

OECD ROUNDTABLE, OCTOBER 2006

COMPETITION ISSUES IN BIDDING MARKETS: NEW ZEALAND

A. Introduction

1. “Bidding markets” are quite often encountered in the New Zealand Commerce Commission’s merger adjudication and competition enforcement work. These essentially are markets where some sort of bidding process is used to determine price. A seller invites buyers to bid for the offered product, where generally the highest bid wins; or more commonly, in a procurement auction, a buyer invites suppliers to bid for the right to supply it with a product or service, where generally the lowest bid (or more strictly, the lowest quality-adjusted bid) wins. “Open auctions” occur where the bidders interact through successive bids, resulting in an ascending bid auction in the first case above. “Sealed bid” auctions occur where each bidder puts in one bid, which is not disclosed to the other bidders, whose identities may not be known to the bidder. In the latter case, the winning bidder pays the price it bid in a “first-price” auction, and the highest losing bid in a “second-price” auction. Auction theory has shown that in certain circumstances these alternative bidding mechanisms can produce identical outcomes.
2. Auctions are often used in markets where the market participants have different, and incomplete, information, such that, for example, the value of the item is uncertain, or the cost of supply is imperfectly known. Recognising this, auctions in economic theory have been classified into two broad categories, according to the nature of the information bidders hold over the value of the prize being auctioned, although clear-cut cases may not be common in practice. First, *private value auctions* are those in which each of the bidders knows their own personal valuation of the item, but these valuations are both private (not known with certainty to the other bidders), and independent (knowledge of other bidders’ valuations would not alter how much the object is worth to a particular bidder). The private values assumption is most nearly satisfied in auctions for non-durable consumer goods.¹ Secondly, *common value auctions* are those in which, *ex post*, the true value of the prize is the same for all bidders, but in which, *ex ante*, each bidder has incomplete information about its value. For example, uncertainty about the value of the ore recoverable in an auction for mineral rights lends it a substantial common value aspect.
3. Auction theory predicts that the independence of valuations in private value auctions means bidding generally becomes more aggressive as the number of competitors increases.² However, the outcome is more ambiguous in the case of common value auctions. An increase in the number of bidders puts pressure on

¹ P. R. Milgrom and R. J. Weber, “A Theory of Auctions and Competitive Bidding”, *Econometrica*, vol. 50/5, 1982, pp. 1089-1122.

² See, for instance, R. P. McAfee and J. McMillan, “Auctions and Bidding”, *Journal of Economic Literature*, vol. 25(2), 1987, pp. 699-738.

all the competitors to bid more aggressively to increase the chances of winning. But, the presence of additional bidders also increases the chances of any individual bidder overestimating the true worth of the prize, and therefore of overbidding. Consequently, rational bidders faced with this situation will shade their bids to avoid the problem known as the *winner's curse*, namely, winning the tender at an inflated price.³ The paradoxical result that fewer bidders produce a more competitive bidding outcome arises in instances where the winner's curse dominates, which is a departure from standard market power analysis.

4. It has often been argued in auction theory literature, and before various competition authorities, that market share does not correlate to market power in bidding markets, as tends to happen in "normal" markets. Competition occurs during the bidding process, and as market shares reflect the outcomes of previous bidding contests, they may not indicate the competitiveness of the process itself. This competitiveness may be accentuated if large portions of the market are being contested for in a single auction, and if firms have high fixed costs. Hence, it is argued, the existence of just two competing players may be enough to ensure competitive outcomes, or perhaps even just one firm if that firm cannot be sure that no-one else will bid.⁴
5. An alternative view put forward by Klemperer is that bidding markets are often incorrectly analysed in antitrust cases.⁵ First, they are often falsely used by merger parties and their advisers to justify the creation of highly concentrated markets; and secondly, the term itself tends to lead to an over-emphasis on the special features of such markets, and the extent to which such markets should be treated differently from "ordinary" markets. He argued that if the bidding market were to satisfy certain extreme assumptions, comparable to those needed for contestability in ordinary markets, then market power might not arise even when the market is concentrated, as is often claimed; but that once these assumptions are relaxed, problems of market power through unilateral and coordinated effects reveal themselves, just as in ordinary markets. For example, the clear formal rules of auctions, especially in "open" auctions, can facilitate collusion. Moreover, the view that the bid-taker can set the rules so as to overcome any competition concerns, although technically possible in principle, is rarely achieved in practice.
6. Klemperer argued that the competitive outcome result flows from the implied adoption of the following strict assumptions:
 - competition is 'winner take all' so there is no smooth trade-off between price and quantity;
 - competition is 'lumpy' so that in each contest, there is an element of 'bet your company';

³ See: R. H. Thaler, "Anomalies: The Winner's Curse", *Journal of Economic Perspectives*, vol. 2(1), 1988, pp. 191-202.

