Substantive Criteria Used for the Assessment of Mergers- Brazil (Seae/MF)[1]

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RESUMO

Este trabalho compara as diferentes decisões tomadas sobre atos de concentração de acordo com o enfoque de análise seguido: teste de *Substantial Lessening of Competition* (SLC), teste de Dominância ou teste de Interesse Público.

Segundo o estudo, na jurisdição brasileira torna-se preponderante a utilização do SLC, a despeito do fato de que a legislação de defesa da concorrência contemple também os dois outros.

Após a introdução, há exemplos das diferenças que poderiam ser constatadas em algumas análises empreendidas pela Seae caso fosse utilizado o teste de Dominância em vez do SLC.

A principal conclusão é que há poucas diferenças entre o SLC e o teste de Dominância e que as próprias definições destes instrumentos ainda são controversas.

ABSTRACT

This paper compares the different decisions on mergers according to the focus of the analysis followed: the Substantial Lessening of Competition Test (SLC), the Dominance Test or the Public Interest Test.

The paper states that in the Brazilian jurisdiction the use of the SLC Test becomes dominant, despite the fact that the Competition Law also contemplates the two other tests.

After the introduction, there are some examples of differences that could be observed if, in some analyses carried out by the Secretariat for Economic Monitoring, the Dominance Test were used instead of the SLC Test.

The main conclusion is that there are not significant differences in the results weather the analysis is carried out using the SLC or the Dominance Test and that the very definitions of these instruments are still controversial.

1. INTRODUCTION

In Brazil, mergers are reviewed under the rule of reason criterion and are dealt with administratively, according to the Competition Law. The Secretariat for Economic Monitoring of the Ministry of Finance (SEAE-MF) and the Secretariat of Economic Law of the Ministry of Justice (SDE-MJ) prepare the case and are responsible for issuing non-binding opinions to the Administrative Council for Economic Defense (CADE), a federal autarchy linked to the Ministry of Justice, which finally decides it. The preparation of the case follows the analysis criteria as expounded in the Joint Merger Guidelines issued by SEAE and SDE[3], quite similar to the North-American Merger Guidelines.

Administrative penalties, whenever applicable, are imposed by CADE according to Title V (on infringements of economic order), Chapter III ("on penalties") of Article 23, Law no. 8884/94. The Judicial Branch is in charge of reviewing all CADE's decisions, thereby respecting not only the due process of law but also the full defense principle and the free access to the Judicial Branch, as seen in Sections LIV[4], LV[5] and XXXV[6], respectively, of Article 5 of the Federal Constitution of Brazil.

2. NATURE OF THE SUBSTANTIVE TEST

In accordance with Brazilian jurisdiction, competition status exerts strong influence in favour of the Substantial Lessening of Competition test (SLC), although Law no.8884/94 also contemplates the Dominance and the Public Interest tests.

The main section of article 54 (Law no. 8884/94) provides that "Any act that may limit or otherwise restrain open competition (e.g., SLC test), or that result in the control of relevant markets for certain products or services (e.g., dominance test) shall be submitted to CADE for review". Therefore, according to the Brazilian Competition Law, it seems that both tests could be applied whenever reviewing a merger: the dominance and the SLC tests.

The former takes into consideration the market share and the probability of the new firm to exercise its market power (by analyzing entry conditions, for example). The latter is more rigorous in that it does not only take into account market share and probability, but also checks the merger's efficiency. It is likewise important to mention that variables such as "quality of the product offered by this new firm" could also be included in this part of the analysis.

Despite the fact that the main section of article 54 expresses the two interpretations, Clause 1 of article 54 (Law no. 8884/94) establishes the <u>rule of reason principle</u> when reviewing a

[3] Joint Directive Seae/SDE n.º 50/2001.
[4] "[N]obody shall be deprived of his or her liberty, or of his or her assets without due legal process."
[5] "[T]o the litigants, in a judicial or administrative process, and to the defendants in general, are assured the right to <u>contradictory</u> and <u>full defense</u>, with their inherent means and resources." <u>Full defense</u> = the right to produce proof, regardless of whether there has been a change or not. <u>Contradictory</u> = right to deny what the other party has stated, whether by producing proof or otherwise. Usually contradictory and full defense operate jointly, i.e., the individual produces proof to defend himself/herself from a charge.
[6] "[The] law shall not exclude a grievance or a threat from the right to appreciation by the Judicial Branch."

merger. This means that a merger may be blocked, approved with restriction or approved as it is, after balancing the costs – benefits of it from a consumer perspective. Therefore, an analysis of the merger's efficiency is done if the merger brings costs for the consumers (e.g. if there is a possibility and also a probability of the new formed enterprise exercise its market power), what suggests that a SLC test is carried out.

