

ENERGY REGULATORY COMMISSION

COMPETITION GUIDELINE

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**AMENDMENT RECORD**

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## 1. INTRODUCTION

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### 1.1 Purpose of this Guideline

- 1.1.1 Section 45 of the Electric Power Industry Reform Act provides that no participant in the electricity industry or any other person may engage in any anti-competitive behaviour including, but not limited to, cross-subsidization, price or market manipulation, or other unfair trade practices detrimental to the encouragement and protection of contestable markets. One of the objectives of this prohibition is to enhance the welfare of electricity consumers: effective competition lead to benefits in the form of lower prices, greater choice and better service.
- 1.1.2 The Electric Power Industry Reform Act and the Implementing Rules and Regulations issued pursuant to that Act accordingly require the Energy Regulatory Commission (the **ERC**) to promulgate rules that prohibit, and that specify appropriate penalties and remedies for, among other things, anti-competitive behaviour and abuse of market power. The ERC promulgated such rules, called the Competition Rules, on [#].
- 1.1.3 The purpose of this Guideline is to provide guidance to participants in the electric power industry, their advisers and the public as to the approach that the ERC will generally adopt in administering and enforcing the Competition Rules. This is considered to be important because the Philippines electric power industry is undergoing significant restructuring and regulatory reform, and because there has to date been little experience in the Philippines of a competition regulatory regime of the kind embodied in the Competition Rules.
- 1.1.4 However, this Guideline is not a substitute for the Competition Rules. In particular, for the sake of simplicity, this Guideline sometimes contains generalizations about the application of the Competition Rules. It is therefore important to read the Competition Rules themselves and not just to rely on the summary of them which is contained in this Guideline.
- 1.1.5 Moreover, this Guideline does not have any legal force. As stated above, it is simply intended to indicate the approach that the ERC will generally adopt in administering and enforcing the Competition Rules. Indeed, it is not possible to set out a prescriptive approach in dealing with all of the types of conduct to which the Competition Rules might apply: the precise approach in any particular case will depend upon the circumstances of the individual case, including the specific characteristics of the relevant market or markets.

### 1.2 Coverage of Competition Rules

- 1.2.1 The prohibitions imposed by the Competition Rules (which are described below and discussed in more detail in sections 4, 5 and 6 of this Guideline) relate to “persons”. For this purpose, Rule 3(1) of the Competition Rules defines a “person” to mean a natural or juridical person, and to include an individual, a corporation, a partnership or an association to which the law grants a juridical personality, a

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trustee, a government-owned or government-controlled corporation, a local government unit, an electric cooperative and an entity of any other kind, which has a separate legal personality.

- 1.2.2 Accordingly, the Competition Rules apply to, among others, generation companies (including independent power producers), IPP administrators, the transmission concessionaire, distribution utilities (including electric cooperatives, government-owned utilities and local government units), suppliers, traders<sup>1</sup>, aggregators, end-users, TRANSCO, the Independent Market Operator (IMO)<sup>2</sup>, National Power Corporation and Power Sector Assets and Liabilities Management Corporation.
- 1.2.3 The Competition Rules also apply to such persons whether or not they are Philippine nationals.
- 1.2.4 Finally, the Competition Rules apply to things done, or omitted or refused to be done, outside the Philippines to the extent that the doing of, or the omitting or refusing to do, those things affects a relevant market in the Philippines (see Rule 18(2) of the Competition Rules).

### 1.3 Overview

1.3.1 The Competition Rules impose four separate **prohibitions**:

- **Anti-competitive agreement prohibition** – a person is prohibited from:
  - entering into an agreement, arrangement or understanding that would have, or would be likely to have, the effect of substantially lessening competition in a market; and
  - giving effect to a provision of an agreement, arrangement or understanding that has, or is likely to have, the effect of substantially lessening competition in a market.

This prohibition, together with examples of the kinds of agreements, arrangements and understandings to which it might apply, is discussed in section 4 of this Guideline.

- **Price-fixing prohibition** – a person is prohibited from:
  - entering into an agreement, arrangement or understanding that contains a provision that has the effect of fixing, controlling or maintaining the price at which any party to that agreement, arrangement or understanding may supply goods or services to, or acquire goods or services from, a person which is not a party to that agreement, arrangement or understanding; and
  - giving effect to such a provision.

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<sup>1</sup> This refers to speculative traders of financial electricity contracts who do not fall under any of the other categories mentioned.

<sup>2</sup> Specifically, in its role as issuer of transmission rights under the WESM Rules.

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This prohibition, together with examples of the kinds of agreements, arrangements and understandings to which it might apply, is also discussed in section 4 of this Guideline.

- **Misuse of market power prohibition** – a person that has a substantial degree of power in a market is prohibited from misusing that power. For the purposes of determining whether a person has violated this prohibition, it is necessary to take into account:
  - whether, if the person did not have that power, the person would have acted in the way it did; and
  - whether, in all the circumstances, the person was reasonably justified in using its power in the way it did.

This prohibition, together with examples of the kinds of conduct to which it might apply, is discussed in section 5 of this Guideline.

- **Merger prohibition** – a person is prohibited from acquiring shares or assets, or merging or consolidating with another corporation, if that acquisition, merger or consolidation would have, or would be likely to have, the effect of substantially lessening competition in a market. This prohibition is discussed in section 6 of this Guideline.

1.3.2 Except for the price-fixing prohibition, the application of each of these prohibitions is critically dependent on the definition of the relevant **market**. The Competition Rules apply to any market in the Philippines in which electricity, or other goods or services that are related to or used in connection with the generation, transmission, distribution or sale of electricity, are or may be supplied or acquired. The relevant market or markets that need to be considered in any particular case will depend upon the circumstances of that case. For these purposes, a market is identified by reference to the goods and services that are traded in it (the “product dimension”), the area which it covers (the “geographic dimension”), and the capacity in which the participants trade in it (the “functional dimension”). The dimensions of a market might also change over time (eg. with the removal of transmission constraints). Indeed, a market might even be defined by reference to time (eg. there could be a separate market for peak and off-peak electricity). Section 2 of this Guideline describes the process of identifying and defining a market.

1.3.3 The application of each of the prohibitions referred to above (other than the price-fixing prohibition) is also dependent on an assessment of the **level of competition** in the relevant market. The anti-competitive agreement and merger prohibitions require a (sometimes hypothetical) comparison of the nature and effect of competition in that market both with and without the relevant agreement, arrangement, understanding, acquisition, merger or consolidation. The misuse of market power prohibition only applies where a person has a substantial degree of power in a market – and whether or not this is the case also depends upon the nature and extent of competition in that market (the existence of effective competition will preclude the existence of a substantial degree of market power). An assessment of the level of competition in a market entails a consideration of,

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among other things, the degree of concentration of the market, the height and nature of barriers to entry to the market, the existence of countervailing power (ie. the bargaining strength of counter-participants in the market), the nature of competition in the market (eg. whether or not the market participants compete vigorously), the contractual links between market participants and the extent of vertical integration. These matters are discussed in section 3 of this Guideline, and such factors as are particularly relevant in the context of the merger prohibition are further discussed in section 6 of this Guideline.

- 1.3.4 Because the definition of a market and the assessment of the level of competition in a market is, to some degree, a matter of judgment, the Competition Rules enable concerned parties to apply for a clearance from the ERC in certain circumstances. A clearance is a determination that a proposed agreement, arrangement, understanding, share or asset acquisition, merger or consolidation will not violate the anti-competitive agreement prohibition or the merger prohibition (as the case may be) – ie. that it would not have, and would not be likely to have, the effect of substantially lessening competition in a market. The clearance process is discussed in sections 4.6.1 to 4.6.10 of this Guideline (in relation to the anti-competitive agreement prohibition) and in sections 6.4.1 to 6.4.9 of this Guideline (in relation to the merger prohibition).
- 1.3.5 However, even if an agreement, arrangement, understanding, share or asset acquisition, merger or consolidation would violate the anti-competitive agreement prohibition, the price-fixing prohibition or the merger prohibition, it can (and must) be authorized (ie. permitted) by the ERC if it meets a public benefit test:
- in the case of the anti-competitive agreement prohibition and the price-fixing prohibition, the test is whether the benefit to the public resulting from the agreement, arrangement or understanding is likely to outweigh the detriment to the public constituted by the lessening of competition;
  - in the case of the merger prohibition, the test is whether the share or asset acquisition, merger or consolidation is likely to result in such a benefit to the public that it should be allowed to take place.

Authorization is a public process in which any interested party may participate. The authorization process is discussed in sections 4.6.11 to 4.6.26 of this Guideline (in relation to the anti-competitive agreement and price-fixing prohibitions) and in sections 6.4.10 to 6.4.25 of this Guideline (in relation to the merger prohibition).

- 1.3.6 A violation of any of the prohibitions referred to above will render the offender liable to a range of remedial and punitive orders. These orders, and some of the matters which the ERC will consider in determining the appropriate orders to be made in any particular case, are discussed in section 7 of this Guideline. Such orders may be made not just against the offender, but also against those who are in some way involved in or associated with the violation (this might include directors, officers or employees of a corporation that violates any of these prohibitions). In addition, the ERC is empowered to issue an order restraining a person from violating a

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prohibition where the ERC has reason to believe that the person is likely to violate that prohibition.