⁴ See, for example, S. Bishop, and M. Walker, *The Economics of EC Competition Law: Concepts, Application, and Measurement*, London: Sweet & Maxwell, 2002, chapter 14.

⁵ P. Klemperer, "Bidding Markets", *Working Paper*, UK Competition Commission, 2005, p.4.

- competition begins afresh in each contracting round so there is no ‘lock-in’ or significant advantages from incumbency; and
 - entry of new suppliers to the market is easy.
7. In addition, of course, such markets, depending upon the auction mechanisms used, can encourage bid-rigging and other collusive forms of behaviour. For example, Klemperer argued that open auctions (as opposed to the sealed-bid variety) provide ideal conditions to support collusion by allowing easy detection of, and retaliation against, deviations from an agreed bidding strategy, as well as opportunities for signalling.⁶ Open auctions can deter entry and facilitate predation because it is often easier in such setups to identify the relative strengths of other bidders and respond accordingly. Repeated auctions also provide bidders with opportunities for learning through the formulation of appropriate strategies based on past outcomes, which can influence the way future competition unfolds. Hence, mechanism design is an important consideration for competition agencies when analysing bidding markets.
 8. In this paper we provide brief case studies of the Commission’s experiences of bidding markets in recent competition enforcement and merger adjudication cases, from which we draw some general conclusions on the nature of the competition issues encountered.

B. Principles to Maximise Competition in Auctions

Introduction

9. The Commerce Commission has never provided advice or made public comments to promote better auction design, nor has it been involved in auction design or redesign. These are policy matters outside of its remit.
10. However, it has encountered auction markets in a number of competition enforcement cases. The following are brief studies of some current cases.

Wood Preservative Chemicals

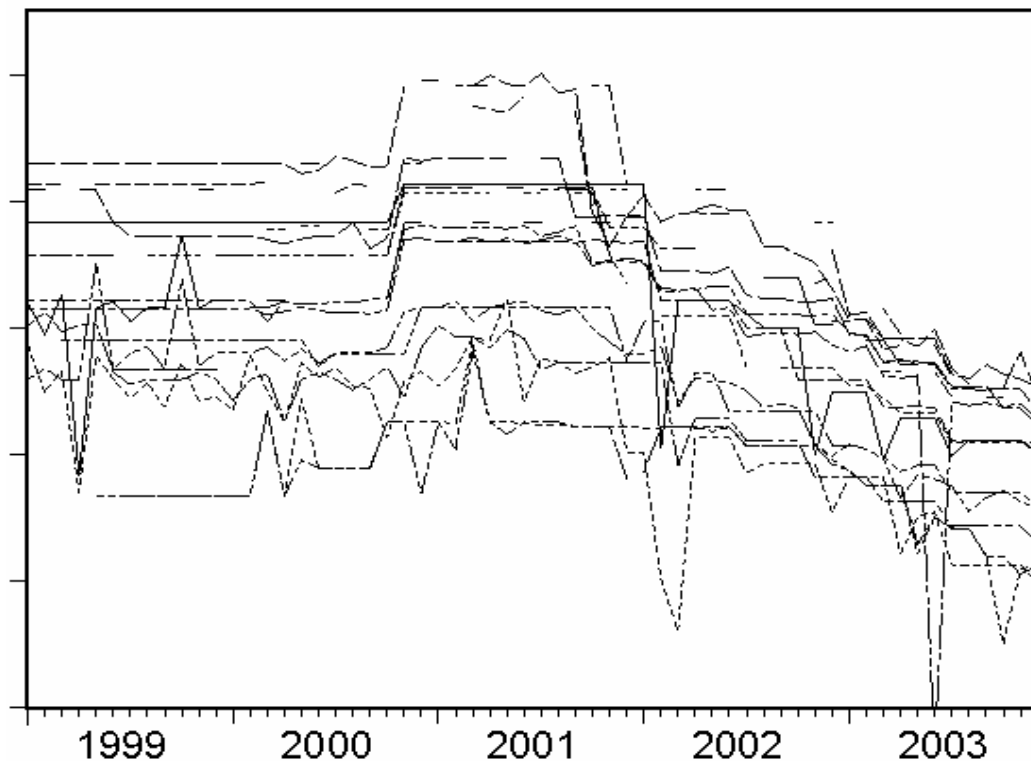
11. The Commission’s investigation was triggered by complaints of attempts by the two incumbents to exclude a new, small entrant from the market. These chemicals are sold to a number of saw-millers and timber treatment firms. Market pricing was characterised by suppliers bidding a price per tonne for supply of an anticipated amount of chemical, including associated support services, on individual supply contracts. The Commission uncovered evidence that not only upheld the original complaint, but also revealed that collusion had been attempted by the two incumbents.
12. The cartel had functioned in two ways: first, through customer allocations, where both suppliers would bid for contracts, but the nominated supplier would win by offering the lowest bid; and secondly, through attempts to maintain or increase general levels of prices. The cartel was undermined by the entry of the

