further underground. There are a number of tell-tale signs that may alert one to price fixing and market sharing activities.
These are:

- Firms have identical prices for long periods of time
- Parallel conduct between firms
- Price increases do not seem to be supported by increases in costs
- Groups of firms have the same discount policy, credit policy and payment conditions
- Sellers charge higher prices in certain markets than in other distinct (geographic) markets.

These elements might sometimes be perfectly legitimate behaviour by competing entities or individual firms. They are only contraventions when an agreement to fix prices or trading conditions, to divide the market, or to tender collusively exists between competitors.

Cartels and collusive activities inflict serious harm on consumers and the economy as a whole. The benefits of a competitive economic process, i.e. efficiency, choices and innovation, are lost to all. In the longer run the industry also suffers, as it does not progress as it should do under competitive circumstances.

The Competition Commission is committed to the fight against anti-competitive agreements between competitors.

New targets for

Black Economic Empowerment

The Black Economic Empowerment Commission (BEECom) recently issued a document entitled "An Integrated National Black Economic Empowerment Strategy". This article, the first in a series dealing with BEE and the document, will explain and evaluate the new BEE targets, and also touch on some competition aspects to do with the recommendations.

The document takes a comprehensive look at the progress made towards BEE over the past few years. The main finding that emerges repeatedly in several chapters, is that in fact, very little has been achieved. While some of the evidence relied upon is sketchy, the findings cannot really be challenged. The situation is extremely bleak and that is what the report seeks to address. Small wonder, then, that the report recommends fairly drastic revisions of the BEE targets.

The BEE Commission was established in May 1998 under the auspices of the Black Business Council, representing 11 black business organisations. Its objectives were to assess the pace and results of BEE initiatives during the 1990s, for example those contained in the Reconstruction and Development Programme (RDP).

BEECom defined BEE broadly as:

- An integrated and coherent socio-economic process
- Being located in the context of the country's national transformation programme, namely the RDP
- Aimed at redressing the imbalances of the past by seeking to substantially and equitably transfer and confer the ownership, management and control of South Africa's financial and economic resources to the majority of its citizens
- Seeking to ensure broader and more meaningful participation in the economy by black people to achieve sustainable development and prosperity.

The report sets out ambitious BEE targets. They must be achieved within 10 years and stipulate the following:

- 30% of productive land to be in black hands
- 25% of equity shares in each sector to be in black hands; 50% where 25% target already met
- 25% of JSE shares to be in black hands
- 40% of directors of JSE-listed companies to be black
- 50% of Government procurement to black companies/collective enterprises
- 30% of these companies should be black-owned small, medium and micro enterprises (SMMEs)
- 30% of private sector procurement
- 40% of management of private companies (with more than 50 employees) should be black
- Human Resource Development (HRD) strategy to ensure that 40% of professionals and those training to be professionals are blacks
- HRD strategy to ensure that the higher education and training system (HET) increases the participation rate to 20%
- 50% of value of loans from National Development Finance Institutions (DFIs) should be to black-owned companies/ collective enterprises
- 30% of restructured State-Owned Enterprises (SOEs) should be owned by black companies/collective enterprises
- 30% of long-term public sector concessions (PPPs) should incorporate black-owned companies and collective enterprises
- 40% of Government incentives should go to black companies
- Government and the banks to agree to targets for access to financial services (community reinvestment targets).

Given the appalling inequalities that persist in the South African economy, the targets do appear justified, and even too low in some cases (e.g. that only 40% of Government incentives should go to black companies).

Targets should possibly also be set in relation to other objectives. In particular, the issues of land reform, the use of equity as opposed to debt finance for financing of black businesses and an increase in competition in the banking sector should be considered for BEE targeting.

BEECom states some initial objectives concerning growth and investment. Fixed investment as a share of Gross Domestic

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"The BEE policies will certainly impact on the ability of previously disadvantaged people to supply products competitively"

Product (GDP) must be boosted to 25% from its present level of around 15%; this will be necessary if growth in GDP is to rise to 6%. An Integrated Manufacturing Strategy is suggested to create a number of world-class, export-oriented producers, but this process must be driven with BEE as a fundamental pillar.

These are ambitious plans, requiring some elaboration as to how they will be achieved. In particular, a boost in investment to 25% from only 15% is a major change, and will not be accomplished without trade-offs in the short term. Such a shift in expenditure may require the deferment of present consumption to the future.

The recommendations of the BEECom will certainly affect business and consumers considerably, seeing as many of the recommendations stipulate compulsory flows, the allocation of revenues, proceeds and expenditures, loans, price preferences and the like. At the outset, the document made reference to a greater focus on asset-based redistribution, rather than income redistribution, but that is not really evident from the rest of the paper. BEECom clearly envisages massive investment expenditures in targeted sectors, but it is not clear what the source of these investments will be. Surely, taxes will have to be redirected in the Budget, away from being used for directly empowering social expenditures (such as health, water and housing) towards these targeted industries that are yet to be identified.

The focus of the document is on business and ownership of business. The BEE policies will certainly impact on the ability of previously disadvantaged people to supply products competitively. But the ultimate beneficiaries of BEE, ie households and the communities where they are located, should form part of the objectives in terms of their measured household incomes, the prices they pay for goods and services, and developmental measures of living standards. Some culture of business responsibility to communities should be inculcated as part of the BEE process, and perhaps the BEECom document and the proposals contained in it should be accompanied by a strong consumer awareness campaign.

The next article in the Competition News BEE series will examine some of the detailed, sectoral proposals for how the revised BEE targets might be achieved.

The Competition Appeal Court speaks

In the first judgement delivered by the Competition Appeal Court (CAC) on the 14th June 2001 in the matter of Novartis SA (Pty) Ltd and Others v New United Pharmaceutical Distributors and Others (Case No: 07/CAC/DEC 00) the learned Judge President Davis and Acting Judges of Appeal Mailula and Jali made their voices heard.

The appeal dealt with a variety of matters, including locus standi, a cross appeal, the meaning of "submitted in the prescribed manner", retrospectivity and costs. Some of the aspects are particular to the factual situation and, in others, the Competition Act has subsequently been amended and are therefore of academic interest, except to the parties.

The one area of great interest has been that of retrospectivity. The court discusses the transitional sections and refers to the eminent Constitutional Court decision of S v Mhlungu and Others 1995 (3) SA 867 (CC) at para 65-67 where the distinguished jurist Kentridge AJ holds: "there is a strong presumption that new legislation is not intended to be retroactive."

When there is any ambiguity in the legislation the fundamental principles, as enunciated by Kentridge AJ, should be applied. The use of the words "any proceedings that were pending" coupled with the words "must be proceeded with" would appear to mean that the procedures which must be employed in any matter which is pending at the time that the Amendment Act came into effect, are those contained in the Amendment Act.

The CAC then comes to the conclusion that it was clearly the intention of the Legislature to ensure that the new procedures would apply to all proceedings which were pending at the time the legislation came into effect.