With regard to the public interest test, Clause 2 of article 54 (Law no.8884/94) states: "Any action under this article may be considered lawful if at least three of the requirements listed in the above items (which establish the rule of reason principle) are met, whenever any such action is taken in the public interest (public interest test) or otherwise required to the benefit of the Brazilian economy, provided no damages are caused to consumers or users." This means that the public interest test could also be applied.

Even though this last test is included under Law no. 8884/94, SEAE and SDE have never reviewed a merger case based on the public interest test. However, one can say that CADE has approved merger cases based on such test, when imposing restrictions. That is, in some cases macroeconomic variables have been taken into consideration (such as "employment", "exportation" and "investment"). Therefore, in Brazil, we can not identify examples of the public interest test that have been used to asses a merger case by SEAE or SDE, but CADE has considered it sometimes when clearing a merger. Ambev´s (beer) case is an example where CADE imposed some restrictions on employment.

Consequently, in practice, although the Law contemplates the three tests, the antitrust authorities review a merger using the SLC test. In fact, one can say that, as the dominance test is a part of the analysis of the SLC test, it is also considered in Brazil. On the other hand, once the public interest test was never used by the Secretariats and was never used solely to approve a merger by CADE, until now, one can say that this test is not really used in Brazil.

In addition, when reviewing a merger, the antitrust authorities are concerned about the possibility of a collusion. Normally, SEAE uses three concentration measures to identify the strength of a collective dominant position. They are: Ci (i could be 4, 5, 6 or even 8), Herfildahl Hirshman Index (HHI) and the one used by "La Comisión Federal de Competencia de México", called the "dominance test" (which has no bearing on the dominance test so far mentioned in this article). The first two are commonly used in many jurisdictions, though not much can be said of them. The last one proposes a rivalry analysis. That is, in cases where the index is negative, the merger would be able to bring about a more competitive market structure because the new formed enterprise would have grown to a size equal to other existing competitors on the market and, thus, would be able to compete on an equal footing. Furthermore, it would decrease the probability of collusion since after the merger there would be one more "large firm" to be included in the collusion assessment. On the other hand, if the index were positive, it would be an indication that a problem with respect to the competitive structure might arise.

The reason for analyzing the possibility of a collusion is not exactly to block a merger (e.g., a merger has never been blocked because of a high probability of collusion), but to approve it with restrictions or to alert the other antitrust authorities that a problem could arise in a particular

[7] Schmidt, Cristiane and Lima, Marcos, Working Paper (*Documento de Trabalho)* no. 13 SEAE/ MF.

economic sector. Moreover, this analysis would serve to alert the antitrust authorities with respect to future problems in forthcoming mergers in this particular economic sector.

In summary, Brazilian jurisdiction does use the SLC test, is concerned with possible collusion regarding dominant position (although not to block a merger) and has never reviewed a merger solely under the public interest test, although has approved some cases with restrictions that considered non-competition variables.

3. EXPLORING HOW THE PARTICULAR COMPETITION TEST, I.E. DOMINANCE VERSUS SLC, MIGHT MAKE A DIFFERENCE IN SPECIFIC MERGERS

I. Several cases in the ELEVATORS sector

Twenty-two mergers in the elevator’s services sector, dealing with conservation, maintenance, repair and modernization of elevators, have been presented to SBDC over the last few years. All of them, but two, were acquisitions of small companies by “Elevadores do Brasil Ltda.”, a subsidiary of the Otis Elevator Company, belonging to the United Technologies Corporation group (UTC). The others were mergers between producers companies.