⁶ Ibid. P. Klemperer, “What Really Matters in Auction Design”, *Journal of Economic Perspectives*, vol. 16(1), 2002, pp. 169-89.

third supplier, when the incumbents began the behaviour that initiated the investigation. When the Commission initiated court action, a number of firms and individuals admitted liability and settled with the Commission, with agreed penalties being recommended to the Court and approved by it. The case resulted in the largest aggregate company penalty to date in a New Zealand competition proceeding. Penalties against other parties are pending.

13. The following graph shows price trends over time for different customers during and after the cartel period (the dividing line is roughly early 2002). One striking feature is that prices during the cartel were very stable compared to the period following, and this appears to be in spite of changing underlying costs, caused in particular by changes in the prices of imported input chemicals due to exchange rate fluctuations. This price stability is consistent with the findings in a paper on a frozen perch cartel in the US that also involved bid-rigging during the 1980s.⁷ The authors noted that there is theoretical support for prices being less variable during cartels due to a high cost of coordinating price changes.
14. One interesting consequence of price rigidity was indicated by econometric analysis of prices for the periods during and following the cartel. This found that the impact of the cartel on prices relative to the 'no-cartel' situation, after allowing for fluctuating input costs, varied considerably over the cartel period, even briefly going negative shortly before a (coordinated) price rise in late 2000. The points where the coordinated price rise occurred, and when the cartel broke down, are both evident in the graph.

⁷ R. M. Abrantes-Metz, L. M. Froeb, J. F. Geweke and C. T. Taylor, "A Variance Screen for Collusion", Working Paper No. 275, Federal Trade Commission, March 2005.



A Confidential Price-fixing Case

15. In 2005 a government purchasing agency ran a first price, sealed-bid procurement auction. The winner of the auction would be the sole-supplier of a market in which there were previously three competitors. In anticipation of this auction, two of these competitors—call them A and B—together prepared a bid with a view to eventually forming a joint venture to provide the required service. This bid won the auction and the two firms were awarded the contract.
16. The desired amalgamation between A and B required Commerce Commission approval, which, after a lengthy deliberation, was declined. As a result, the procurer was forced to rethink its preferred supplier. It responded by declaring the first auction void, and running a second, but this time requiring all three firms to bid separately.
17. The Commission is currently investigating the two firms for a price-fixing law breach through their submitting a joint bid in the auction when they were in competition with one another in the market.⁸ The firms have argued that as no supply occurred at the jointly-agreed price (since the procurer declared the first auction void), there are no competition concerns.
18. However, in the process of formulating a joint bid for the first auction, A and B shared valuable operational information (costs, capacity, strategic detail, etc.),

⁸ Price fixing is a per se offence under the *Commerce Act, 1986*.

which previously was privately held.⁹ The concern is that due to the exchange of private information between the bidders in the first auction, the second auction was less competitive than it would have been absent information-sharing, because in the latter case the bidders may have bid only to the extent necessary to win the auction, but no more, whereas in the former they may have bid more aggressively to increase their chances of success. So, although supply did not occur at the jointly-agreed price, the act of fixing a joint bid may ultimately have had the effect of substantially lessening competition.

19. There appears to be some support in the economic literature for this hypothesis. For example, Milgrom and Weber showed, using a sealed-bid auction model in which there are asymmetrically informed bidders, that the bidder with private information generally makes no profit in equilibrium, whereas the informed bidder generally makes positive profits. Moreover, the informed bidder's profits increase as they gather extra information.¹⁰
20. The investigation and economic analysis of this case have yet to be concluded.

⁹ There is also evidence that the procurer shared some operational information previously private to the third firm, C, with A and B prior to the first auction, but C did not receive any private information relating to A or B.

¹⁰ P. Milgrom and R. J. Weber, "The Value of Information in a Sealed-Bid Auction", *Journal of Mathematical Economics*, vol. 10, 1982, pp. 105-14.