The further question was posed: "...whether any matter of substance which had been disposed of by the Tribunal under existing law, that is law prior to the Amendment Act should now be adjudicated in terms of the Amendment Act?" Again, reference is made to S v Mhlungu and Others supra, this time to Mahomed J (later to become Chief Justice) "such an appellant would have to confine himself to the substantive law which applied during his trial." It is further stated that should the Legislature have intended that it was to be governed by a provision in the Amendment Act, it would have been required to employ an express provision to that effect. The CAC comes to the conclusion that the cross appeal must be decided in terms of the law which existed when the Tribunal made its determination.

In conclusion, it was held that:

- In the absence of an express provision the amendments are not retrospective; and
- The substantive law that applied at the time of the hearing would also apply at the time of the appeal.

Consumers

and the Competition Act

The purpose of the Competition Act, Act 89 of 1998 (the Act), is to promote and maintain competition in order to, amongst other things, provide consumers with competitive prices and product choices. Consumer protection is, however, largely the responsibility of the Department of Trade and Industry and related provincial offices.

The primary purpose of the Act is to enhance the economic efficiency of players in the economy so that consumers can enjoy lower prices and increased product choices.

There are at least three functional requirements for markets to work to the benefit of consumers:

- Competitors must be able to provide a range of choices to consumers
- Consumers must be able to make informed decisions from amongst those options
- Prices must be determined by market forces.

The main provisions of the Act that can be used to protect consumer welfare are merger control and prohibited practices. To give effect to these provisions, the Competition Commission conducts investigations into alleged restricted practices and evaluates and controls mergers and acquisitions in the economy.

Consumers may file complaints with respect to practices prohibited by the Act, declare material injury demonstrating how a practice in relation to a filed complaint affects consumers, submit an endorsement or opposition to an application for a merger, or submit an opposition to an application for an exemption from the provisions of the Act.

However, competition policy alone does not address consumer needs. The ability of consumers to protect their interests from the anti-competitive behaviour of firms lies to a large extent in consumer actions, individually or collectively. In many instances materially injured consumers may not have sufficient standing as individuals. However, a pro-active consumer lobby group may pose a threat to firms who are not responsive to consumer needs.

The impact of competition regulation on consumer welfare is often ambiguous, mainly because consumer welfare is a multi-jurisdictional responsibility and also because, competition policy is more concerned with business-to-business activity than with business-to-consumer transactions. Often consumer movements do not see their relevance in the competition policy arena.

Internationally, the interrelatedness of competition policy and consumer rights are acknowledged. The UK Competition Commission for instance, takes into account consumer issues when evaluating transactions. In its statement of aims and objectives, the Commission states that the outcome of its activities will increase the level of competition in the UK economy and make markets work well to ensure that consumers benefit from lower prices and a wider range of choice. In the long term the Commission envisages an environment with innovation and higher quality products and services.

The United States Federal Trade Commission takes its consumer welfare responsibility a little further by establishing, within its jurisdiction, the *Office of Consumer and Competition Advocacy* and the *Office of Consumer and Business Education*. The former oversees an advocacy program through which the Commission shares its consumer and competition expertise with other government agencies, concerning possible effects of proposed actions on consumers. The latter plans and implements public education campaigns for consumers and industry, about fraud, deception, and unfair practices.

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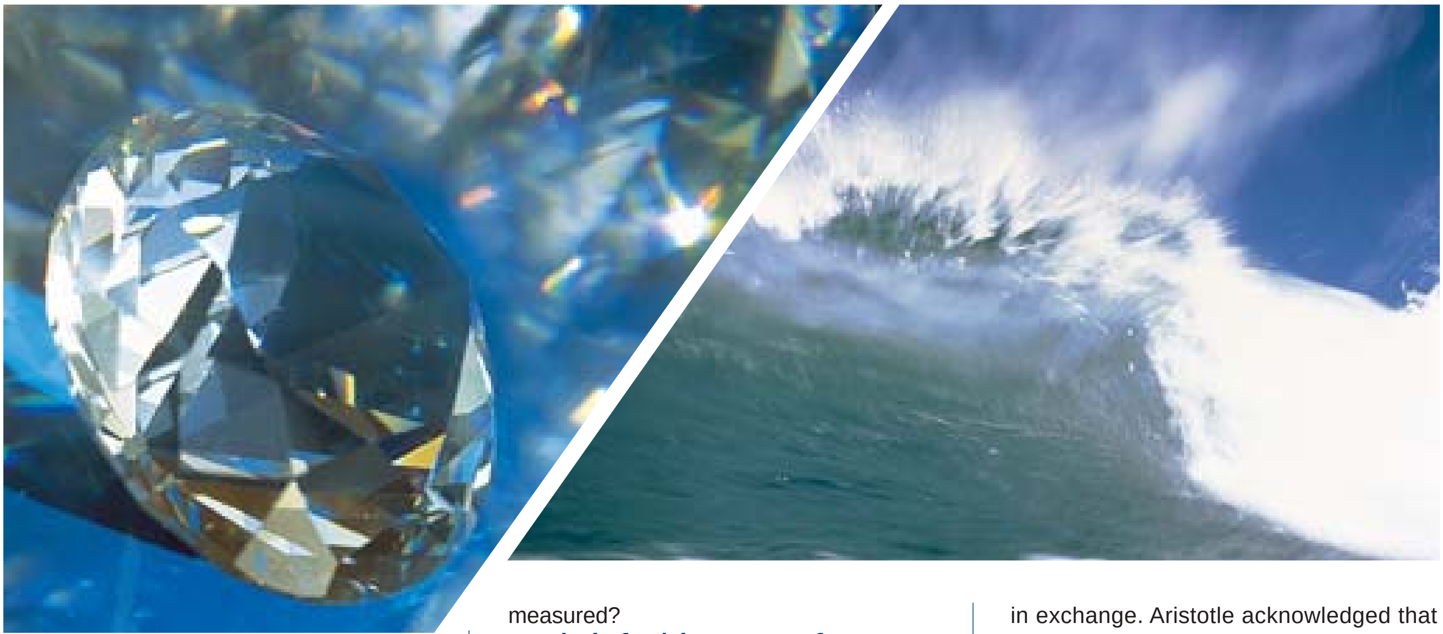
The Australian Consumer and Competition Commission is, in effect, a consumer and competition protection agency. It has enshrined in its legislation consumer protection provisions (Part V). The Commission enforces these provisions on industry-wide conduct, aiming to strengthen the position of consumers, by ensuring that businesses compete fairly on price and quality. They do this by including in consumer contracts, provisions pertaining to quality, fitness and title.

Consumers are usually the ultimate victims of anti-competitive practices and monopolistic market structures. The Competition Commission believes consumer protection and competition enforcement should work hand in hand to ensure that consumers receive the benefits of effectively functioning markets.