- 1.3.7 The ERC has extensive powers to investigate actual or potential violations of the Competition Rules. These powers are described in section 8 of this Guideline.
- 1.3.8 Certain exclusions from the application of the Competition Rules are described in section 9 of this Guideline.
- 1.3.9 The provisions of the Competition Rules that deal with the confidentiality of information provided to the ERC are described in section 10 of this Guideline.
- 1.3.10 Section 11 of this Guideline describes those provisions of the Competition Rules that:
- define concepts that are relevant to certain other activities that are prohibited by section 45 of the EPIRA;
  - prohibit cross-subsidisation by TRANSCO (or its buyer or concessionaire) and distribution utilities; and
  - require the provision of information to the ERC (the “reportorial requirements”).
- 1.3.11 Finally, the amendment of the Competition Rules is dealt with in section 12 of this Guideline.
- 1.3.12 The Competition Rules do not, and cannot, override any existing laws. This is because, being rules made under the EPIRA, they take the form of subordinate rules rather than legislation. On the contrary, they operate in addition to existing laws by imposing additional prohibitions. Accordingly, for example, the mere fact that the EPIRA permits an accumulation of installed generating capacity up to the thresholds contained in the EPIRA (see s.45) will not preclude that accumulation being prohibited under the Competition Rules (eg. as where it is achieved by way of a merger that would violate the merger prohibition as opposed to by way of the construction of new generating capacity).

#### **1.4 Amendments to Guideline**

The ERC may amend this Guideline from time to time – for example, to take account of relevant developments in the electric power industry or of amendments to the Competition Rules (see section 12 of this Guideline). However, before making any such amendment, the ERC will undertake appropriate consultation with relevant persons.

#### **1.5 Input from Interested Parties**

The ERC welcomes comments, discussion or suggestions for amendments to this Guideline from any interested party. Any contribution in this regard should be addressed to:

*Energy Regulatory Commission*

*PO Box 181 Greenhills, Metro Manila*

*Facsimile: 631-5871*

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## 1.6 Version History

An Issue Number will identify every version of this Guideline. This version is Issue No. [G2/1].

## 1.7 Definitions

The following terms, which are used in this Guideline, have the meaning set out below unless the contrary intention appears:

“**affiliate**”, in relation to a person (the **subject person**), means any person who, alone or together with any other person, directly or indirectly controls, is controlled by, or is under common control with, the subject person and “**affiliates**” include:

- (a) a subsidiary company and a parent company; and
- (b) subsidiaries, directly or indirectly, of a common parent.

For this purpose “**control**” means the power to direct or cause the direction of the management policies of a person by contract, agency or otherwise;

“**Competition Rules**” means the Competition Rules (as amended from time to time) made pursuant to section 45 of the EPIRA and Rule 11.8 of the Implementing Rules and Regulations issued pursuant to the EPIRA;

“**EPIRA**” refers to Republic Act No. 9136, otherwise known as the Electric Power Industry Reform Act, as amended from time to time;

“**ERC**” means the Energy Regulatory Commission created by section 38 of the EPIRA;

“**market**” means a market in the Philippines in which electricity or other goods or services that are directly or indirectly related to or used in connection with the generation, transmission, distribution or sale of electricity are or may be supplied or acquired;

“**person**” means a natural or juridical person and includes an individual, a corporation, a partnership or an association to which the law grants a juridical personality, a trustee, a government-owned or government-controlled corporation, a local government unit, an electric cooperative organised pursuant to Presidential Decree No. 269, or an entity of any other kind whatsoever, which has a separate legal personality;

“**WESM**” means the Wholesale Electricity Spot Market created in accordance with the EPIRA.

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## 2. MARKET DEFINITION

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### 2.1 Introduction

2.1.1 The Competition Rules prohibit a person from:

- making an agreement or arrangement, or arriving at an understanding, if a provision of that agreement, arrangement or understanding would have, or would be likely to have, the effect of substantially lessening competition in a **market** (Rule 4 of the Competition Rules; see section 4 of this Guideline);
- giving effect to a provision of an agreement, arrangement or understanding if that provision has, or is likely to have, the effect of substantially lessening competition in a **market** (Rule 4 of the Competition Rules; see section 4 of this Guideline);
- where that person has a substantial degree of power in a **market**, misusing that power (Rule 5 of the Competition Rules; see section 5 of this Guideline); or
- acquiring shares or assets, merging with another corporation, or consolidating with another corporation to form a new corporation, if the acquisition, merger or consolidation would have, or would be likely to have, the effect of substantially lessening competition in a **market** (Rule 6 of the Competition Rules; see section 6 of this Guideline).

For these purposes, a “market” is defined by Rule 3(1) of the Competition Rules to mean:

a market in the Philippines in which electricity or other goods or services that are directly or indirectly related to or used in connection with the generation, transmission, distribution or sale of electricity are or may be supplied or acquired.

Moreover, “services” are defined in Rule 3(1) to include rights conferred under derivatives, futures contracts, hedge contracts or other financial instruments, and firm and non-firm transmission rights.

2.1.2 The identification of the relevant market (or markets) is therefore critical for the purposes of determining whether or not there has been or is likely to be a violation of the prohibitions referred to above. Only once the relevant market has been identified is it possible to determine:

- whether any actual or likely lessening of competition in that market as a result of the agreement, arrangement, understanding, acquisition, merger or consolidation is substantial; and
- whether a person has a substantial degree of power in that market.

Many of the matters which will be taken into account in answering these questions, such as the identification of actual and potential competitors, suppliers and customers, the calculation of market shares and the existence of any barriers to

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entry, are self-evidently dependent on the identification of the relevant market. And the significance of these matters, as well as the ultimate answers to these questions, is likely to vary depending on the way in which the relevant market is defined. At the simplest level, the more broadly a market is defined, the less likely it is that a particular agreement, arrangement, understanding, acquisition, merger or consolidation will have, or will be likely to have, the effect of substantially lessening competition in that market, and the less likely it is that any one person (or group of persons) will have a substantial degree of power in that market. Conversely, the more narrowly a market is defined, the more likely it is that the same agreement, arrangement, understanding, acquisition, merger or consolidation will have, or will be likely to have, the effect of substantially lessening competition in that market, and the more likely it is that a person (or group of persons) will have a substantial degree of power in that market.

2.1.3 It is important to note that the Competition Rules are not restricted in their application to a single defined market. In any particular case, and depending on the circumstances, there may be one or more relevant markets that need to be considered. These markets may vary in respect of:

- the goods or services that are traded in them - eg. electricity traded by way of power supply contracts or through the WESM, ancillary services, financial electricity derivatives (such as hedge contracts) or transmission rights;
- the participants in them - eg. generators, distribution utilities, suppliers, traders and customers (whether or not of a particular size, possessing a particular characteristic or located in a particular location); and
- the geographic area which they cover - eg. this may be an area that is determined by reference to a transmission grid or grids, a distribution franchise area or some other locational descriptor.

Such markets may also change over time – for instance as grids become interconnected, new generation plant is commissioned or the transmission or distribution networks are augmented. Indeed, a market may be defined by reference to time itself – for instance, the market in which electricity is supplied at the wholesale level during peak periods (when transmission constraints come into operation and peaking generators participate) might be a separate market from that in which electricity is supplied at the wholesale level during off-peak periods (when interconnectors are unconstrained and only baseload generators participate).

2.1.4 The definition of the relevant market or markets will therefore depend on all of the circumstances and may well change over time. As a result, the ERC will not simply assume, for example, that for all purposes and in all circumstances the market for electricity in a particular area is defined by reference to the grid that services that area, or that the WESM constitutes a single market for all of the goods and services traded in it.

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2.1.5 In light of the above, while the fact that the ERC has previously defined a market in a particular case may provide some useful guidance, it needs to be appreciated that the ERC will not necessarily simply adopt that market definition in a subsequent case. This is because:

- competitive conditions may change over time - in particular, innovation may make substitution between goods or services easier, or more difficult, thereby changing the definition of the relevant market;
- a previous market definition may be specific to a particular area as a result of the substitution possibilities available in that area, with the result that a different market definition may be appropriate in respect of a different area; and
- the market definition can vary depending on the competition issue that is under investigation, including the parties that are involved and the nature of the goods or services they supply or acquire.

2.1.6 Finally, it should be appreciated that the process of defining markets is not a rigid, scientific process but inevitably requires a degree of judgment. Accordingly, the ERC will apply the analytical framework described below in a practical and common sense manner for the purposes of defining a market in any particular case.

## **2.2 Market definition**

2.2.1 A market is the area of close competition (or rivalry) between firms. For these purposes, a market may generally be defined by reference to three dimensions:

- the product dimension;
- the geographic dimension; and
- the functional dimension.

2.2.2 The Competition Rules (Rule 3(2)) provide that a reference to a market in which goods or services are or may be supplied or acquired “includes a market in which those goods or services, and other goods or services that are substitutable for, or otherwise competitive with, [those] goods or services, are or may be supplied or acquired”. Substitutability includes both demand-side substitutability and supply-side substitutability.