The definition of the relevant market for this segment was established as being within a radius of 100km from the city headquarters of the company that was being acquired, as well as from the cities where the acquired company had a branch office or even a resident technician.

Once this area was demarcated, all service contracts inside the given area were verified and finally the market share of each service company in the area was calculated.

The region that presented the greatest number of cases was Salvador and its surrounding area (three cases): one merger happened in December 2000, one in January 2002 and one in February 2002.

To show that the strategy of acquiring did not succeed, the market share of the top three companies in the period of 2000 – 2002 in the region of Salvador is presented below. As it can be seen, Otis was supposed to add 6% + 0,2% + 0,4% = 6,6% in the three acquisitions, but added only 5%. Therefore, even acquiring firms, Otis did not have a proportional increase in its market share.

Table I – Market Share of Salvador and Region

Companies	Market Share (Dec/2000)	Market Share (Feb/2002)
Atlas/Schindler	38.0 %	39.2 %
Otis	27.0 %	32.0 %
Thyssen/Sûr	12.0 %	16.2 %
Other	29.0 %	17.7 %
TOTAL	100.0 %	100.0 %

Source: Elevadores Brasil Ltda.

The explanation for the fact that Otis did not have a proportional increase in its market share can be that there is big rivalry among firms. As can be seen, Thyssen did not undergo an acquiring strategy and augmented its market share. Furthermore, especially in other cases, entry of small service companies was quite an easy matter and occurred frequently in the analyzed markets.

We believe that the use of either the SLC or the dominance test would have made no difference in such cases. Either one would have resulted in the approval of the Acts since entrance barriers are sufficiently low in this market to guarantee the entry of new competitors.

II. Petrobras & Repsol-YPF

This operation involved Petróleo Brasileiro S.A. – Petrobras and Repsol YPF S/A and occurred in the oil and derivatives sector, involving exchange of assets between the petitioners in fuel distribution, oil refining and extraction. At that time, this market in Brazil was regulated.

Repsol, the owner of a refinery in the northeast of Argentina, called Baía Blanca, would have a participation of 30% of a refinery in the south of Brazil, called REFAP. And Petrobras would own some fuel distribution in Argentina and vice-versa.

To define the Geographic Market (GM), three hypotheses relative to the future regulated market in January 20002 were considered: 1) GM = south of Brazil & liberalization of imports of derivatives with or without open access for ducts and terminals after January 2002; 2) GM = south of Brazil + northeast of Argentina + Uruguai & liberalization of imports of derivatives without open access; 3) GM = south of Brazil + northeast of Argentina + Uruguai & liberalization of imports of derivatives with open access.

In the first case, there was no concentration, so the operation could be accepted. In the second case, once neither before nor after the operation there was no open access, Repsol was not a rival and was not going to be one. Therefore, after 2002 Repsol would still not be able to distribute oil in Brazil. Consequently, the operation could be accepted. In the last GM, if after other competitors could distribute oil in Brazil, Repsol would be one of the others firms that could use the pipelines. Therefore, the operation could also be accepted

Consequently, the conclusion SEAE reached was that in all considered scenarios, the elimination of a potential competitor would not be sustainable.

With regard to retailing, the analysis demonstrated that the operation did not evidence the existence of risks to the competition in the involved markets. So, Seae concluded that the operation could be approved by without restrictions.

In this case, as the analysis of the efficiencies was not necessary, we believe that the decision would have been the same, had the SLC or the dominance test been applied. The operation would have been approved, once the possibility of elimination of a potential competitor had not been evidenced.

III. Brahma & Antarctica = AMBEV

This was a fusion between "Companhia Antarctica Paulista" and "Companhia Cervejaria Brahma", creating the "Companhia de Bebidas das Américas – AmBev" – in the drinks and malt sector.

Seven relevant markets of distinct products had to be defined: bottled water, beer, soda, tea, sports drink, juice and malt.

For the tea, sports drink and juice markets, the analysis did not substantiate any coincidence in operations between Brahma and Antarctica. They were seen to be quite complementary as there was no horizontal concentration in such markets.