Excessive pricing, fairness and economic value



The Competition Act (Act 89 of 1998) prohibits dominant firms from charging excessive prices to the detriment of consumers, where excessive price is defined as a price that bears no reasonable relation to the economic value of goods and services, and is higher than the said economic value. Translated into ordinary language it means that dominant firms are not allowed to charge prices that are "too high", or "unfair".

This leads to the questions of how much is too high, or what is a reasonable relation? And, how should economic value be measured?

A brief history of some thoughts on value

The philosophical question of the measurement of value had interested many thinkers. The Greek philosopher Aristotle was one of the earliest thinkers to consider the issue of fairness in exchange and commercial activity. Except for his notion that fairness in exchange requires equality of proportion[1], his study of economic value did not offer a tool or logical standard to test a fair exchange. Aristotle distinguished between two possible uses for products, namely particular use (functional use) and use in exchange. These two uses manifest in two types of value, i.e. value in use and value in exchange. Aristotle acknowledged that there might be a difference between the two values.

The ideas of Adam Smith were founded on the same premise of value in use and value in exchange. He used water and diamonds to explain that the exchange value of a commodity may bear no reasonable relation to its usefulness. (It should be noted that the classical economists regarded usefulness as serving some kind of biological or social need, which may be far removed from the materialistic needs that are acknowledged today.) Water is crucial for survival and therefore serves the highest need, i.e. has the highest use. Diamonds do not serve such a need. Yet water is free (or was then) and diamonds are very expensive. This dissonance was called “the paradox of value”.

Adam Smith was concerned with the determinants of value and the best measures of value. He proposed two methods to measure value: both stand testimony to the lack of analytical tools available to the classical economists of that time and both give a kind of “intuitive feel” for value.

The first method of calculation is the cost of production theory. Adam Smith proposed that there is a “normal” or “natural” price for products. Fluctuations in these prices are due to short-term demand and supply fluctuations. The value of a commodity is the sum of the normal or natural amounts payable to the factors of production used in making it. This method explains prices by prices and does not examine the underlying principles in determining value.

Smith’s second method of calculation focuses on supply determined prices. The relative scarcity of goods determines its exchange value. Relative scarcity is ruled by the cost of producing an article, i.e. diamonds have a higher value in exchange because they are more scarce than water. Diamonds are more scarce than water because their cost of production is higher than that of water.

Smith’s attempt at establishing an objective measure of value fails. Further work in the classical tradition by David Ricardo and Karl Marx also fail to deliver such a measure of value. Ricardo introduced the labour cost theory, but this does not account for relative prices.

Marx’s labour theory of value and surplus value theory are well known. Simplistically stated the value of a commodity is its price in terms of labour time. Surplus value is a statement about the relationship between the value of labour and the value of the final product. Marx’s theory is not one of exchange value. He only goes as far as to say, that prices diverge from the labour value and that profit is unpaid labour.

These attempts at purely objective value theories did not take full consideration of the methods whereby market forces produce equilibrium or normal prices. To appreciate this process it is necessary to examine how the values of the factors of production and the final goods are determined, from the supply of the factors of production to the demand of the finished goods.

Alfred Marshall and the neo-classical economists[2] provided a more thorough analysis of the determination of competitive prices, incorporating the subjective influences on market prices as well as cost factors. Marshall integrated the tools of supply and demand as is widely used in mainstream economics today.

A major contribution to this method of analysis is the theory of decreasing marginal utility, where utility is recognised as a subjective value. As an individual consumes greater quantities of a product, beyond a certain point the extra utility derived from each extra unit will fall as the consumer reaches satiation. The principal of decreasing marginal utility explains the law of demand. Since consumers derive less utility from the consumption of successive units, they will only be prepared to purchase more units if they can get it at a lower price. Demand for a product is a function of the subjective utility that a consumer derives from it at different levels of consumption.

The supply of a product, on the other hand, is a function of the objective costs the firm incurs to produce the product. Equilibrium (or competitive) prices are established at the price level where the quantity demanded equals the quantity supplied.

An approach for competition analysis

For the purposes of competition analysis the economic value of a good or service is its competitive price as the competitive price incorporates all the elements of objective and subjective values.

A firm would have to be able to act independently to diverge from the competitive level of prices. The Act acknowledges this fact and therefore excessive pricing is an abuse of dominance prohibited. The Act acknowledges this fact and therefore excessive pricing is seen as an abuse of dominance and is consequently prohibited.

In order to establish excessive pricing one would need to see that the price charged includes an unreasonable premium over the competitive price. Establishing the competitive price may be extremely difficult, as the firm with market power may already have been charging the excessive price for some time and there is no benchmark available for a competitive price level.

Also, because the competitive price includes a measure of subjectivity in value (from the demand side), it makes it even more difficult to estimate correctly under laboratory circumstances.

Competitive prices of products are, under competitive circumstances, equal to the marginal cost faced by the firms who produce them. If a measure of marginal cost was available this could easily replace the competitive price measure. Marginal cost is, however, an economic term and not always easy to calculate from a set of accounts. It is in many instances impossible to calculate marginal cost, particularly where firms produce more than one product.

It may be necessary to take a pragmatic approach to the analysis of excessive pricing. Such an approach may be as follows: in order to establish economic value, a cost-based approach should be followed, taking the manufacturing costs of the particular product into account, with an industry norm profit margin added. It may also be necessary to add premiums for special circumstance, i.e. risk, cost of innovation or intellectual property, etc.

Some indicators of excessive pricing may be abnormal profit levels (monopolistic profits), high level of x-inefficiency, and high barriers to entry rendering the market incontestable. Deviation of domestic prices from international prices may under certain circumstances also be indicative of excessive pricing.

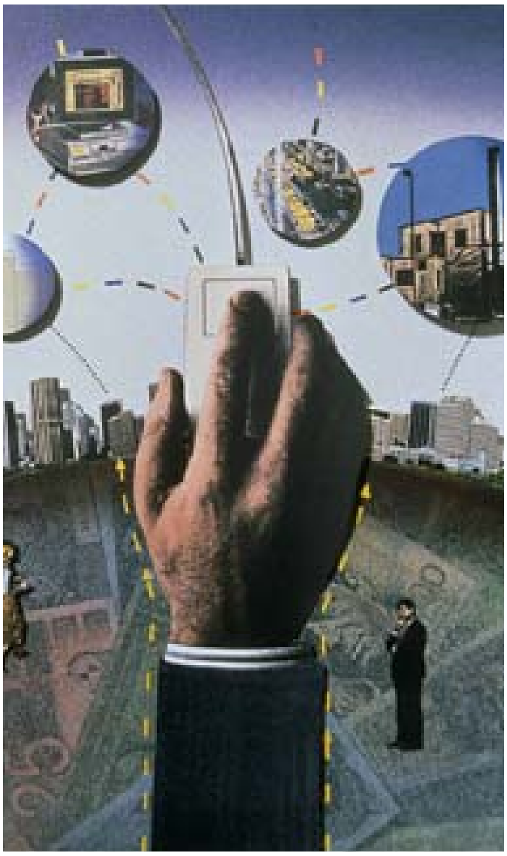
[1] Equality of proportion: If the exchange ratio between good A and good B is 2-to-1, then the exchange is fair if the manufacturers of the goods possess some attributes in the same ratio as between the goods. This can relate to the skills or other inputs required to manufacture the goods. I.e. the skill to manufacture good B is worth twice as much as the skill to manufacture good A.