2.2.3 Demand-side substitutability occurs where, in response to a small but significant increase in the price of the relevant goods or services, customers would switch to purchasing other goods or services or would switch to purchasing those goods or services from an alternative source of supply. The unique characteristics of electricity mean that substitution with another good (eg. gas) will generally be limited, at least in so far as existing consumers of electricity are concerned (as opposed to those who are choosing whether to install equipment run by electricity or some other fuel). Accordingly, electricity markets will typically be considered in isolation and not as part of a larger “energy” or “fuel” market.

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- 2.2.4 Supply-side substitutability occurs where, in response to a small but significant increase in the price of the relevant goods or services, other suppliers could, without significant capital costs, switch to supplying those goods or services to the relevant customers. If the expenditure of significant capital costs is required for a supplier to supply such goods or services (eg. because of the need to undertake the expansion or modification of a facility) then the market will not be expanded to include that source of supply but the supplier might be taken into account as a potential entrant into the market (see section 3.3). In relation to electricity generation, supply-side substitutability would come primarily from existing generation capacity which may be currently in service or may be temporarily kept out of service (ie. “mothballed”). Potential new capacity would generally be treated as a potential entrant into the relevant market, rather than as part of the market itself.
- 2.2.5 Consistently with common practice in other jurisdictions, a market for goods or services is considered to be the smallest area of product, geographic and functional space within which a hypothetical profit-maximising monopolist would impose a small but significant non-transitory increase in the price of those goods or services. For these purposes, and again consistently with other jurisdictions, the ERC will generally consider a price increase of 10% above competitive levels as a small but significant price increase. This method of defining a market is called the “price elevation” test. Under this test, the process of defining the boundaries of a market commences with the product, geographic and functional areas of supply covered by the relevant person or persons, and those dimensions are then progressively extended to encompass additional goods or services and additional geographic areas and functional dimensions until the hypothetical monopolist would be able to maintain its prices at 10% above competitive levels. The resultant delineation of the market will include all actual and potential goods or services and sources of supply which are reasonably substitutable for the goods or services supplied by the relevant person or persons. This is because, if goods or services, or sources of supply, which are close substitutes for the relevant goods or services are not included in the definition of the market for those goods or services, then it would not be profit-maximising for the hypothetical monopolist to impose the relevant price increase as the monopolist’s customers would switch to such alternative goods or services or other suppliers would supply the relevant goods or services to the monopolist’s customers, thereby enabling the price increase to be avoided and reducing the monopolist’s profits. Conversely, if all goods or services, or sources of supply, which are close substitutes for the relevant goods or services have been included in the definition of the market for those goods or services, then it would be profit-maximising for the hypothetical monopolist to impose the relevant price increase because the monopolist’s customers would have no alternative goods or services, or alternative sources of supply, to which to switch, ie. the monopolist’s customers could not avoid the price increase.
- 2.2.6 It should be noted that the fact that different prices may be charged for different goods or services does not mean that those goods or services are necessarily in

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different markets: such price differentials may simply reflect differences in the quality or characteristics of the goods or services. However, if a particular type of goods or services, or a particular source of supply of such goods or services, does not place any constraint on the price which may be charged for the goods or services under consideration, then they will not be in the same market. This means that, for example, while two products might technically be suitable as alternatives, if the price of one is much higher than that of the other then they are unlikely to be in the same market because (for commercial reasons) consumers are unlikely to switch between them.

2.2.7 For similar reasons, goods or services do not have to be identical to be included in the same market; they need only be able to fulfil a similar role to the goods or services in question and to be goods or services to which customers would be prepared to switch in the event of a price increase. However, a substantial degree of differentiation may result in particular goods or services not being reasonably close substitutes and therefore not being included in the same market.

2.2.8 In some cases it might also be appropriate to define separate markets for different groups of customers (or customers in different areas). This will be the case, for example, where suppliers are able to price discriminate between such customer groups or areas due to different demand elasticities or due to regulatory restrictions or constraints.

2.2.9 The following paragraphs describe the manner in which a market is defined by reference to its product, geographic and functional dimensions.

## **2.3 Product dimension**

### General

2.3.1 The definition of the product dimension of a market will commence with the identification of the goods and services supplied (or to be supplied) by the parties to the agreement, arrangement or understanding (in the case of Rule 4 of the Competition Rules), the relevant person (in the case of Rule 5 of the Competition Rules) or the merged entity<sup>3</sup> (in the case of Rule 6 of the Competition Rules). It is then necessary to determine what other goods or services should be included in the market by virtue of them being a reasonably close substitute for the relevant goods or services (either on the demand-side or on the supply-side).

### Demand-side

2.3.2 For the purposes of determining demand-side substitutability, the price elevation test will be applied to each category of the relevant goods and services so as to incorporate into the definition of the market for goods or services in that category

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<sup>3</sup> The reference to “merged entity” means: in the case of the acquisition of shares, the shareholder and the corporation in which the shares are held; in the case of the acquisition of assets, the business in which the assets are used; in the case of a merger between two or more corporations, the corporation into which the others have merged; and in the case of a consolidation between two or more corporations, the new corporation that is formed by the consolidation.

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goods or services to which customers would be likely to switch in the event of the postulated increase in price of the relevant goods or services.

- 2.3.3 It is not necessary for all customers, or even the majority, to be likely to switch to the alternative goods or services for those goods or services to be included in the relevant market. The critical issue is whether the number of customers likely to switch is large enough to prevent the hypothetical monopolist from increasing its prices beyond competitive levels.
- 2.3.4 The alternative goods or services will be included in the same market if such substitution is likely to take place relatively quickly (so that it would not be worthwhile for the hypothetical monopolist to raise its price in the first place) and without customers having to incur significant switching costs. As a rough rule of thumb, if the required degree of substitution was likely to take more than one year the alternative goods or services would not be included in the same market.
- 2.3.5 So, for example, wholesale electricity can be traded in a number of different forms: through spot trading (through the WESM), physical forward trading (through power supply contracts) or financial forward trading (through financial electricity derivatives). Although these are different products, they would not generally be considered to be in separate markets, given their substitutability. This is because a small but significant increase in price driven by a monopolist in forward traded electricity is likely to cause purchasers to buy an increased proportion of their electricity needs from alternative suppliers through the spot market.

#### Supply-side

- 2.3.6 For the purposes of determining supply-side substitutability, the price elevation test will be applied to each category of goods and services supplied (or to be supplied) by the parties to the agreement, arrangement or understanding (in the case of Rule 4 of the Competition Rules), the relevant person (in the case of Rule 5 of the Competition Rules) or the merged entity<sup>4</sup> (in the case of Rule 6 of the Competition Rules) so as to incorporate into the definition of the market for the relevant goods or services alternative sources of supply of those goods or services (or of close substitutes for them). Supply-side substitution occurs where, in response to the postulated small but significant non-transitory price increase, other suppliers (sometimes called “near entrants”) would switch to supplying the relevant goods or services or close substitutes for them (eg. by diverting their production process to produce those goods or services). Such switching might not always be possible eg. as where the supplier’s capacity is committed to supplying other goods or services.
- 2.3.7 Alternative sources of supply will be included in the same market if such substitution can be achieved relatively quickly (within one year) and without significant capital costs (eg. significant investment in new production capacity or in establishing a distribution network, or significant advertising or marketing expenditure). So, for example, in the case of electricity generated by a particular

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<sup>4</sup> See footnote 3.

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generator, alternative sources of supply would include existing operating or mothballed generating plant. While traders can in principle supply wholesale electricity through financial electricity derivatives without the need for physical capacity, in practice their willingness to do so will be limited due to the trading risks involved, and so this potential alternative source of electricity supply will generally not be considered significant.

#### Information requirements

2.3.8 In establishing the product dimension of a market, the ERC will have regard to (among other things):

- the end use of the relevant goods or services and potential substitutes;
- the physical and technical characteristics of the relevant goods or services and potential substitutes;
- the costs likely to be incurred by customers in substituting from the relevant goods or services to a potential substitute (and the time likely to be taken to switch) – high switching costs relative to the value of the relevant goods or services will make substitution less likely;
- the past behaviour of customers when faced with price changes – price divergence over time, without significant levels of substitution, may suggest that the relevant goods or services and a potential substitute are in fact not substitutes;
- patterns in price changes - if the pattern of price changes between the relevant goods or services and a potential substitute is similar (and is not explicable in terms of changes in the cost of common inputs) then this may suggest that the relevant goods and services and the potential substitute are in fact substitutes;
- the technical feasibility and costs of switching production and distribution systems from an existing product line to producing or distributing the relevant goods or services (and the time likely to be taken to switch) – the existence of spare capacity, ready access to any necessary inputs and an existing accessible distribution network will increase the potential for such substitution whereas the need to incur significant capital costs (eg. in expanding facilities or in marketing) - particularly where such costs are sunk costs<sup>5</sup> - will decrease the potential for such substitution; and
- the past behaviour of suppliers (eg. in terms of their own pricing, production and marketing) when faced with changes in the price or marketing of the relevant goods or services.