Electricity Industry Investigation

21. In 2005, the Commerce Commission opened an investigation into whether breaches of Part II of the Commerce Act have occurred in New Zealand's wholesale and retail electricity markets. There has been a high level of public debate about whether New Zealand electricity prices have been at workably competitive levels. The Commission has received complaints from residential and business consumers about both prices, and also in relation to other behaviour in the marketplace, including customer swapping and allegations of fair trading breaches.
22. New Zealand's electricity wholesale market may be better defined as a bidding mechanism rather than a bidding market, as the auctions held do not result in a 'winner takes all' situation. Rather, the market comprises repeated auctions, in which multiple participants bid to 'win' the right to generate a share of the total power required at the marginal bid price. The repeated nature of the electricity auctions mean that learning through experience is possible, and failure to 'win' in any one auction may not have a significantly large effect on a generation company over a larger timescale.
23. The wholesale market includes a spot market and a reserves market. The spot market operates on a daily basis for half-hourly periods. Purchasers submit bid functions that are decreasing in the bid price, and can contain up to ten price bands. Generators, for each generating unit, submit increasing offer step functions, giving the amount of capacity they are willing to supply as a function of the price, for all half-hours during the following day. Each generation unit can have a maximum of five price and quantity bands. The total amount of capacity offered into the market by generation unit within a trading interval must be less than a reasonable estimate of the maximum amount that can be produced from that unit.
24. The system operator uses a price-setting process for each half-hour period that co-optimises the as-bid cost of energy, reserves and transmission losses, whilst accounting for transmission losses, respecting transmission constraints and operating constraint (primarily ramping constraints) on generation units. Dispatch energy and reserve instructions are then issued to generators.
25. High half-hourly prices at certain nodes in the transmission system can benefit some generators over others. Extreme prices could be caused by events outside the control of any market participant, such as transmission line and generation unit outages, or unexpected increases in demand at certain locations in the transmission network. Or high prices at certain nodes could be caused (in part) by the unilateral actions of the generators that benefit from them. One measure of market power used in assessing electricity market outcomes is the ability to affect the marginal price at which the market clears.
26. Participants in such repeated auctions benefit from observing rivals' behaviour over time. Experience of others' behaviour will enable a generator to form an expectation as to the probability of his bid setting the market price (or, in the

case of New Zealand, the nodal price). Best-response bidding strategies will therefore depend upon the expected actions of others in the market, which will be easier to gauge as time passes and experience is accumulated. Use of market power by generators has been cited as a cause of California's energy crisis in the summer of 2000.¹¹ Research on the England and Wales energy market between 1995 and 2000 found signs of the exercise of generator market power.¹²

27. If market power were used for the purpose of impeding competition in a market, or there were contracts, arrangements or understandings between competitors that substantially lessened competition in a market, a Part II breach of the *Commerce Act, 1986* (New Zealand's competition law) would be likely to have occurred.
28. An interesting aspect of the New Zealand market is the prevalence of vertical integration, with most of the generation entities also have retailing operations, and *vice versa* (lines companies are forbidden from having retailing interests, and are severely constrained in terms of generation interests). The Commission's investigation may lead to some insights into bidder behaviour given the incentives arising when parties have business interests on both sides of the wholesale electricity market.
29. The position of market participants in the energy hedge market will also be considered by the Commission. This market is relatively 'thin', especially as vertical integration allows 'natural' hedging using 'captive' retail demand. A firm's forward hedge contract position, as well as whether it is a net generator or retailer, can influence its optimal bidding strategy into the electricity market. The liquidity of hedge markets will also be a relevant factor in a firm's ability to exercise market power. If hedge contracts are scarce, then net-generator firms may face less competitive constraints on their ability to affect certain nodal prices.
30. Bidding behaviour in the wholesale market may also be affected by capacity across the transmission network. Where transmission constraints preclude energy generated elsewhere from entering a particular region, the opportunity for localised market power to be exerted may arise. Transmission losses are a further physical impediment to generation serving more distant electricity demand centres. The New Zealand grid differs from many other electricity systems in a number of ways, including the lack of interconnectivity with a geographically adjoining network, the long slim configuration of the grid along the land mass, and two separate Islands joined by only one point of interconnection (the inter-Island HVDC link).
31. To complete its investigation the Commission has required substantial amounts of market data to be made available for use in complex modelling by an external consultant. The quality and availability of industry data (particularly going back

¹¹ P. L. Joskow and E. Kahn. "A Quantitative Analysis of Pricing Behavior in California's Wholesale Electricity Market During Summer 2000", *Energy Journal*, 2002, vol. 23(4), pp. 1-35.

¹² A. Sweeting, "Market Power in the England and Wales Wholesale Electricity Market 1995-2000", *Cambridge Working Papers in Economics*, no. 0455, 2004.

four or five years) is not comparable with that in other, similar, electricity markets. Obtaining robust historic information has therefore taken considerable time and effort.