The Competition issues in B2B commerce

Business to business e-commerce (B2B) refers to paid transactions of goods and services between businesses over the Internet. With B2B e-commerce many of the labour services traditionally required in producing and processing economic transactions are replaced by computer data processing and Internet communications systems. By automating the procurement process B2B exchanges can reduce transaction costs substantially. B2B electronic marketplaces create an enabling environment for heightened interaction between buyers and sellers. This creates considerable scope for facilitating supply chain management. However, despite these efficiencies, some concerns have been raised over the potential for B2B exchanges to facilitate anti-competitive conduct.

An e-marketplace is an efficient information exchange, and as such could facilitate collusion. Competition policy issues may arise in those cases where the B2B online marketplace is co-owned by a number of significant market participants. It should be noted, however, that some form of collaboration between competitors is unavoidable if a B2B e-marketplace is to be successfully developed. Any anti-competitive concerns must be balanced with this consideration. Nevertheless, when competitors hold equity in the B2B marketplace, the likelihood of co-ordinated behaviour may be greater because equity holders presumably have greater access to information, unless conditions are implemented that restrict the degree and type of information that may be shared. Although the primary concern is with e-marketplaces that are co-owned by the market participants, similar issues may also apply to independent trading exchanges and joint Internet sales ventures by traditional competitors.

The difficult task for the Competition Authorities is to determine when information-sharing agreements are pro-competitive



and when they are likely to harm competition. In assessing whether competition issues may arise the following factors should be considered:

- Whether the B2B is owned by the participants or is independently owned. Participants that hold equity in the exchange may have greater access to information
- Collusive behavior is more likely to occur in more concentrated markets with fewer players. Market shares, barriers to entry, and combined market shares of participants should be taken into account
- The nature and extent of information sharing - price information, capacity, sales of competitors and quantities purchased etc.
- Whether information shared on the B2B is also available from other sources.

Most of the B2B exchanges in South Africa involve buying groups. The information sharing practices of a B2B marketplace may facilitate monopsony (is this a real word?) co-ordination under certain conditions. The key criterion for evaluating the potential for anti-competitive harm is to identify whether the buyer or buying group buys a sufficiently large share of the inputs in the market. The joint purchasing of indirect inputs like goods for maintenance, repair, or operation (MRO's) is not likely to raise competition concerns. With companies in many other industries buying MRO's it is highly unlikely that a group of buyers could dominate the market for MROs. However, in the market for direct inputs, with companies in fewer industries buying, the likelihood that a group of buyers will dominate is greater.

The participant-owners of an exchange may deny their competitors' access to the B2B exchange or disadvantage those competitors in their use of the B2B. If there were a complaint of an exclusionary practice the analysis would have to establish the impact on competition in the market in which the excluded firm participates. In a recent FTC report on anti-trust policy and B2B exchanges, it was argued that this analysis should proceed by focusing on the following questions:

- Is the B2B the only platform for buying and selling the product (and its substitutes) at comparable prices? How difficult would it be for the excluded rivals to reach suppliers or buyers through other mechanisms? Are the alternatives efficient, or are there special advantages attached to using the existing B2B? Are there strong network efficiencies in an existing B2B that make alternatives unsatisfactory?
- What are the barriers to entry of alternative market places? What are the counter strategies that rivals might pursue?
- Are the excluded rivals important for maintaining effective downstream competition? Would denial or limitation of access give the B2B participants the power to raise the price of the products

they sell above the competitive level?
- What are the efficiency arguments? These should be analyzed 'in the context of particular factual settings'.

It would appear that B2B e-commerce does not raise any unique competition issues. The speed and efficacy with which information can be assimilated and disseminated generates new efficiencies for firms but can also facilitate anti-competitive co-ordination and exclusionary behaviour. The greatest potential for abuse lies with participant-owned B2Bs. Those that control B2B market places should be interested in ensuring that as many buyers and sellers as possible transact over their B2B on a free and fair basis. However, industry participants that also own or control B2Bs may have an incentive to engage in anti-competitive behaviour. The competition authority must evaluate the implications of allowing dominant industry players to own or control B2Bs.

There are great pro-competitive gains to be had from promoting the development of B2B e-commerce. However, an effort must be made to promote and maintain transparency and neutrality among buyers and sellers transacting over B2Bs. Compliance with the Competition Act is an effective way of ensuring that this objective is met.

Banking
and the Competition Act

The banking sector in South Africa is traditionally regulated through the Banks Act (Act 94 of 1990) as amended and other legislation administered by the Registrar of Banks and the Financial Services Board. Since 1 February 2001, the banking sector is also subject to the Competition Act, 1998 (Act 89 of 1998) as amended. In terms of the amended Act, the Competition Commission now has concurrent jurisdiction with the Registrar of Banks.

What does concurrent jurisdiction mean for the banking sector?

In the past, bank mergers and the acquisition of shares in banking institutions required approval of the Registrar of Banks, and, in some cases, of the Minister of Finance. Section 37 of the Banks Act required the Registrar of Banks to consult with the Competition Commission on any competition matters inherent in the proposed transaction. Banking institutions did not have to notify the Competition Commission separately.

Since 1 February 2001, all bank mergers or acquisitions in which a change of control occurs, as defined in Section 12 of the Competition Act, have to be notified to the Competition Commission in a separate

process and require approval of the competition authorities.

The jurisdiction of the competition authorities is only precluded if the Minister of Finance issues a notice to the Competition Commission on the basis of public interest issues as specified in the Banks Act. This could occur, for example, in cases where a bank has been placed under curatorship and its speedy acquisition by another institution is in the public interest.

Concurrent jurisdiction therefore implies that there is no legal requirement for only one decision to be made by the regulators, but rather that two separate processes occur and two decisions may be made. In the normal course of a merger evaluation, the Competition Commission would, however, always consult with and consider the inputs of any other relevant regulators.

Any legal requirement for consultation between the Competition Commission and the Registrar of Banks is, therefore, a formality resulting from the fact that the Banks Act has not yet been amended.

In addition to merger evaluations, the Competition Commission investigates alleged anti-competitive conduct, such as the abuse of a dominant market position, potential cartel activities, as well as anti-competitive conduct by parties in a vertical relationship. The banking sector is subject to these provisions of the Competition Act.

Competition in pharmaceuticals

A peek into the pharmaceutical market using basic economic tools, can determine whether it is functioning properly from a product-based competition perspective. Is there price competition between manufacturers?