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<sup>5</sup> See section 3.3.6 which defines “sunk costs”.

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## 2.4 Geographic dimension

### General

2.4.1 The geographic dimension of a market is the area over which the relevant person or persons and their competitors supply, or could supply, the relevant goods or services and their substitutes. The geographic dimension of a market is defined using a similar process to that used to define the product dimension of a market – that is, it is determined by the extent to which an increase in price for the relevant goods or services in a particular region would lead customers to switch to a supplier in a neighbouring area (demand-side substitution) or would lead suppliers in a neighbouring area to supply those customers (supply-side substitution). As with the product dimension, the starting point is to identify the area or areas over which the parties to the agreement, arrangement or understanding (in the case of Rule 4 of the Competition Rules), the relevant person (in the case of Rule 5 of the Competition Rules) or the merged entity<sup>6</sup> (in the case of Rule 6 of the Competition Rules) supply the relevant goods or services.

### Demand-side

2.4.2 For the purposes of determining demand-side substitutability, the price elevation test will be applied to incorporate into the definition of the market for the relevant goods or services those sources of supply of those goods or services or their close substitutes in another area to which customers would turn in the event of the postulated small but significant non-transitory increase in price. If such substitution is potentially so significant that it would prevent the hypothetical monopolist from raising its prices, that area will be added to the market definition. Generally, the higher the value of the relevant goods or services, the wider will be the geographic market because the more willing will consumers be to travel and “shop around” for the best buy.

2.4.3 Electricity must be delivered directly to a consumer’s premise, so there is no sense in which a consumer can “shop around” for the physical electricity. However, an electricity retailer may be active in selling electricity in a geographic area without necessarily having a corporate presence in that area and vice versa. Accordingly, an electricity retailer would be considered to be a participant in a market in which electricity is retailed if that retailer is involved or potentially involved in selling the electricity which is physically delivered in the geographic area covered by that market.

### Supply-side

2.4.4 For the purposes of determining supply-side substitutability, the price elevation test will be applied to incorporate into the definition of the market for the relevant goods or services those entities in another area which supply, or would supply, the relevant goods or services or their close substitutes to the subject customers in the event of the postulated small but significant non-transitory price increase. Again,

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<sup>6</sup> See footnote 3.

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such substitution is only relevant if it is likely to occur in the short run (ie. within one year) and does not entail significant capital expenditure (eg. on advertising or marketing or on the establishment of new distribution channels where existing ones are foreclosed).

- 2.4.5 For electricity generation, supply-side substitutability may be limited by transmission constraints, which may restrict the amount of “remote” generation which could supply a locational market. Indeed, typically a locational wholesale electricity market will be determined by the constraints – or the absence of constraints – on the transmission system.

#### Information requirements

- 2.4.6 In establishing the geographic dimension of a market the ERC will have regard to (among other things):
- the convenience to customers of accessing alternative sources of supply;
  - the costs likely to be incurred by customers in switching to alternative sources of supply (and the time likely to be taken to switch);
  - the past behaviour of customers in switching between geographic sources of supply;
  - the costs of transportation from, or access to, the alternative sources of supply – the higher those costs relative to the price of the relevant goods or services the smaller the likely degree of substitution;
  - the practicality of transporting the goods or services by various modes and over various distances;
  - the perishability and bulkiness of the goods or services – the more perishable and bulky the goods or services, the narrower the geographic market is likely to be;
  - whether the goods or services require face-to-face contact between suppliers and customers;
  - any regulatory or other practical constraints on suppliers selling to the relevant customers;
  - the costs of extending or switching production and distribution systems to supply the relevant customers (and the time likely to be taken to switch);
  - the past behaviour of suppliers regarding the impact of price and marketing decisions in one geographic area on supply from another geographic area; and
  - the relative price levels and price movements of different geographic sources of supply.

## **2.5 Functional dimension**

- 2.5.1 A market may also have a functional dimension, eg. it may be a market in which wholesalers, retailers or end users compete. So, for instance, the market (or

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markets) in which generators sell electricity to distribution utilities and suppliers (the wholesale electricity market(s)) are likely to be distinct from the market (or markets) in which such distribution utilities and suppliers sell electricity to end-users (the retail electricity market(s)).

## **2.6 Time**

- 2.6.1 Markets are typically dynamic and will change over time as new goods or services are developed, technologies change, statutory monopolies or franchises are removed and new competitors become established. As indicated above, the ERC will take into account substitution possibilities in the foreseeable future (typically one year) in defining the relevant market. Consistently with this approach, the ERC will take into account the potential for substitutes where those substitutes do not actually exist but are nonetheless likely to come into existence in the foreseeable future. Correspondingly, the ERC will discount the significance of transitory effects, eg. as where the existence of temporary significant excess capacity results in goods or services being supplied in areas where they would not normally be supplied.
- 2.6.2 The non-storability of electricity tends to make physical electricity markets more time-specific than most other markets. For example, a purchaser requiring electricity at 3pm cannot purchase that electricity from a generator supplying electricity at 2pm. However, this does not preclude a shift in consumption or generation behaviour as between times. For instance, if the price of electricity at 2pm is much lower than the price of electricity at 3pm, consumers may bring forward some of their consumption to 2pm while electricity generators may postpone some of their output until 3pm. In other words, the non-storability of electricity would not result in there being separate physical electricity markets at different times of the day in the absence of other differentiating characteristics.
- 2.6.3 Conversely, the different characteristics of electricity consumption and production at different times of the day may result in there being separate physical electricity markets. For example, markets at times of peak demand will tend to be quite different to markets at times of low demand: the peak market is much larger (in terms of traded volume), will have different participants (eg. expensive generators will only operate at peak times), will have less sources of alternative supply (due to generation capacity constraints) and may have a different geographic configuration (due to different transmission constraints).

## **2.7 ERC approach to market definition**

- 2.7.1 In practice it will often be difficult to precisely define a market – particularly where information is incomplete - and so it will often not be possible to precisely identify the boundaries of a market. For these reasons, in order to ensure that adverse consequences on competition are minimised and that market power abuses are appropriately penalised, the ERC will tend to look at the narrowest definition of a market which is reasonable in the circumstances.

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### 3. ASSESSMENT OF THE LEVEL OF COMPETITION IN A MARKET

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#### 3.1 Introduction

3.1.1 The Competition Rules prohibit a person from:

- making an agreement or arrangement, or arriving at an understanding, if a provision of that agreement, arrangement or understanding would have, or would be likely to have, the effect of **substantially lessening competition** in a market (Rule 4 of the Competition Rules; see section 4 of this Guideline);
- giving effect to a provision of an agreement, arrangement or understanding if that provision has, or is likely to have, the effect of **substantially lessening competition** in a market (Rule 4 of the Competition Rules; see section 4 of this Guideline); or
- acquiring shares or assets, merging with another corporation, or consolidating with another corporation to form a new corporation, if the acquisition, merger or consolidation would have, or would be likely to have, the effect of **substantially lessening competition** in a market (Rule 6 of the Competition Rules; see section 6 of this Guideline).

In considering whether an agreement, arrangement, understanding, acquisition, merger or consolidation has, or is likely to have, the effect of substantially lessening competition in a relevant market, the ERC will generally compare the nature and extent of competition in the market both with and without the relevant agreement, arrangement, understanding, acquisition, merger or consolidation. This will involve a hypothetical comparison where the agreement, arrangement or understanding has not yet been made, the relevant provision has not yet been given effect to or the acquisition, merger or consolidation has not yet been effected.

3.1.2 The Competition Rules also prohibit a person with a **substantial degree of power in a market** from misusing that power (Rule 5 of the Competition Rules; see section 5 of this Guideline). For these purposes, the reference to “power” means “market power” (Rule 5(6)). Where a person has a substantial degree of market power that person is able to persistently behave independently of competitive pressures, ie. to persistently behave in a manner that is different from the behaviour that a competitive market would otherwise impose. Whether a person has a substantial degree of power in a market will depend upon the nature and extent of competition in that market: the existence of effective competition will preclude the existence of such a degree of market power.

3.1.3 In short, in considering whether there has been or is likely to be a violation of the Competition Rules, the ERC will (except in the case of the price-fixing prohibition) need to consider the level of competition in the relevant market or markets.

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3.1.4 In assessing the level of competition in a market, the ERC will consider, among other things:

- the level of concentration in the market;
- the nature and effect of barriers to entry to the market;
- the degree of countervailing power in the market; and
- the dynamic characteristics of the market.

This list of matters is not exhaustive, and there may be other factors that are relevant in any particular case – for example, the nature and extent of vertical integration in the market or, in the case of a share or asset acquisition or a merger or consolidation, whether that acquisition, merger or consolidation results in the removal of a vigorous and effective competitor from the market. These matters are discussed in more detail below.

## **3.2 Market concentration**

3.2.1 Market share refers to the share of the market (typically measured in sales volume, sales value or capacity) that is held by a particular participant in the market. The appropriate measure of market share will depend on the circumstances. For example, in markets in which the goods or services are differentiated (with the result that customers' purchase decisions are made on the basis of product characteristics as well as price), market share may often be most appropriately measured by sales volume or value. On the other hand, in the case of markets in which the goods or services are not differentiated (with the result that customers' purchase decisions are largely based on price), market share may often be most appropriately measured by capacity. An example of an undifferentiated product market is that in which physical electricity is traded.