32. By the end of the investigation, the Commission will have analysed the workings of the New Zealand electricity markets using a much richer data set than has heretofore been available, and will hopefully be in a position to draw sound conclusions about the operation of the market, the competitiveness of observed prices, and the behaviour of the participants in the market. Further, the investigation may also provide a valuable insight into how effective is the market bidding mechanism.

C. Merger Evaluation in Bidding Markets

Introduction

33. The Commission's *Mergers and Acquisitions Guidelines* do not address auction or bidding markets specifically. However, the Commission has encountered bidding markets in a number of merger cases. Brief case studies of the three most recent examples are now set out, all of which were declined clearance or challenged in the court.

Sonic/NZDG

34. In June 2005 the Commission received a notice seeking approval for the merger of two private pathology businesses—New Zealand Diagnostic Group Limited ('NZDG') and Sonic Healthcare (New Zealand) Limited ('Sonic')—in several districts throughout New Zealand.
35. Historically, diagnostic pathology services in New Zealand were funded on a fee-per-test basis. That is, providers could claim remuneration from the District Health Boards (DHBs)—provincially governed boards, of which there are 21 in total, responsible for procuring public health services—for all testing work performed. Over time, this open-ended funding policy led to an escalation in healthcare costs to apparently unsustainable levels.
36. Several DHBs responded to these rising costs by altering the contracting arrangements for pathology services. First, some DHBs sought a single supplier (either public or private) of pathology services in their districts, believing that the consolidation of operations would avoid wasteful duplication and generate economies of scale, ultimately leading to cost savings. Secondly, funding for pathology services would be capped at a fixed amount, and it would be left to the provider to manage volume risk.
37. The first DHB to adopt this new model proposed to allocate a fixed-term supply contract through a competitive tender process. (Several other DHBs have since run, or indicated that they would run, tenders for the procurement of pathology services.) NZDG and Sonic submitted a joint bid to supply this DHB and were declared the winner of the tender subject to, among other conditions, Commission approval.

38. The change to the way contracts were allocated meant competition for pathology services would in the future be *for* the market (winner-takes-all), rather than *in* the market (multiple providers competing day-to-day). To allow for this when considering the likely effect of the proposed merger, the Commission modified its standard analysis of “existing competition” and “potential competition”, and instead analysed the nature of competition by identifying the likely potential bidders for future contracts, and the degree of constraint these bidders would offer in the factual and the counterfactual scenarios. In addition, the Commission defined the time dimension of the relevant markets according to the term of the procurement contracts (between three to ten years, depending on the DHB). This was a departure from the Commission’s usual approach to analysing mergers, which involves assessing the impact on competition over a two year period.
39. One of the Commission’s standard tools when defining markets is the SSNIP test. However, practical application of the SSNIP test in this case was problematic, given that providers compete through simultaneously-placed sealed bids. Hence, there is no obvious price on which to apply the SSNIP. Nevertheless, the notion of substitutability is useful when considering the appropriate definition of the market. There are several non-price factors that can help inform the extent of product substitutability on both the demand- and supply-side. These may include: distinct product characteristics and uses; unique production facilities or processes; distinct purchasers; specialisation of sellers; and recognition and views of industry participants of market boundaries. Given the difficulties in applying the SSNIP test, the Commission gave greater weight to such non-price considerations when defining the relevant markets.
40. The Commission considered arguments that market shares do not provide a true picture of the competitiveness of bidding markets. In particular, the element of “betting the firm” in a winner-takes-all contest, a characteristic of bidding markets, means that even a small number of competitors is sufficient to ensure competitive outcomes. In considering these arguments, the Commission was convinced by the arguments set out in Klemperer (2005) that few markets, including those relevant to the present case, satisfy the assumptions that underlie an ‘idealised’ bidding market. The Commission therefore concluded that the use of a bidding mechanism in the markets relevant to the proposed merger did not obviate the need to conduct a standard competition analysis.
41. In assessing whether the proposed merger would result in a substantial lessening of competition, the Commission considered the likelihood and scope for potential competing bidders to constrain the merged entity in future contracting rounds, relative to the counterfactual. In doing so, the Commission identified a number of barriers to entry and expansion, which included apparent advantages from incumbency. This is often a characteristic of winner-takes-all markets.
42. The Commission found that NZDG and Sonic were the largest, most well-resourced, and experienced of the potential bidders in the market, and absent the proposed merger, would exert a significant degree of constraint on one another. In contrast, the remaining likely bidders would offer only a weak constraint.

The Commission came to the view that the proposed joint venture would have the effect of eliminating the strongest source of competition that would otherwise exist in the counterfactual.