In terms of demand, consumers of pharmaceutical products in South Africa can be divided into the private and public sectors. The public sector serves approximately 70 percent of the population, but contributes only approximately 15 percent of the Rand value of the industry's activities. The private sector makes up 85 percent of the Rand value sales and 30 percent of the volumes. In other words, the private sector pays a large part of the profit margins of the pharmaceutical manufacturers.

The market is characterised by relatively inelastic demand. In essence, demand for product is not determined by consumer choice, but rather by the doctor, who has the "power of the pen" to prescribe medicines. Moreover, doctors prescribe medicine based on efficacy or their own profit motive (if they dispense too), rather than affordability to the patient.

The resulting lack of substitutability between drugs from the consumer's point of view is exacerbated by the willingness of patients to pay for health care at almost any price, by using medical insurance, and the fact that some doctors are influenced in prescribing medicine by incentives (bonuses, free samples) offered by certain pharmaceutical manufacturers.

Moreover, there is an asymmetry of information in that doctors know what's best for consumers, so patients must rely on their doctors' choices, rather than being able to make informed choices of their own, which would, presumably, be more price based.

On the supply side of the market, pharmaceutical manufacturing is calculated as catering for 70 percent of local demand. South African firms operate alongside local branches of most the major international pharmaceutical companies that undertake formulation and final synthesis of a wide range of products. The 72 multinational pharmaceutical companies present in South Africa supply 73 percent of the local market. The remaining 27 percent comes from local suppliers. On the face of it therefore, the market appears contestable, but it is really a whole range of markets rather than just one market, and there is monopoly power in several of those, protected by intellectual property rights.

Products supplied are in different markets based on their therapeutic effect. This is especially so for ethical drugs, where there are only a few large suppliers with monopoly power in a particular therapeutic category due to patent rights. Consequently, the substitutability in supply is often close to zero, as a manufacturer cannot produce a rival's drug if its active ingredients are patented.

In addition, other barriers protect the incumbent firms' monopoly power and subsequent monopoly rents. These barriers include brand loyalty and packing the product space (by producing a wide range of products with similar therapeutic qualities), as well as the barrier of needing millions of dollars to develop effective new drugs. It is estimated that the large multinationals budget approximately 10 percent of their annual turnover on R&D expenditure, which comes to hundreds of millions of dollars annually.

The reaction of some countries to pharmaceutical market distortions has been to regulate by introducing countervailing power. Some jurisdictions have regulatory price control over pharmaceutical products, whilst both generic substitutability and parallel imports are allowed. However, South Africa has been slow on the uptake of such measures and only recently addressed the necessity of change by tabling the *Medicines & Related Substances Control Amendment Bill* (No 90 of 1997). The Bill was to implement the Government's National Drug Policy, which has the goal of ensuring "an adequate and reliable supply of safe, cost-effective drugs of acceptable quality to all citizens of South Africa and the rational use [thereof] by prescribers, dispensers and consumers".

Although the Pharmaceutical Manufacturers Association (PMA) challenged the Bill as being unconstitutional in the Pretoria High Court, the case was subsequently settled and it is now full steam ahead for implementation. In a nutshell the Bill provides for the following:

- The parallel importing of patented drugs at lower cost from a foreign supplier, provided the patent holder has consented to the drug being in the South African market, as opposed to the purchase of the drugs from the local subsidiary (i.e. domestic patent holder) of the same manufacturer
- The generic substitution of established, normally more expensive branded ethical products for the generic equivalent by permitting the pharmacist to offer the cheaper product to the consumer. Moreover, the Act makes provision for the doctor to write “do not substitute” on the prescription if he/she believes that the branded product is not substitutable
- The elimination of incentive schemes for the marketing of pharmaceutical products. Such incentives consist of measures to influence demand by providing samples and bonuses to both prescribing doctors and pharmacists
- The establishment of a pricing committee, which will monitor the price of medicines and ensure transparency in the pricing system[1].

In conclusion, it seems that the nature of the pharmaceutical industry is that its firms are often able to exert significant market power. But it is hoped that regulatory intervention will address the distortions and introduce some countervailing power to the pharmaceutical companies, through the provisions of the new Act. This should increase competition, by reducing prices and promoting the affordability of health care for all South Africans.

[1] It is worth noting that the Competition Commission is fundamentally opposed to pricing intervention in terms of the promotion of competition principles, however section 3(1A) of the Competition Act (No. 89 of 1998) ensures that the Commission has concurrent jurisdiction with other regulatory bodies to enable such principles not to be unduly undermined and to reach agreement with other regulators on those issues.

Summary of M&A Activity

An overview of mergers and acquisitions for the first half of 2001

The first six months of 2001 has seen a total of 96 merger notifications. A sample of 49 of the finalised cases has been analyzed for this article. There has been a dramatic decline in the average number of notifications following the lowering of the thresholds for merger filings at the end of 2000. Figure 1 provides a clear illustration: note the “long drop” in the line from December 2000 to January 2001.

Under the old thresholds, the average number of notifications for the period January 2000 to June 2000 was approximately 36 per month. This has fallen to a mere 16 per month on average for the period January 2001 to June 2001. With the new thresholds there are only two types of mergers that must be notified and for which filing fees are charged: large and intermediate. The Commission decides on intermediate mergers while large mergers are referred to the Tribunal. There is no filing fee for small mergers falling outside the thresholds and parties are not obliged to notify. However, the Competition Commission may investigate a small merger that it considers problematic and has the right to prohibit such a merger, but only within six months of the merger having taken place. The Commission is also obliged to investigate and decide on a small merger if the parties so request.

CONTINUED ON PAGE 12

FIGURE 1. NUMBER OF NOTIFICATIONS PER MONTH FROM JANUARY 2000 - JUNE 2001

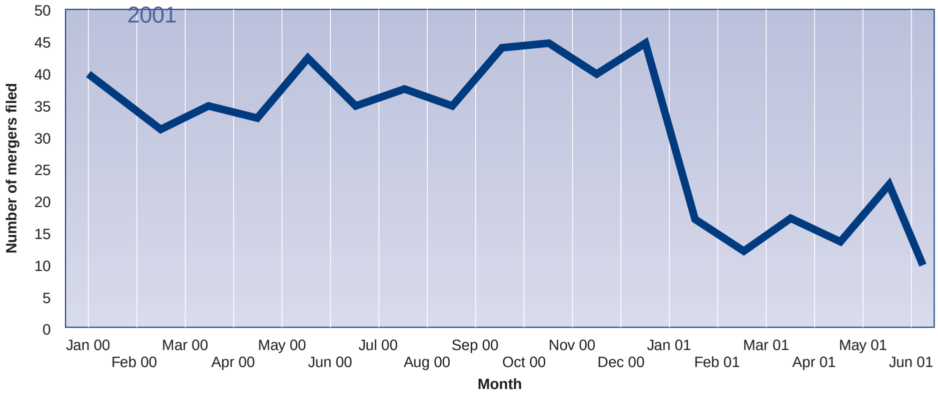
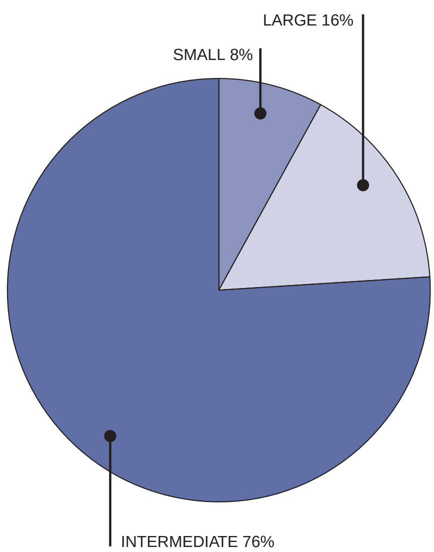