3.2.2 The fact that a person has a potentially high market share may indicate that the person has market power: the greater a person's market share, the less severely it needs to restrict its output to produce a given price increase, and the more likely that output restriction is to be profitable. However, market shares are not always a reliable guide to market power. For example, a person with a persistently high market share might not hold market power:

- if entry into the market is easy – in such a case the person is likely to be constrained to act competitively so as to avoid attracting entry over time by potential competitors;
- in a market characterized by a high degree of innovation – in such a case a persistently high market share may indicate no more than persistently successful innovation; or
- if that person's ability to restrict output in the short-term is constrained by contractual obligations (eg. under financial contracts such as swaps and caps or under physical supply contracts) – in such a case any market power would only arise on the termination of the relevant obligations.

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- 3.2.3 Market concentration refers to the number and size of participants in the market.
- 3.2.4 The higher the degree of concentration of a market (ie. the less the number of participants in the market), the greater is the scope for unlawful collusion because the easier it is for market participants to reach agreement on the terms of co-ordination, to signal intentions to other market participants and to monitor behaviour to ensure compliance with the collusive agreement, arrangement or understanding. In addition, the higher the degree of concentration of a market, the greater is the scope for “co-ordinated” conduct that does not violate the Competition Rules (eg. conscious parallelism or price leadership). Both types of conduct have a detrimental effect on competition (see also section 6.3.9).
- 3.2.5 In the case of the WESM there is potential for collusion even in the absence of a high degree of concentration in generation. This is because the WESM is designed as a repeated generator auction. Particularly where auction bids and results are published, this mechanism may facilitate co-ordinated conduct because market participants will be aware of the behaviour of their competitors. Therefore, in the context of the WESM, even a relatively unconcentrated generation market may lead to uncompetitive outcomes.
- 3.2.6 One commonly used measure of market concentration is the Herfindahl-Hirschman Index (HHI), which is the sum of the squares of the individual market shares of all the participants in a market. The HHI gives proportionately greater weight to the market shares of the larger competitors in accordance with their relative importance in competitive interactions. In the context of the Philippines electricity industry, a HHI of below 1500 will indicate an unconcentrated market, a HHI of between 1500 and 2500 will indicate a moderately concentrated market and a HHI of above 2500 will indicate a highly concentrated market.
- 3.2.7 The non-storability of electricity, and the relatively low short-term elasticity of electricity demand, give rise to high prices at times of capacity constraint – namely, at times where there is insufficient generation capacity to meet potential demand. This gives a large amount of market power to any generator which sees a level of “residual demand”, ie. demand that is only able to be met by that generator because all of its competitors in the market are operating at full capacity or because that generator must be dispatched for power system reliability reasons. Such a generator knows that it has an effective monopoly in supplying that residual demand, as there are no alternative sources of supply, and furthermore that it can offer that supply at a high price without inducing a significant reduction in the level of residual demand. Residual demand is typically possessed by mid-merit or peaking generators (as opposed to baseload generators). Residual demand is therefore also an important measure of market concentration.
- 3.2.8 For the purpose of calculating market concentration and market shares, the market shares of a person and its affiliates will be aggregated and it may be appropriate (if practical) to include the likely market share of “near entrants” (see section 2.3.6). In addition, in the context of a market in which electricity is physically supplied, it will be relevant to have regard to the quantity of electricity supplied through

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physical interconnection with other markets, which (for these purposes) may be treated as a competing source of supply. (Conversely, where the interconnector is deemed to be within the scope of the market as defined, which will depend on the constraints under which the interconnector operates, their duration and their frequency, the suppliers in that market will include the generators who actually supply electricity through the interconnector).

- 3.2.9 Clearly the calculation of market shares and market concentrations is critically dependent on the definition of the relevant market. Accordingly, the ERC may wish to examine market share and market concentration measures under various alternative plausible market definitions.
- 3.2.10 For example, in considering the market in which electricity is traded on a wholesale basis, it may be appropriate to consider a generator's overall market share in the bilateral contract, spot and forward markets. This is because a generator may diminish its market power – in the short-term – by selling in the forward market but, conversely, may augment its market power by buying in the forward market. A particular example of this may be a generator with significant market share in a geographic market enhancing its market power by buying the transmission rights applying to the transmission interconnections between this and adjacent geographic markets. This would have the effect of reducing any competitive response from generators in these adjacent markets.
- 3.2.11 In addition, the ERC will consider the movement of market shares over time: the fact that market shares are volatile (eg. as a result of the periodic tendering of significant contracts) may well indicate that the market is relatively competitive. The ERC will also take into account likely future movements in market shares (eg. a result of the commissioning of substantial new capacity).

### **3.3 Barriers to entry**

#### Introduction

- 3.3.1 A barrier to entry is any feature of a market that places an *efficient* prospective entrant at a significant disadvantage compared with an incumbent market participant. An advantage created by superior efficiency is therefore not a barrier to entry.
- 3.3.2 If the relevant market is characterized by low barriers to entry then (irrespective of the degree of market concentration or the relative market shares of participants in the market) the behaviour of the incumbent market participants is likely to be constrained by the threat of potential competition, and so such incumbents are likely to behave in a manner consistent with competitive outcomes. Where barriers to entry are low, prices set above, or output, quality, service or innovation which is below, competitive levels for even a short period of time should attract new entry into the market and restore prices, output, quality, service or innovation (as the case may be) to their competitive levels. Conversely, the existence of barriers to entry may reduce the scope for potential competitors to enter the market, with the result that incumbent market participants are able to raise their prices above, or

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reduce their output, quality, service or innovation below, competitive levels without the threat of new entry.

- 3.3.3 There are many different types of barriers to entry. Some of the more common types are described below.

Absolute advantages

- 3.3.4 In some markets an incumbent may own or have (preferential) access to important assets or resources which are not accessible to a potential entrant (except, perhaps, at a substantially higher cost than that paid by the incumbent). Absolute advantages may, for example, arise as a result of:

- Regulatory restrictions – where the number of market participants is limited by regulation, such regulation will constitute a barrier to entry when the number of participants reaches that limit. There is a distinction, however, between regulation which sets objective standards and that which places a limit on the number of competitors in a market. Objective standards which apply equally to all market participants, such as system security or safety requirements, industry standards, or planning and environmental controls that must be met by all generators, do not constitute such a barrier to entry (although they may make entry more expensive). Conversely, franchises (which currently exist in the Philippines in relation to distribution and supply) will limit the number of participants in the market the subject of the franchise to one.
- Limited access to an essential facility or a necessary resource - in some cases, entry to a market might require the use of an essential facility (ie. a facility that is indispensable in order to compete in the market and the duplication of which is not economically feasible). An example of such an essential facility in the electric power industry is the transmission grid which conveys electricity from the generation plants to the various distribution networks. The transmission grid is an essential facility because, if a generator or distributor wishes to enter the electric power industry and compete effectively, it will need to be connected to the grid. If it is not able to connect to the grid, it will face a very significant barrier to entry. Alternatively, entry into a market may depend on the ability to access a necessary resource. For example, access to the resources required to enable the generation of electricity (eg. fuel, fuel delivery infrastructure and land) may well be limited by the availability of these resources or by virtue of environmental and planning restrictions which apply to the exploitation of these resources. Again, an inability to obtain such resources will constitute a barrier to entry.
- Intellectual property rights – if an incumbent holds an intellectual property right which confers on it the exclusive right to use a particular process to produce a good or service, this may constitute a barrier to entry if no alternative production processes can be used to produce competing goods or services.

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### Strategic advantages

3.3.5 When a potential competitor contemplates entering a market, it weighs up its expected revenue from entering against the expected costs of entering and exiting (which may be necessary if entry is unsuccessful). Expected revenues depend on how the potential entrant expects the incumbent to react when it enters the market (the potential entrant might believe that the incumbent market participants would, for example, reduce prices substantially if it entered and so reduce the prospective revenue available from entering the market). Accordingly, the fact that an incumbent has a reputation for aggressively retaliating against new entrants may result in a barrier to new entry. Incumbency may also result in significant barriers to entry where the incumbent has previously had the benefit of a statutory monopoly (as is the case with the monopoly that distribution utilities have over the sale of electricity to their franchise customers), particularly in the initial stages when that monopoly is being dismantled (ie. through the introduction of retail competition). This is the case not just with regard to the sale of electricity but also with regard to other activities that might become contestable (eg. metering and meter reading).