In the specific case of malt, although the act would generate horizontal concentration, most of the companies production would be directed to their own consumption, so the concern over the exercise of market power became irrelevant.

With respect to the other relevant markets, the conclusions were the following:

- bottled water market: SEAE concluded that there would be no damage to the competition, since combined market shares only amounted to 1.08%;

- soda pop market: five distinct geographic markets were defined, in which the total sales of Ambev shares varied from 16.8% to 24.5%. The analysis evidenced that the entrance of new
- competitors into this market would be easy and sufficient;

- beer market: five distinct Geographic Markets were defined, where Ambev´s shares after the merger would vary from 65.1% to 91.8% in total commercialized hectoliters.

Because of the high concentration verified in all five regions in the beer market, SEAE proceeded to the study of the market power exercise probability. Since the entrance would be neither easy nor sufficient and faced with the fact that rivals had not presented themselves as effective competitors capable of disciplining price formation in this market, the Secretariats analyzed the efficiencies of the case and considered them too low. Therefore, the Secretariats suggested the merger could not be approved in the form it had been presented to SBDC, recommending, among others, the following alterations:

- The selling of total tangible and intangible assets corresponding to the entire beer business associated to the Skol brand, a property of Brahma;

- The selling of one of two plants located in Cuiabá: Cuiabana (Brahma) and Cuiabá Branch office (Antarctica);

- The selling of one of two plants located in Manaus: Miranda Corrêa (Brahma) and Manaus Branch office (Antarctica);

CADE's interpretation of the alleged efficiencies was quite different from the Secretariats' as the Council decided to approve the merger with lighter restrictions: the new firm had to sell the total tangible and intangible assets corresponding to the entire beer business associated to the Bavária brand to a purchaser who could not already be the owner of more than 5% of the beer market; the selling of five plants (one in each geographic market); and the sharing in net distribution.

If the dominance test had been applied in the analysis of this Act, the operation would have probably been rejected or approved only under certain restrictions, for example, that of having to sell one of the three main brands involved in the operation, namely, Antarctica, Skol or Brahma, since the market participation of Ambev would then be very high in all of the defined relevant markets and this particular market had been characterized by high barriers to entry.

In the case of the SLC test, taking into consideration the analysis of efficiencies, the decision becomes rather subjective, depending on the interpretation each Agency of the SBDC sees fit to use. SEAE's and SDE's recommendation pointed to the selling of one of the three main brands, whereas Cade's decision was less severe.

IV. <u>Merger of 5 firms - CROMA</u>

The operation to form CROMA (American Metallic Cork Company) consisted of a commercial agreement among the top five metallic cork producing companies in the country: Amorim Pinto e Cia Ltda.; Aro S.A. Exportação, Importação e Comércio, Indústrias Reunidas Renda S/A; Metalúrgica Cearense S/A; Tapon Corona Metal Plástico Ltda. and Tapon Corona Industrial do Norte S/A. Once the agreement was approved, these five companies would own 98.75% of the national metallic cork market.

We believe that the choice of the SLC or the dominance test would have made no difference in this case, and that either one would result in blocking the Act. This would occur because the merger companies were unable to demonstrate that the agreement would generate reduction of production costs and to assure that the final consumer price would not be increased.

V. <u>Praxair & Nicrom</u>

With this operation, Nicrom Industrial Limitada would yield to Praxair Surface Technologies do Brasil Ltda. the surface and burnishing machinery used for laser engraved ceramic anilox rolls manufacturing. Also, through this acquisition, Nicrom and/or any member of it would be forbidden to proceed over the next 5 years, directly or indirectly, in manufacturing anilox rolls engraved with equipment similar to the ones acquired (what we would call an non-competition clause).

The analysis was restricted to the laser engraved ceramic anilox rolls market. Praxair´s market share in the relevant market would be 100% after the Act. The absence of effective competitors, allied to the difficulties for entrance in the market, together with imports incapable of serving as an effective tool against the exercise of market power, led SEAE to the analysis of possible economic benefits in the operation. Moreover, the rule of reason principle demonstrated that the net effect of the concentration to the consumer welfare– i.e., the comparison between the economic costs and potential benefits derived from the Act that could not be reached by any other form in less than two years, - was considered to be negative.