FIGURE 2. PERCENTAGE OF LARGE, INTERMEDIATE AND SMALL MERGERS



FROM PAGE 11

Figure 2 shows the percentage of large, intermediate and small mergers for the period reviewed. The majority of mergers dealt with in 2001 have been intermediate. Large mergers constituted 16% of the total with eight percent of the mergers investigated being small. The Commission has not prohibited any of the intermediate mergers filed and finalised in 2001 so far, although two have been approved with conditions. In the case of large mergers, the Tribunal prohibited the merger between Sasol and candle manufacturer Price's Daelite.

More than half (57%) of the cases investigated have been purely horizontal involving the merger of competing firms. Conglomerate type mergers were also investigated, making up 27% of the total. It should be noted that conglomerate mergers are defined as such following an investigation that has established that the products of the merging firms are not substitutable for each other (horizontal) and there is no vertical link between the merging firms. Only six percent of the mergers reviewed in 2001 were defined as purely vertical in nature. There was a small percentage of cases (eight percent) involving mixed mergers with horizontal overlap and vertical integration.

In four of the cases reviewed the parties involved anticipated that jobs would be lost following the merger. The total number of anticipated jobs lost as a result of these mergers has been estimated to be approximately 453. The sectors affected would largely be in wholesale and retail trade including the distribution of liquid petroleum, wholesale of pharmaceuticals, and retail trade in stationery.

The sectors in which the mergers reviewed have taken place were classified according to the standard industrial classification (SIC). Figure 3 shows the percentage of mergers in different sectors according to the first digit SIC code. The majority of mergers in 2001 so far have been related to financial services and real estate - under the broad sector "financial intermediation, insurance, and real estate". There have been seven mergers of firms involved in real estate and at least 10 mergers of financial services firms. Merger activity continues to feature in the manufacturing sector but to a lesser extent than in the past. No single sub-sector in manufacturing has featured more than once. A further 20% of mergers took place in diverse areas in the wholesale and retail sectors.

"The majority of mergers dealt with in 2001 have been intermediate ones."

FIGURE 3. PERCENTAGE OF MERGERS BY SIC CODE

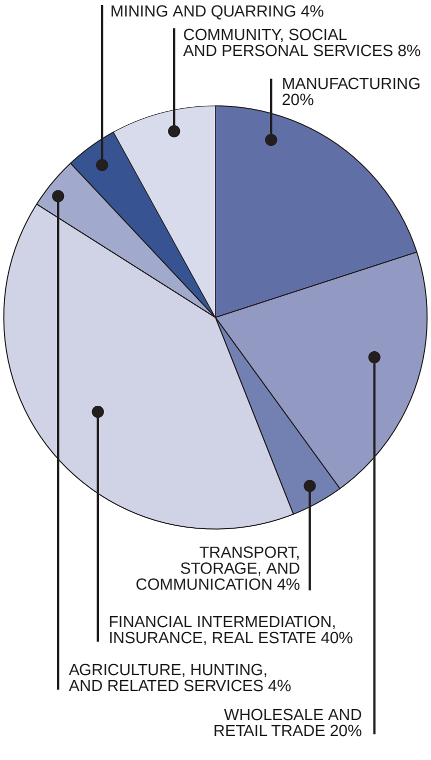


TABLE 1. MERGER BY TYPE AND ARGUMENTS USED

	April – December 2000	
	Number of mergers	Percentage
Type of merger:		
Purely Horizontal	28	57
Purely Vertical	3	6
Conglomerate	13	27
Management buy-out	1	2
Horizontal/ Vertical mix	4	8
Total	49	100
Acquisition by foreign firm	8	16
Failing firm argument	1	2
Anticipated job losses	4	8

Enforcements and Exemptions

A summary of complaints

Of the 58 complaints-related cases notified with the Enforcements and Exemptions Division over the period January 2001 to June 2001, 14 were concluded and 44 are still under investigation. There are two new applications for exemption under consideration.

Chapter two of the Competition Act makes provision for 'Prohibited Practices'. This is divided into two parts, 'Restrictive Practices' and 'Abuse of Dominant Position'. Restrictive practices include Horizontal Restrictive practices (section 4 of the Act) and Vertical Restrictive practices (section 5 of the act). Abuse of Dominant Position is detailed under section 8 of the Act. Section 9 deals with Price Discrimination by a dominant firm.

A sample of 48 cases[1] for which information is available was examined. Note that each case may involve more than one complaint in terms of the Act. The 48 cases examined here yielded 52 complaints. Table 1 (below) presents a breakdown.

The feature that stands out most clearly in Table 1 is the predominance of section 8 (abuse of dominance) complaints. More than half of these related specifically to section 8(c) which prohibits exclusionary acts by a dominant firm. Complaints of exclusionary conduct have been targeted at firms in a diverse range of industries. Some important cases have arisen with respect to the pharmaceutical industry, but also in security services, some areas of manufacturing, and maintenance and repair of motor vehicles. Allegations of restrictive vertical practices have also been made regarding the activities of firms in the pharmaceutical industry.

Figure 1 gives an indication of the percentage of complaints cases taking place in different sectors. Most of the complaints are in different service-related sectors. This includes financial services, legal services, medical aid services and others. There have also been a significant number of complaints with respect to the pharmaceutical industry and, to a lesser extent, in transport services.

[1] This sample is taken from those cases that have been concluded (13) and those under investigation (28).