### Sunk costs

- 3.3.6 Sunk costs are costs which are unrecoverable on exit (because the purchased assets cannot be redeployed outside the relevant market) and so a potential new entrant risks incurring (but not recouping) them if it enters a market which it subsequently exits. Sunk costs are market-specific costs and so will differ across markets due to the different nature of the assets involved. Examples of sunk costs are market-specific investments in production facilities, technologies, research & development, marketing and brand establishment, regulatory approvals or testing.
- 3.3.7 In the case of electricity generation, a significant proportion of costs are fixed (ie. independent of output) and the majority of these fixed costs will be sunk (because generation assets cannot easily be moved to another market). In a fully contestable supply market, a significant proportion of costs will also be sunk (particularly the costs of marketing and brand establishment).
- 3.3.8 Sunk costs, particularly when combined with strategic advantages, may confer a “first mover” advantage on incumbent market participants in that:
- to the extent the incumbents have recouped some of their initial sunk investment they might not need to earn as high a rate of return as a potential entrant; and
  - an incumbent may use its own sunk costs strategically (eg. by “over-investing” in sunk assets so as to build significant spare capacity) thereby signalling to potential entrants that it is prepared to respond to the threat of new entry by increasing output and depressing price so as to make new entry unviable.

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### Economies of scale

- 3.3.9 Economies of scale occur where average costs fall as output arises. If successful entry depends on entry on a large scale (in relation to the size of the market) this is likely to involve a significant degree of risk as it involves a larger commitment on the part of the potential new entrant (especially when a substantial share of the entry costs is sunk). It might also have a considerable depressing effect on prices which, in turn, might make entry at a particular level less viable. This may be a particular concern in electricity, where demand is relatively inelastic.
- 3.3.10 There are large economies of scale in the sale of electricity due to the fact that a large proportion of retailers' costs are largely independent of market share – for example, information technology (IT) costs and marketing costs. In the case of electricity generation, the economies of scale largely depend upon the generating technology used. For example, conventional thermal generation exhibits scale economies up to 1,000 MW or more, whereas wind generation is unlikely to exhibit scale economies beyond 100MW. Moreover, larger generators are likely to be able to offer more reliable supply, as the impact of a single failure of a generating unit will be proportionately lower. There are also overheads for electricity generators and retailers associated with trading in the wholesale electricity market – for example trading systems – which again are largely independent of market share and so result in potentially significant economies of scale.

### Access to finance

- 3.3.11 Entry, particularly large scale entry, has to be financed. A potential entrant might, however, face a higher cost of finance than an incumbent (whether such finance is raised through borrowings or new equity) because it lacks a proven track record in the market, because it is relatively small or because the existence of established successful competitors may limit the potential entrant's opportunities to gain sustainable market share.

### Exclusionary behaviour

- 3.3.12 Exclusionary behaviour by incumbent market participants (eg. through vertical restraints which foreclose distribution channels or retail outlets, predatory behaviour or refusal to supply a required input) may constitute a barrier to entry. (It might also violate the misuse of market power prohibition: see section 5). Exclusionary behaviour may occur where, for example, a generator also owns or controls access to fuel sources or fuel delivery infrastructure.

### Information requirements

- 3.3.13 In considering the existence and height of barriers to entry, the ERC will have regard to (among other things):
- sunk costs (eg. expenditure on production capacity and advertising and promotion);
  - any regulatory restrictions on entry (such as licensing requirements and industry standards);

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- any requirements for scarce inputs;
  - the minimum efficient scale of operation (ie. the size of the plant that an entrant would require to be able to produce in scale terms as efficiently as an incumbent);
  - any cost penalties for operating at sub-optimal capacity;
  - the price elasticity of demand for the relevant goods or services;
  - any trend of growth or decline of the market; and
  - the potential response of incumbents to new entry.

3.3.14 The ERC will have particular regard to evidence of the past success or failure of new entrants in establishing themselves as significant competitors in the relevant market. Historical evidence of high prices and profits being maintained for long periods of time without new entry, or historical evidence of participants entering, failing and leaving the market, will suggest that there are barriers to successful effective entry to the relevant market.

3.3.15 In addition, growth, or prospective growth, in a market will usually have a bearing on the likelihood of entry. Entry will usually be more likely in a growing market than in a static or declining one because it will be easier for an entrant to be accommodated without any precipitous collapse in prices and profits. The rate of innovation is also important: in markets where high rates of innovation occur, or are expected, innovation may overcome barriers to entry relatively quickly. Indeed, any profits that result from an entry barrier created by successful innovation may be an important incentive to innovate.

### **3.4 Countervailing power**

3.4.1 Countervailing power exists where a supplier (buyer) faces a buyer (supplier) with market power. In such a case, any potential market power of the supplier (buyer) may be offset by the power of the buyer (supplier). In particular, if a buyer or buyers are able to exert a substantial influence on the price, quality or terms of supply of the goods or services which they purchase, that power may constrain the exercise by a supplier of any power that it may have to increase the price of those goods or services, to reduce their quality or to impose less favourable terms in relation to their supply. This power of the buyer or buyers arises from their ability to switch, at relatively little cost to themselves, from one supplier to another (or even to commence production of the relevant goods or services themselves).

3.4.2 Initially, the existence of retail franchises in the Philippines (which are part of the distribution franchises) will mean a high level of supplier concentration. However, this does not necessarily create countervailing power to generators in the wholesale electricity market because the franchisee will typically have regulatory obligations to supply consumers in its franchise area at a regulated price and this will limit its ability to negotiate better deals with generators.

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### **3.5 Dynamic characteristics of the market**

- 3.5.1 Markets which are growing rapidly are likely to experience new entry and the erosion of market shares over time. Similarly, markets which are characterized by rapid product innovation may see market leaders rapidly replaced. Conversely, where products are differentiated, first mover advantages can result in the accumulation of market power because of the ability of the incumbent to establish (or entrench) its product in the market prior to the entry of other competitors.
- 3.5.2 Regulatory or technological changes may also change market boundaries or enable new entry in the foreseeable future. For example, the introduction of retail competition is likely to expand the markets in which electricity is retailed beyond the current distribution franchise areas: for so long as end-users are the “captives” of the local distribution utility, the market in which electricity is sold to those end-users is likely to be defined, in a geographical sense, by the area of the distribution utility’s franchise; however, once end-users become free to choose their supplier, then the geographical area of the market in which electricity is sold to those end-users is likely to expand dramatically because there is then no constraint on the retailers who may sell that electricity to them. Similarly, technological changes may result in the development of new substitutes for particular goods and services or may facilitate new small scale entry into a market in any particular case.

### **3.6 Other considerations**

- 3.6.1 The above list of factors is not exhaustive and there may well be other factors that impinge on the level of competition in a market.
- 3.6.2 For instance, an agreement, arrangement or understanding might result in efficiencies that have a positive effect on competition through enabling the relevant parties to compete more effectively in the market as a result of them being able to realise economies of scale or scope (thereby enabling a reduction in unit costs and prices), to combine different capabilities or resources (eg. to combine a special technical expertise with a production process so as to improve and/or lower the cost of that process), to produce new or improved goods or services (eg. in the case of a research & development collaboration), or to enhance levels of service (eg. as in the case of the development of a distribution network that specialises in servicing particular goods or services to the exclusion of other (competing) goods or services). However, to be taken into consideration, the relevant efficiencies will need to be substantiated by factual material.
- 3.6.3 On the other hand, the degree of competition in a market might be tempered because of historical links, contractual relationships or ownership structures (eg. common shareholders or directors), or the degree of vertical integration, which reduce the rivalry between apparent competitors.
- 3.6.4 For instance, if the market is characterized by long term power supply agreements under which each distribution utility in the market sources all of the electricity it is permitted to source by way of bilateral power supply contracts from a single

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generator<sup>7</sup> then the level of competition in that market between generators is likely to be low for the duration of those agreements, but may well be intense when the agreements come up for renewal.

- 3.6.5 Conversely, the existence of a vigorous (albeit small) competitor might result in a high degree of competition in a market, while the “neutralisation” of that competitor through it entering into an anti-competitive agreement might result in a corresponding decrease in competition in that market.
- 3.6.6 A further consideration, in the context of the wholesale electricity market, is the existence of liquid and transparent forward markets. Such markets will tend to enhance the level of competition by reducing the information asymmetry between large and small players and by allowing small players to better manage the risks associated with an unreliable demand or supply. The existence of these markets may also lower barriers to entry by providing better signals for new investment and possibly by providing some funding for such investment.
- 3.6.7 Finally, the existence of spare generation capacity might be particularly relevant in the context of the degree of competition in a market in which electricity is physically traded. It may take some time to build additional capacity to meet growing demand and so supply-side competition is likely to be less intense where there is no excess capacity and correspondingly more intense where there is excess capacity and generators are trying to utilise it. Spare capacity is closely related to the residual demand measure of market concentration, discussed in section 3.2.7.

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<sup>7</sup> This proportion is 90% for the first five years from the establishment of the WESM: see section 45 of the EPIRA.

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## 4. ANTI-COMPETITIVE AGREEMENTS, ARRANGEMENTS AND UNDERSTANDINGS

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### 4.1 Introduction

#### 4.1.1 Rule 4(1) of the Competition Rules:

- prohibits a person from making an agreement or arrangement, or arriving at an understanding, if a provision of that agreement, arrangement or understanding would have, or would be likely to have, the effect of substantially lessening competition in a market; and
- prohibits a person from giving effect to a provision of an agreement, arrangement or understanding if that provision has, or is likely to have, the effect of substantially lessening competition in a market.