43. The Commission also considered the possibility that the DHBs might threaten self-provision as a means of disciplining the merged entity in future bidding rounds. However, it concluded that the substantial costs and risks that would entail self-provision might mean that the DHBs would accept significant cost increases before considering it worthwhile to exercise such an option.
44. The Commission also found evidence that the proposed joint venture might result in increased coordination between NZDG and Sonic in other districts not relevant to the proposal.
45. Taking all these factors into account, the Commission therefore declined the merger in November 2005.

EMS/M-co

46. Energy Market Services (EMS), a subsidiary of Transpower (the New Zealand electricity transmission network owner and system operator), and a provider of reconciliation services to the wholesale electricity market, sought a clearance to acquire M-co, a provider of a pricing, clearing, information system and administration services to the same market.
47. All of these services are provided under contract to the Electricity Commission, the Crown entity set up to regulate the operation of the electricity industry and markets. The Electricity Commission runs a periodic tender process to appoint service providers for each contract.
48. In assessing whether the proposed merger would lead to a substantial lessening of competition, the Commission analysed the likely state of competition at the point in time at which competition would occur, that is, when the Electricity Commission requested bids for the future provision of the services. Consequently, as in the *Sonic/NZDG* clearance, the Commission modified its standard approach to competition analysis set out in its *Mergers and Acquisitions Guidelines*, based on the distinction between “existing competition” and “potential competition”, and instead analysed the nature of competition by identifying the likely potential bidders for future contracts, and the extent of competition these bidders would provide in the factual (with merger) and the counterfactual (without merger) scenarios.
49. As noted above (para. 5), the argument that the competitive outcome will result from an auction in which there are only two potential bidders is based on strict assumptions that describe an idealised bidding market, and that where the market in question departs from these ideals, the problems of unilateral and co-ordinated market power effects may arise. The Commission took the view that although some of the assumptions needed to separate competition from market structure held for the markets for the Electricity Commission service provider contracts, not all did. In particular, there appeared to be some

incumbency advantages in these markets. Also, while the contracts were important in financial and/or strategic terms to both M-co and EMS/Transpower (and therefore there was an element of betting the firm), this was less likely to be true for other potential competitors in these markets, such as large IT firms, since the absolute values of the contracts were not particularly high.

50. The Commission considered that these markets could not be regarded as ‘pure’ bidding markets, or that a competitive outcome would be assured with only one or two bidders. However, the Commission did recognise that the markets had some of the characteristics required for an ‘idealised’ bidding market. It therefore found that the number of competitors (above two) might be a less significant factor for competition than would be the case in “normal” markets. Instead, the Commission regarded the key determinant of competition in these markets as whether or not the incumbent was likely to face at least one well matched and aggressive challenger.
51. Based on these considerations, the Commission took the view that there would be some lessening of competition in a market if, in the counterfactual, EMS and M-co were each other’s strongest competitor and, in the factual, no third party could provide a comparable constraint on the behaviour of the combined entity.
52. Therefore, in considering whether removing one competitor from these markets would result in a substantial lessening of competition, the Commission assessed whether the incumbent in each market was likely to face another competitor at the end of the contract period similar to EMS and/or M-co standing alone, in terms of having:
 - similar costs and facing similar barriers to entry; and
 - similar incentives to bid aggressively for the contracts.
53. The Commission concluded that this was unlikely to be the case for several of the service contracts, and therefore declined the clearance.

NZBL/Mana

54. In January 2006 New Zealand Bus Limited (NZBL) applied for clearance to acquire the 74% shareholding of Mana Coach Service Limited (Mana) that it did not already own. NZBL is the largest bus operator in the Greater Wellington region, and Mana the second largest.
55. Just before the Commission reached a decision on whether or not to clear the merger, the applicants withdrew the clearance application and proceeded with the acquisition regardless. The Commission quickly responded by completing its investigation, and then applying to the High Court for an interim injunction to prevent the acquisition. In the substantive hearing that followed the Court found for the Commission that there would be a substantial lessening of competition. An appeal of this judgment is currently pending.