FIGURE 1. SECTORAL BREAKDOWN: CASES CONCLUDED AND UNDER INVESTIGATION

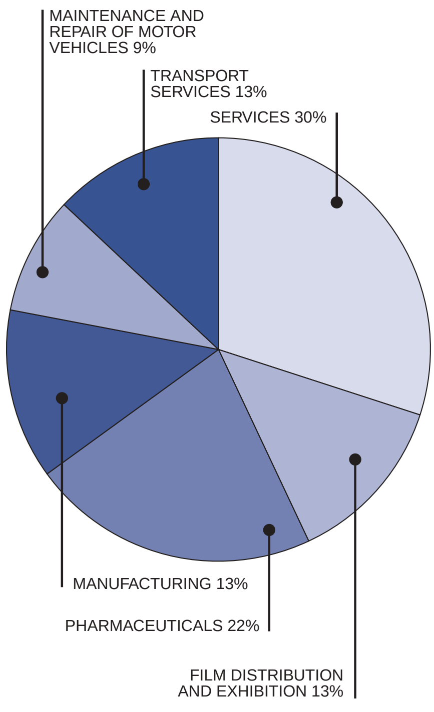


TABLE 1. CONTRAVENTIONS DEALT WITH IN TERMS OF CHAPTER 2 OF THE ACT FOR THE PERIOD JANUARY 2001 TO JUNE 2001

Provisions of the Act	Number received	Percentage of Total
Horizontal Restrictive Practices (section 4)	4	8
Vertical Restrictive Practices (section 5)	15	29
Abuse of Dominance (section8)*	33	63
TOTAL	52	100

* Note that price discrimination (Section 9) is a concern if it involves an abuse of dominance and, as such, is considered as part of Section 8 of the Act.

Commission Cases

Tibbett & Britten (SA) (PTY) Ltd and Synergistic Alliance Investments (PTY) Ltd merger

On 13 February 2001 the parties to the merger transaction filed their notification requirements with the Competition Commission. The acquirer, Tibbett & Britten (SA) (Pty) Ltd, as part of the Tibbett & Britten Group, distributes a wide range of products on behalf of various principals. These principals included SmithKlineBeecham Consumer Healthcare (Pty) Ltd, Tiger Brands and Warner Lambert S.A. (Pty) Ltd. Consequently, the consumer products distributed varied from foodstuffs to over-the-counter medicines. These products were then distributed to wholesale and mainline retailers such as Pick 'n Pay, Shoprite Checkers and Makro.

On the other hand the target firm, Synergistic Alliance Investments (Pty) Ltd ("SAI"), was a holding company of a wholly-owned subsidiary Kinesis Logistics (Pty) Ltd, which provided distribution services to the pharmaceutical industry. SAI was in fact a joint venture between various multi-national pharmaceutical companies and its subsidiary Kinesis Logistics therefore distributed prescription medicine, over-the-counter medicine (i.e. non prescription medicine) and para-pharmaceutical products such as toothpaste, toothbrushes and so on. The customers to whom SAI distributed on behalf of its principals varied considerably from wholesale pharmacies to healthcare organizations to the State.

The Commission's subsequent investigation and evaluation of the merger revealed that the nature of distribution of consumer products, specifically pharmaceutical products, in South Africa was undergoing considerable change. In particular, an alternative model of distribution was being held forth in opposition to the traditional wholesale model. The new approach was based on distribution companies charging a distribution fee for their service offered or value added. Moreover, ownership of the product vested at all times in the principal and not in the distributor as in the wholesale models.

The differences in 'models' go more to the relationship between the manufacturer and distributor than they do to the actual task being performed, which is still fundamentally the movement of goods from point A to B. Whereas traditionally, an independent distributor/wholesaler would buy goods from a manufacturer and receive a discount on those purchases, an alternative arrangement favoured by the pharmaceutical manufacturers, is to own a distributor/wholesaler (such as SAI) and pay it a distribution fee for performing that service. The distribution fee is notionally equivalent to a discount.

There were concerns that the new model would impact negatively on intra-brand competition. Traditional wholesalers would find it difficult to source product at competitive prices from the manufacturers, for the manufacturers would tend to favour their wholly-owned distributors (e.g. SAI). Therefore part of the rationale for the merger was to divest the pharmaceutical companies' shares in SAI to an independent wholesaler: Tibbett & Britten. The Commission was, however, concerned with certain provisions in the Sale of Shares Agreement that related to exclusivity. The sale agreement in effect promised all the distribution business of the pharmaceuticals manufacturers exclusively to Tibbett & Britten, and in advance. That was the basis of determining the purchase price, too. The Commission insisted that these agreements could not be entered into in advance of the merger, for they would amount to collusion by competing manufacturers on terms and conditions.

In the end, the merger was approved on 14 May 2001 once the exclusivity provisions had been removed from the sale agreement.

From a public interest perspective, the merger was given the green light, as the unions were consulted and possible job loss concerns addressed.

> "Part of the rationale for the merger was to divest the pharmaceutical companies' shares in SAI to an independent wholesaler: Tibbett & Britten."

The Competition Commission approves JSE/SAFEX merger

The Commission approved the proposed merger between the Johannesburg Stock Exchange (JSE) and the South African Futures Exchange (SAFEX) unconditionally.

The transaction had initially raised possible concerns for the Commission, which necessitated a more in-depth investigation.

The Commission firstly needed to assure itself that the products offered by the two exchanges did not compete with one another. If one or more products are substitutable, then the merger in question is horizontal and would be anti-competitive if it removes the only other competitor from the market. After further investigation, the Commission concluded that although there was some degree of substitutability between the products, they were primarily complementary. Thus no competition concerns existed in this regard.

The second concern related to the clearing and settlement system, and in particular to Strate. Internationally, there is strong evidence suggesting that clearing and settlement functions are a natural monopoly and an essential facility in the supply chain of trading, settlement and clearing. The Commission was concerned that Strate, as a natural monopoly, could present a barrier to entry to potential new entrants into the market, i.e. new exchanges to be established. Even though the JSE may give a new exchange access to Strate, the access could be granted at uncompetitive costs.

The ideal solutions to the above concerns are either the structural separation of the exchange and the clearing and settlement arm or alternatively, price regulation of these functions through benchmarking. As part of the investigation, the Commission highlighted its concerns to and explored these options with the relevant regulators and the Treasury. The Commission concluded that these issues present potential problems in the longer-term and it will continue to explore appropriate regulatory approaches with the relevant regulators.

International News

Canada releases abuse of dominance guidelines

The Canadian Competition Bureau released *Enforcement Guidelines on the Abuse of Dominance provisions* on 1 August 2001. The release of the guidelines is part of the Bureau's efforts to ensure transparent and predictable enforcement policy. Together with merger review and criminal conspiracy prohibitions, enforcements dealing with abuse of a dominant position form the cornerstones of Canadian competition policy.

The guidelines explain the abuse of dominance provisions, the institutional framework for enforcement, key elements of the statutory provisions (Subsection 79(1) of the Canadian Competition Act), the anti-competitive acts (Section 78) and remedies.

Dominance is synonymous with market power, where market power is the ability of a firm (or in some jurisdictions a group of firms who are collectively dominant), to act independently or unconstrained by competition. Abuse of a dominant position occurs when a dominant firm (or firms) in a market substantially lessens or prevents competition through conduct intended to eliminate, discipline or deter a competitor.

Dominance is in many cases established by market share. The higher the market share the greater the likelihood that the firm or firms possess market power.

Some of the anti-competitive acts listed in the Canadian Competition Act are:

- Margin squeezing by a vertically integrated supplier against a customer-competitor
- Acquisition by a supplier of a customer for the purpose of foreclosing a competitor
- Freight equalization on a competitor's plant to impede or eliminate a competitor
- Selective use of fighting brands to discipline or eliminate a competitor; and many others.