These prohibitions are collectively referred to in this Guideline as the “anti-competitive agreement prohibition”. The anti-competitive agreement prohibition is discussed in more detail in section 4.2 and examples of the types of agreements, arrangements and understandings to which this prohibition may apply are given in section 4.3.

#### 4.1.2 Rule 4(3) of the Competition Rules:

- prohibits a person from making an agreement or arrangement, or arriving at an understanding, if a provision of that agreement, arrangement or understanding is a price fixing provision; and
- prohibits a person from giving effect to a provision of an agreement, arrangement or understanding if that provision is a price fixing provision.

These prohibitions are collectively referred to in this Guideline as the “price-fixing prohibition”. Agreements, arrangements and understandings which contain a price-fixing provision are considered in themselves to be so antithetical to competition that it is unnecessary to consider their actual or likely effect on competition. Instead, such agreements, arrangements and understandings are prohibited per se. The price-fixing prohibition is discussed in more detail in section 4.4 and examples of price fixing provisions are also given in that section.

#### 4.1.3 The anti-competitive agreement prohibition and the price-fixing prohibition do not apply in certain circumstances. These circumstances are set out in Rule 7 of the Competition Rules (see section 9 of this Guideline). In addition the ERC may, on application by a person:

- give a “clearance” in respect of a proposed agreement, arrangement or understanding (other than one which would violate the price-fixing prohibition) where the ERC determines that making that agreement or arrangement, or arriving at that understanding, will not have, and will not be likely to have, the effect of substantially lessening competition in a market – while a clearance remains in force, the applicant may enter into

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that agreement, arrangement or understanding in accordance with the clearance; or

- authorize that person to make an agreement or arrangement, arrive at an understanding, or give effect to a provision of an agreement, arrangement or understanding, that would or might otherwise violate the anti-competitive agreement prohibition or the price-fixing prohibition - such an authorization must (and can only) be granted if the ERC determines that the making of the agreement or arrangement, the arriving at the understanding or the giving effect to the provision will result, or be likely to result, in a benefit to the public that would outweigh the detriment to the public constituted by any lessening of competition that would result, or be likely to result, from it.

The clearance and authorization processes are contained in Rule 8 of the Competition Rules and are described in section 4.6.

- 4.1.4 If a person violates the anti-competitive agreement prohibition or the price-fixing prohibition, the ERC may make certain orders against that person. The range of potential orders is extensive and a description of these orders, together with an indication of the circumstances in which they are likely to be made, is contained in section 7 of this Guideline.
- 4.1.5 The relationship between Rule 4 of the Competition Rules and the misuse of market power provisions (Rule 5) is addressed in section 4.7.

## **4.2 Anti-competitive agreement prohibition: terms and concepts**

### Agreements, arrangements and understandings

- 4.2.1 The term “agreement” is widely defined by the Competition Rules to include written or oral agreements, whether or not having legal or equitable force. It includes so-called “gentlemen’s agreements”. The terms “arrangement” and “understanding” are not defined by the Competition Rules but refer to something which is less formal or less binding than an agreement (eg. informal cooperation). For there to be an agreement, arrangement or understanding there must, at the very least, be a consensus as to what action is, or is not, to be taken.
- 4.2.2 Evidence that supports the existence of the necessary consensus may be inferred from the circumstances – for example, as where:
- parallel conduct;
  - joint action of the relevant parties;
  - collusion between the relevant parties; or
  - similar pricing structures

occurs following some contact between the parties. In this regard it should, however, be noted that parallel conduct is not of itself sufficient to prove the existence of an agreement, arrangement or understanding – it may simply be the result of independent decisions or other economic factors. Similarly, price leadership will not itself be proof of an agreement, arrangement or understanding.

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Particularly where (as in the WESM) nodal and zonal energy prices are publicly available, parallel conduct may follow from observation and independent decision-making rather than from an agreement, arrangement or understanding. However price signalling, where one participant changes its prices and this signals to other participants to do likewise in accordance with an arrangement to that effect, will be evidence of an agreement, arrangement or understanding.

- 4.2.3 The fact that a person may have played only a limited part in making the agreement or arrangement, or in arriving at the understanding, may not be fully committed to its implementation or may only have participated under pressure from another party or parties does not prevent that person from being a party to the agreement, arrangement or understanding and from having violated the anti-competitive agreement (or price-fixing) prohibition. However, this fact may be taken into account in deciding the penalty to be imposed on that person (see section 7).

#### Effect

- 4.2.4 Rule 4(1) of the Competition Rules is concerned with the effect or likely effect of the relevant provision on competition. The purpose of the provision is therefore irrelevant, although it may be taken into account in deciding the penalty to be imposed (see section 7).
- 4.2.5 In determining the effect or likely effect of a provision on competition, the effect or likely effect on competition of the other provisions of the relevant agreement, arrangement or understanding must also be included, as must the effect or likely effect on competition of the provisions of any other agreement, arrangement or understanding to which the relevant person, or an affiliate of that person, is a party (Rule 4(2)).
- 4.2.6 The references to “likely effect” mean that the ERC must consider not just the actual effect of the relevant provision on competition but also the possible effect on competition that the relevant provision may have (taking into account factors such as the characteristics of the relevant market and the behaviour or anticipated behaviour of competitors or potential competitors in that market). For an effect to be “likely” there must be a real possibility that the effect will occur. This does not, however, mean that it must be more likely than not that the effect will occur.

#### Give effect to

- 4.2.7 A provision of an agreement, arrangement or understanding may be “given effect to” by being put into effect in any way. This includes, but is not limited to, acting in accordance with the provision or enforcing the provision (eg. through legal proceedings).
- 4.2.8 It should be noted that the anti-competitive agreement (and price-fixing) prohibitions apply so as to prohibit a person giving effect to the relevant provision even if the agreement, arrangement or understanding was entered into before the commencement of the Competition Rules (Rule 4(1)(b), (3)(b)).

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### Substantial lessening of competition

- 4.2.9 Whether a provision of an agreement, arrangement or understanding would have or would be likely to have, or has or is likely to have, the effect of “substantially lessening” competition in a market will generally require a comparison of the nature and extent of competition in the market both with and without the relevant agreement, arrangement or understanding. This will involve a hypothetical comparison where the agreement, arrangement or understanding has not yet been made or arrived at or the relevant provision has not yet been given effect to. Section 3 of this Guideline discusses the factors relevant to assessing the nature and extent of competition in a market for this purpose.
- 4.2.10 In this context, “substantial” is a relative term and, for the anti-competitive agreement prohibition to be violated, the lessening of competition must (for the purposes of this comparison) be real and not merely nominal or otherwise insignificant. In addition, the lessening of competition must not be merely transitory but must be likely to persist over a period of time – for these purposes the ERC will generally adopt two years as the relevant period of time. Accordingly, the duration of the agreement, arrangement or understanding will also be relevant to an assessment of its actual or likely effect on competition in a market.
- 4.2.11 Generally speaking, the ERC will take the view that a provision of an agreement, arrangement or understanding will not have the effect or likely effect of substantially lessening competition in a relevant market if the combined share of that market held by the parties to the agreement, arrangement or understanding does not exceed 20 per cent. However, there will be circumstances in which this is not the case - for example, because of their nature, market sharing arrangements may have a substantial effect on competition even if this threshold is not exceeded.
- 4.2.12 Conversely, even where the parties’ combined market share is higher than 20 per cent, the ERC may find that the effect on competition is not substantial as a result of other factors. This is because the content of the agreement, arrangement or understanding and the structure of the market or markets affected by the agreement, arrangement or understanding (eg. the existence or absence of barriers to entry and the characteristics of buyers) will also be relevant.
- 4.2.13 The Competition Rules also provide that lessening competition includes preventing, restricting or hindering competition (Rule 3(3)).

### Market

- 4.2.14 The definition of “market”, and the way in which the boundaries of a market are delineated, are discussed in section 2 of this Guideline.

### Conditional agreements

- 4.2.15 An agreement will not violate the anti-competitive agreement prohibition to the extent the offending provision is subject to a condition precedent that a clearance or authorization be granted, provided that an application for that clearance or authorization is made within 21 days of the agreement between made (Rule 4(8); see also Rule 8(42)).

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### 4.3 Examples of anti-competitive agreements, arrangements and understandings

4.3.1 The examples that follow are not exhaustive. They are simply examples of the types of agreements, arrangements and understandings (for the sake of simplicity referred to collectively as “agreements”) which might violate the anti-competitive agreement prohibition, assuming that they have the actual or likely effect of substantially lessening competition in a market. However, there will be instances of agreements not listed below which will violate the anti-competitive agreement prohibition because of their particular conditions or restrictions or because of the characteristics of the relevant market.

#### Agreements to share markets

4.3.2 An agreement to share markets, whether by territory, type or size of customer, or in some other way, might violate the anti-competitive agreement prohibition because the very essence of such an agreement is that the parties agree not to compete in a particular way. An example of such an agreement is where two electric power industry participants agree that one of them will only sell electricity to contestable customers in the Visayas area and that the other of them will only sell electricity to contestable customers in the Luzon area.