56. The market was one for local bus passenger services in the Greater Wellington region. In New Zealand such services are generally subsidised, and hence are subject to substantial regulation, by regional councils, who operate in accord with principles set out in statutes. The Greater Wellington Regional Council (GWRC) is required to establish a regional transport strategy, which is implemented in part by subsidising public scheduled bus services. It designs bus routes, and periodically lets contracts for the provision of services—usually as groups of inter-connected routes, and measured by the number of buses required—in which it prescribes fare levels and service standards. Bus operators bid for tenders by nominating the size of the subsidy at which they would be prepared to supply the service.¹³
57. The subsidy funding is provided roughly equally by central government and local ratepayers. The former is disbursed through Land Transport New Zealand (LTNZ). The receipt of such funding is conditional on the recipient council following the procurement procedures specified by the LTNZ. These are currently under review. Some aspects of these procedures seem to limit competition.
58. First, the LTNZ must have regard to encouraging competitive and efficient markets when framing these procedures. This has been interpreted as limiting the sizes of tenders (to a maximum of around 22 buses), although this requirement has been relaxed recently. Small tenders are attractive to small, potential entrants, but not to large ones that might offer stiffer competition. Secondly, the council is required to accept the lowest priced conforming tender. It may negotiate only when there is one bid, and then only with the bidder, which, by disclosing that there is no other bid, undermines the position of the council. Thirdly, the names of winning bidders and contract prices must also be published, along with the number of tenders and the price range, which allows an incumbent to monitor competitor activity. Fourthly, a council must issue a request for tender no more than eight months (formerly six months) before the start of the service, which leaves too little time for a de novo entrant to establish the necessary facilities after a tender is won, and it will not do so before. Finally, contract terms are normally limited to five years, but roll-overs to a maximum term of eight years are now permitted. Overall, the court accepted that some features of the procurement regime—in particular, the limited maximum contract size and short lead times—act as significant entry constraints, but recognised that there are processes for making amendments within a reasonable time.
59. It is also possible for operators to register with the council to undertake unsubsidised “commercial” services on particular routes at specified times of the day nominated by the operator. These accounted for about 20% of services in the GWRC area. Commercial registrations are often less profitable than subsidised services, and may be used tactically by operators, either to defend an incumbency position on a route (the residual part of the service may be unattractive to another operator), or to secure an incumbent advantage when a

¹³ In a “net contract” the operator receives both the subsidy and the revenues collected from ticket sales. A similar process is used by the Ministry of Education to let contracts for school bus services, but on a much smaller scale.

council is establishing a new service. Councils are reluctant to contract over commercial routes, because it risks criticism that public money is being spent unnecessarily.

60. The court found that NZBL and Mana together held 97% of the subsidised contracts by value. The other half-a-dozen firms in the market were all small. NZBL and Mana operated in geographically discrete and largely non-overlapping—although in some areas contiguous—parts of the greater Wellington region. Each operator’s network was supported by a few major depots, together with a number of lesser yards at outlying points. The court also found that with rare exceptions, NZBL and Mana did not compete for GWRC contracts. In fact, 87% of the GWRC contracts attracted only one bid, and 87% of the contracts were won by the incumbent. Most of the competition appeared to take place on the small contracts. The number of bidders also seemed to matter for the price. For GWRC contracts, when the number of bids increased from one to two the average winning price measured in dollars per vehicle kilometre fell very sharply, then was about the same for three-bid contracts, and then fell sharply for four bids. A similar pattern emerged for school bus contracts.
61. Because of the lack of competition, and the nature of the contractual arrangements between the two linked with the 26% share holding in Mana by NZBL, the Court found that there existed an understanding between them that they would not compete on GWRC contracts.
62. As the competition was identified to be mainly *for* the market, the Commission recognised that the key issue in assessing existing and potential competition was the ability of outside firms to bid at the time that contracts were tendered. The Court found that new entry or incumbent loss of contracts was rare. Only three smaller contracts had changed hands since 2000. It also found that both companies were very profitable by international standards for bus companies.
63. The Court found that there was a genuine interest in market entry, and that all the potential entrants had a strong preference for entry by acquisition, this being the established pattern in New Zealand and overseas. However, it also acknowledged that potential bidders faced a number of entry conditions that would make entry difficult. These included: short contract lead times for requests for tender (which made it difficult to hire staff, order buses and establish depots in time); the limited sizes of bus contracts; economies of scale advantages of large operators; commercial registrations; incumbent’s patronage information not being provided to potential entrants; the value of local knowledge; and tendering costs being lower for incumbents.
64. However, in assessing whether a new entrant could effectively enter the market, the judge departed from a strict analysis of barriers to entry and instead concentrated on a LET test approach, by asking whether entry would be Likely, sufficient in Extent, and sufficiently Timely, to constrain the merged entity. The judge adopted the approach taken by the High Court in *Air New Zealand/Qantas v Commerce Commission*, suggesting that the market assessment cannot simply

rely on a principle of low barriers to entry as an answer to a competition problem:

“...it is not necessary for the Commission to catalogue barriers to entry and prove their individual or cumulative effect. Rather, empirical data about entry and prices in this and similar markets may justify a conclusion that substantial conditions of entry exist.”