SEAE understood, though, that simply rejecting the operation would not automatically keep up competitive conditions in the relevant market, as the Praxair's entrance, in 1998 – before the operation – brought a new technology to the relevant market, which was driving down Nicrom's rivalry. Moreover, not only there were no other purchasers interested in buying it but also the dissolution of the acquisition would jeopardize the performance of Nicrom in other markets.

In this view, the Secretariat suggested that the Act should not be approved in the manner in which it had been presented to SBDC, recommending that certain alterations should be made. With an aim towards restricting the take over of the market and of reestablishing minimal conditions of competition, SEAE recommended the creation of a specific import tariff code for laser engraved ceramic anilox rolls and the setting up of an import aliquot of 0% (zero percent). Moreover, it also recommended the exclusion of the non-competition clause in the contract established between Nicrom and Praxair.

We believe that if the dominance test had been used in this case, the Act would have either been rejected, or that it would have been approved with the same restrictions. In the same way, the analysis for the SLC would not have been different, since the presented efficiencies would not have been enough to surpass economic costs generated by the operation.

VI. Casil & Saint-Gobain Group

By this operation, Casil Indústria e Comércio S/A. (Casil) would be acquired by the Saint-Gobain Group (which is the owner of Norton). The operation would create horizontal concentration in the silicon carbide (SiC) market and two vertical integrations: SiC and refractories and SiC and abrasives.

The market share of the Saint-Gobain Group in the SiC sector did not bring on much concern, because Saint-Gobain was not in Brazil. Also, the vertical integration between SiC and refractory did not damage to Brazilian market because Saint-Gobain had an old technology that was being substituted.

However, the vertical integration between the production of SiC and abrasives was a problem. Saint-Gobain Group had high participation in these two segments. The absence of effective competitors, coupled with difficulties for entrance and with difficulties in imports led SEAE to analyze the possible economic benefits (efficiencies) that could be gained from such an acquisition.

The analysis, however, has demonstrated that the net effect of the operation, that is, the comparison between the economic costs and the potential benefits derived from the Act was negative.

Therefore, SEAE suggested that the operation could be approved with restrictions. To ensure that existing competitive conditions could be reestablished, SEAE recommended the alienation of assets from the old Norton company related to the abrasives business.

We believe that if the dominance test had been used in this case, the Act would either have been rejected outright or that it would have been approved under the same restrictions. Likewise, the analysis made by SLC would not have been different, since the alleged efficiencies would not have been enough to cover the economic costs generated by the operation.

4. CONCLUDING REMARKS

It seems Brazilian jurisdiction does use the SLC test, is concerned with possible collusion regarding dominant position (although not to block a merger) and has never reviewed a merger solely under the public interest test, although has approved some cases with restrictions that considered non-competition variables.

In the previously described cases, it is possible to notice that only in the Ambev case the application of the SLC test or the dominance test would probably lead to distinct conclusions. If the dominance test had been applied in the analysis of this merger, the operation would have probably been rejected or approved with stronger restrictions (than an analysis made by the SLC test), once the market share of Ambev was high in the defined relevant market of beers, which was characterized by high barriers to entry. On the other hand, in the case of the SLC test, taking into consideration the analysis of efficiencies, the decision becomes lighter. SEAE's and SDE's recommendation pointed to the selling of one of the three main brands whereas Cade´s decision was less severe, making them to sell one weaker brand, called Bavaria. The difference in the solution could be explained because of the efficiencies analysis: the formers considered that there were not high efficiencies in the beer business, while the latter understood there were.

In a general way, in about 95% of the cases analyzed by the SBDC, the analysis of efficiencies is not necessary, that is, the operations are approved in earlier stages. Therefore, it is reasonable to assume that, in these cases, the conclusion would be the same either with the application of the SLC test or with the dominance test, once that one of the main differences between the two is exactly the analysis of the efficiencies of the operation.

Even considering the other 5% cases, both analyses would lead to the same conclusion. Consequently, we can say that only in very few cases, maybe 2%, the analysis would have led to different results, weather making use of the SLC or the Dominance test, as we could see in the Ambev case.