The guidelines make it clear that dominance or market power is not prohibited. In enforcing the guidelines the Bureau takes the position that it will not protect competitors from legitimate competition.

The abuse of dominance and other guidelines released by the Canadian Competition Bureau can be accessed at **http://strategis.ic.gc.ca**

Canada Competition Policy: Preparing for the Future

The Canadian Competition Bureau in co-operation with the Richard Ivey School of Business of the University of Western Ontario hosted a conference on 19 and 20 June 2001 in Toronto, Canada. The theme of the conference was *Canadian Competition Policy: Preparing for the Future.*

Professor Allan Fels of the Australian Competition and Consumer Commission and Professor Michael Porter from Harvard Business School, were two of the very distinguished speakers at the conference. Transcripts of the papers can be viewed at **http://www.ivey.ca/competitionconference2001/proceedings2/ConfSpeech_eng.htm**

International News continued...

Global Competition Review – rating the regulators 2001

Global Competition Review asked antitrust practitioners and competition specialists to rate competition authorities across the globe. The aim of the survey is to present competition authorities with the perceptions of the competition practitioners who deal with them, in order to facilitate the development of better working environments.

Competition authorities were rated from one to five stars (where one star would mean "deep dissatisfaction", three stars indicated "satisfaction", and five stars "wow!"); on eight different points. Practitioners were asked to specify details for their ratings that they felt were relevant.

The United States of America Department of Justice (US DoJ) was rated the best agency of the 25 surveyed, with an overall rating of four-and-a-half stars. Their success is partly attributed to strong leadership from the then Assistant Attorney-General Joel Klein. The US DoJ understands the merger process well and cases are diligently handled.

The South African Competition Tribunal received an overall three-and-a-half star rating, positioning itself firmly in the company of the Australian Consumer and Competition Commission (ACCC), the United Kingdom Office of Fair Trading (UK OFT), the United Kingdom Competition Commission (UK CC) and the United States Federal Trade Commission (US FTC). The Competition Tribunal was complimented on its handling of merger cases and its use of economics in its analysis. The South African Competition Com-

Overall	★★
Merger handling	★★1/2
Cartel handling	★1/2
Economic expertise	★★1/2
Transparency	★★
Informal guidance	★★
Confidentiality	★★★
Independence	★★★★
Leadership	★★★

mission was rated as follows:
The relatively disappointing rating of the South African Competition Commission is to some extent attributable to low thresholds in the legislation, resulting high workloads and inexperienced staff. Mention was made that as the Competition Commission has attained management experience, things have improved.

The Competition Commission was criticised for its handling of cartel cases. The allegation was made that the Competition Commission tends to "sit on cases". Practitioners did, however, acknowledge that the Competition Commission suffered resource shortages.

The Competition Commission rated "satisfactory and above" on confidentiality, independence and leadership.

Further remarks were that practitioners would like the Competition Commission to issue official guidelines.

Overall the impression of the rating is that things may not have been perfect, but that "most of the elements for successful maturation are now present". Certainly, the Competition Commission is positive about the way forward. The higher thresholds have already addressed some of the capacity and workload issues and the Competition Commission is already able to perform its duties in a more effective manner, as seen in a significant drop in merger turnaround times during April 2001. Furthermore, staff is gaining experience and both internal hiccoughs and relationships with external parties are being addressed at all levels in the Competition Commission.

The Commission is positive that it will receive a better rating in 2002. Already the lower thresholds and resulting decrease in merger filings have freed capacity. Fewer filings and more experienced personnel have resulted in faster turnaround times for merger cases. Furthermore, in response to the rating, the Competition Commission intends to embark on a benchmarking and standard setting exercise and results will be shared with practitioners and other stakeholders.

European Commission imposes interim compulsory licence

The European Commission has imposed an interim compulsory licence on IMS Health (IMS). IMS is the world leader in data collection on pharmaceutical sales and prescriptions.

The order pertains to the 1860 brick structure for collecting pharmaceutical sales and prescription data in Germany. The brick structure divides Germany into 1 860 geographical sales zones or bricks. This structure has become a national standard and sales data presented in any other structure is not marketable.

Before 1999 IMS was the only provider of sales and prescription data in Germany. These data reports are important for the pharmaceutical industry as pharmaceutical manufacturers use them to create strategic sales territories, develop incentive schemes, and generate general market performance and trend information.

When NDC Germany (NDC) and AzyX Geopharma (AzyX), (subsidiaries of NDC Health and AzyX Geopharma services of the United States of America and Belgium, respectively), entered the market for the provision of sales and prescription information for pharmaceutical products,

IMS filed a lawsuit alleging that NDC and AzyX had infringed IMS's copyright for the 1860 brick structure. NDC and AzyX were subsequently prohibited from using the 1860 structure.

NDC and AzyX attempted to sell their regional sales data in a different format to the 1860 brick structure, but found that their product was not marketable because of the position of the 1860 structure in the industry. They both asked IMS for a licence to use the 1860 brick structure. IMS refused both parties a licence, and NDC complained to the European Commission alleging that the refusal to licence was an abuse of dominant position amounting to a denial of access to an essential facility.

After careful analysis which included inquiries to approximately 110 German pharmaceutical companies the European Commission found that the 1860 brick structure has no actual or potential substitute, and is therefore indispensable for competitors in the market for data collection on pharmaceutical sales and prescriptions. Furthermore the European Commission stated that IMS's refusal to license cannot be justified objectively and is likely to foreclose the market.

The European Commission therefore granted interim measures ordering IMS to license the use of the 1860 brick structure to NDC and AzyX on non-discriminatory, commercially reasonable terms.

The European Commissioner for Competition, Mario Monti said: "[The] decision is a rare step and the market concerned is a very peculiar one. A careful analysis has showed that this '1860 brick structure' for collecting pharmaceutical sales data has become a national standard, which the industry contributed towards. IMS's refusal to license it and derived structures, has led the pharmaceutical industry in Germany to be economically locked-in to the brick structure and to foreclosing of the market to competition. The Commission has ruled that the 1860 brick structure, which is covered by copyright, must be licensed on commercial terms."

The circumstances in this case are seen as exceptional and under normal circumstances the refusal to license an intellectual property right is not seen as an abuse of a dominant position, since the owners of intellectual property rights can decide how to exercise these rights. However, without licensing IMS would have a monopoly of the German market in regional sales reports, eliminating price competition and innovation. The "cost" of such a situation outweighs the benefits of rewarding the owner of the intellectual property with monopoly rights.

> "[The] decision is a rare step and the market concerned is a very peculiar one."
>
> Mario Monti

Where to get hold of us

Visit the Competition Commission online at **www.compcom.co.za** for more information about the Commission and the Act, as well as rules and amendments to the Act. You may also forward enquiries, comments and letters to:

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