65. The judge found that NZBL and Mana were the lowest cost operators in the market by virtue of their local assets, in circumstances where bids from firms without such assets are rare, and that their merger would lessen competition in the market. The judge concluded that while potential entry would remain a constraint under the factual scenario, contingent on the GWRC’s ability to offer more attractive tender structures, this possibility was weak compared to the counterfactual scenario, where potential entry would be most likely to occur through the acquisition of Mana. The new entrant would compete more aggressively than Mana traditionally had done by bidding on NZBL routes.
66. The Court also found that the GWRC’s countervailing power would remain modest in the factual, because so many tenders attracted only one bid, its weak bargaining power when it must provide services to meet public demand, and operators’ superior knowledge of patronage and costs. In the counterfactual scenario it would have more power because of the greater likelihood of new entry occurring on a substantial scale.
67. The judge reached the decision that the acquisition would be likely to substantially lessen competition in the relevant market. This decision is subject to an appeal.
68. Interestingly, in 2005 the Commission cleared a similar bus company merger in Christchurch (*Red Bus/Leopard Coachlines*). It found that in the factual scenario there would be two incumbents and regular bidders in the bus subsidies market—Red Bus/Leopard and CBS (plus other potential bidders)—and in the counterfactual there would be three regular bidders, namely Red Bus, Leopard and CBS (plus other potential bidders). However, past evidence of bidding conduct suggested that Leopard would be a weak competitor in the counterfactual, whereas CBS—a relative newcomer and aggressive bidder—would be a strong competitor in both the factual and counterfactual. CBS’s circumstances were unusual in that the director of the company, as an ex-CEO of Red Bus, had firsthand knowledge of the Christchurch bus market, and over 25 years experience in the bus industry. On this basis, the Commission found no substantial lessening of competition between the factual and counterfactual scenarios.

D. Summary and Conclusions

69. The six case studies, drawn from the New Zealand Commerce Commission’s recent experience of bidding markets in its competition enforcement and merger adjudication roles, share a number of similar features, as follows:

- Four involved a single buyer—a government agency or local authority body—wishing to purchase a service. In five cases the supplier market was also highly concentrated.
 - Two cases (or possibly as many as four, depending upon the outcome of investigations) involved tacit or explicit collusion on bidding, sometimes by means of market sharing. The Court in *NZBL/Mana* found that there was a tacit understanding as to geographic market allocation between the two major incumbents, such that they did not compete for council tenders. In wood preservative chemicals the two major operators allocated customers, and agreed a general price increase on one occasion.
 - Three cases involved proposed mergers of the two major private suppliers, in situations where existing competition would have been greatly reduced, and the constraint from potential competition was limited. Two of these were declined clearance, and in the other, an injunction to prevent the acquisition was sought on the grounds that competition would have been substantially lessened.
70. The main analytical features that can be drawn from the series of brief case studies set out above are as follows:
- One of the Commission’s standard tools when defining markets is the SSNIP test. However, practical application of the SSNIP test is often problematic in sealed bid auction markets, as there may be no obvious price on which to apply the SSNIP.
 - Competition in such markets occurs at the time of the bidding, and is *for* the market, rather than *in* the market. This may mean that historical market shares may not necessarily provide a reasonable indicator of the competitiveness of the market at the time of the bidding. Some of the cases involved contracts with supply terms of several years.
 - It does not seem sensible to think in terms of existing and potential competition in situations where competition is compressed into a single discrete point in time (the auction), and involves the winner ‘taking all’, especially where the tender covers a substantial portion of the market.
 - In terms of ‘entry’, even if the hypothetical monopoly incumbent in the market were assumed to add five to ten percent to its full costs in setting its bid, it is difficult to predict whether a provider elsewhere would bid. Nonetheless, it is important to consider whether firms other than incumbents (perhaps in other regional markets, or even in another country) are able to be viable bidders.
 - The evidence from the bus merger case showed that winning bid prices tend on average to be lower when there are more bidders, and especially when going from one-bid to two-bid contracts. This raises doubts about the argument that market structure considerations do not matter for competition in bidding markets.

- It appears that successful bidders may secure incumbency advantages. In the buses case, it was found that the two major companies with local assets in the regional market had lower costs than outside bidders. This advantage was reinforced by: the procurement regime, which made it very difficult for a new entrant to set up an operation in time to supply in the interval allowed after a successful bid.
- The fact that the auctioneer (a buyer of services, in the case of procurement auctions) largely sets the rules of competition via the auction mechanism does not necessarily mean that they can exert strong countervailing power on bidders. Sometimes the tendering rules seem misguided. Also, the ability of the buyer to exercise countervailing power may not be fully realised or exercised. Countervailing power may be frustrated by a range of possible factors: having only one bidder (meaning an inability to play off one against another); the bidder having superior information; the desire to accept initially favourable terms with insufficient consideration being given to possible long-term 'lock-in'; and the pressure on the buyer to purchase in order to provide what is often considered an essential service.