#### Agreements to limit or control production or investment

4.3.3 An agreement to limit or control production or investment, eg. by agreeing generation levels or the investment that is to be undertaken in additional generation capacity in a particular area, might violate the anti-competitive agreement prohibition.

4.3.4 Power purchase agreements between traders and generators are common in wholesale electricity markets. These agreements may take many forms. For example, they may provide that the trader pays the fixed and variable costs of the generator and, in return, the generator assigns to the trader control of the output of a specified generating asset. Such an agreement would not be anti-competitive in itself, but could lead to a substantial lessening of competition if a single trader took control of a number of assets of different generating companies through this means. The impact on the market might be akin to that of a merger of these generating companies. Conversely, more conventional power supply contracts, which do not give the purchaser control of the seller’s output, will not have the same impact on competition.

#### Agreements as to products

4.3.5 An agreement on the type of product, or the characteristics of the product, that may be produced might violate the anti-competitive agreement prohibition. An example of such an agreement is an agreement that the product will only contain a certain type or make of input.

#### Boycotts

4.3.6 An agreement pursuant to which two or more competitors refuse to supply goods or services to, or to acquire goods or services from, another person may substantially lessen competition in a relevant market and so violate the

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anti-competitive agreement prohibition. Examples include where two or more generators agree not to enter into power supply contracts with a particular distribution utility or group of distribution utilities or where two or more distribution utilities agree not to enter into power supply contracts with a particular generator or group of generators.

#### Full-line forcing

- 4.3.7 Full-line forcing occurs where a person supplies goods or services to another person on the condition that the other person will not acquire some or all of its requirements for goods or services from a competitor of the supplier. An example is where a distribution utility agrees to supply electricity to customers on the condition that the customers acquire their metering services from that distribution utility (and from no other metering services supplier). Whether such a condition violates the anti-competitive agreement prohibition will depend upon its actual or likely effect on competition in the market in which metering services are supplied.
- 4.3.8 A form of “reverse” full-line forcing occurs where a person acquires goods or services from another person on the condition that the other person will not supply goods or services to a competitor of the acquirer. So, for example, an agreement pursuant to which a distribution utility acquires electricity from a generator on the condition that the generator will not supply electricity to a competing distribution utility might also violate the anti-competitive agreement prohibition.

#### Third-line forcing

- 4.3.9 Third-line forcing occurs where a person supplies goods or services to another person on the condition that the other person will also acquire goods or services from another entity. An example is where a distribution utility agrees to supply electricity to customers on the condition that the customers acquire their metering services from an affiliate of the distribution utility. Again, whether such a condition violates the anti-competitive agreement prohibition will depend upon its actual or likely effect on competition in the market in which metering services are supplied.

#### Joint ventures

- 4.3.10 Joint ventures (eg. in relation to production, distribution, marketing or research & development) may entail restrictions on the level of output of the joint venture, on the customers to whom or the territories in which each joint venturer may sell their share of the output, on the use of key assets or on the participants in the joint venture from competing with each other. Such restrictions might conceivably violate the anti-competitive agreement prohibition.

#### Joint buying

- 4.3.11 If buyers agree to collaborate in the purchase of their requirements this might violate the anti-competitive agreement prohibition where it enables the use of monopsony (“buyer”) power to reduce prices (and therefore output) below that which would prevail in a competitive market. An example might be the formation of a number of retailers into an electricity buying co-operative.

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#### Agreements to share information

4.3.12 As a general principle, the more information that is made publicly available to market participants, the more effective competition is likely to be. However, where the exchange of information removes uncertainties in the market it may have the effect of substantially lessening competition. Whether or not the exchange of information has this effect will depend on the circumstances of each individual case, including the market characteristics, the type of information exchanged and the way in which it is exchanged.

#### **4.4 Price-fixing prohibition: terms, concepts and examples**

##### Agreements, arrangements and understandings; give effect to

4.4.1 The terms “agreement”, “arrangement”, “understanding” and “give effect to” are discussed in paragraphs 4.2.1 to 4.2.3 and 4.2.7 to 4.2.8 above.

##### Price fixing provision

4.4.2 Rule 4(4) of the Competition Rules defines a “price fixing provision” as:

... a provision that has the effect of fixing, controlling or maintaining the price at which any party to the agreement, arrangement or understanding or any of its affiliates:

- (a) may supply, agree to supply, offer to supply or accept an invitation to supply goods or services to a person who is not a party to the agreement, arrangement or understanding or who is not an affiliate of such a party; or
- (b) may acquire, agree to acquire, offer to acquire or accept an invitation to acquire goods or services from a person who is not a party to the agreement, arrangement or understanding or who is not an affiliate of such a party.

In this context, “goods or services” are defined to mean goods or services (including electricity) that are directly or indirectly related to or used in connection with the generation, transmission, distribution or sale of electricity.

4.4.3 For the purposes of the price-fixing prohibition “price”, in relation to goods or services, is widely defined to include a charge of any description for, or a discount, allowance, rebate or credit for or in relation to, those goods or services. It also includes any component of any such charge, discount, allowance, rebate or credit (see Rule 3(1)).

4.4.4 Moreover, the concept of “fixing, controlling or maintaining” a price is broad and imports the concept of some continuing element of restraint on price changes. A price-fixing provision is not simply limited to a provision that stipulates a specific price for the relevant goods or services. As Rule 4(5) of the Competition Rules makes clear, a provision may also be a price-fixing provision where it specifies the price by reference to:

- a price for those (or similar) goods or services that is specified by another person;
- a set form, method or formula; or

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- a price range, a price cap or a price floor.

So, for example, a price fixing provision includes a provision which stipulates that the price for the relevant goods or services must be as set out in a particular price list, may only increase in accordance with CPI or within a certain range, must not be below a certain amount or must not be above a certain amount.

- 4.4.5 The exchange of information between competitors (while not of itself constituting price fixing) may facilitate price fixing as between competitors, depending on the nature of the information that is exchanged. For example, if the information exchanged is of a sensitive and otherwise confidential nature, such as detailed information relating to the pricing structures adopted under power supply contracts or details of generators' bidding strategies in the WESM, the ERC is more likely to conclude that the parties have an arrangement or understanding in relation to the coordination of their prices. Of course information exchange is more likely where competitors are, for instance, in joint venture with each other.
- 4.4.6 The price-fixing prohibition applies equally to:
- agreements between competitors as to the price at which they may supply goods or services to a customer (or customers) or may acquire goods or services from a supplier (or suppliers); and
  - agreements between a supplier and an acquirer as to the price at which the acquirer may supply goods or services acquired from the supplier to a customer (or customers).

#### Examples

- 4.4.7 An example of an agreement between competitors which contains a price-fixing provision is an agreement to tender collusively (or "bid-rig") – eg. as where two generators agree between themselves the price at which they will bid their capacity into the WESM or the price at which they will offer to sell electricity pursuant to a power supply contract. Similarly, an agreement between distribution utilities as to the price which they will pay for electricity may violate the price-fixing prohibition. Joint venture agreements also typically contain provisions that regulate the price at which the output of the joint venture can be sold, and such provisions may violate the price-fixing prohibition.
- 4.4.8 An example of an agreement between a supplier and an acquirer which contains a price-fixing provision is an agreement for resale price maintenance – this typically occurs where the price at which the acquirer may re-supply the goods or services acquired from the supplier is specified by reference to a floor (ie. a price below which the acquirer may not re-supply the relevant goods or services). The fact that the agreement refers to the relevant price as being a "recommended price" will not preclude there being a violation of the price-fixing prohibition if, as a practical matter, the effect of specifying the recommended price is to fix, control or maintain the price at which the relevant goods or services are actually re-supplied – whether this is so will depend upon all of the circumstances of the case. However, it will generally be prudent to accompany any statement that includes a recommended

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price with a statement to the effect that the relevant price is a recommendation only and there is no obligation to comply with the recommendation.

#### Conditional agreements

- 4.4.9 An agreement will not violate the price-fixing prohibition to the extent that the offending provision is subject to a condition precedent that an authorization be granted, provided that an application for that authorization is made within 21 days of the agreement being made(Rule 4(8); see also Rule 8(42)).

### **4.5 Affiliates**

Neither the anti-competitive agreement prohibition nor the price-fixing prohibition applies to agreements, arrangements or understandings the only parties to which are affiliates of each other (Rule 4(7)).

### **4.6 Clearances and Authorizations**

#### Clearances

- 4.6.1 The Competition Rules enable a person who proposes to make an agreement or arrangement, or arrive at an understanding, to apply to the ERC for a determination that making that agreement or arrangement, or arriving at that understanding, will not violate the anti-competitive agreement prohibition (Rule 8(1)). Such a determination is referred to as a “clearance” and enables the parties to a proposed agreement, arrangement or understanding to obtain certainty as to whether or not entering the agreement, arrangement or understanding will violate the anti-competitive agreement prohibition on the grounds of its actual or likely effect on competition. The ERC must (and can only) give a clearance if it determines that entering, and giving effect to, the agreement, arrangement or understanding will not violate the anti-competitive agreement prohibition (Rule 8(9)).
- 4.6.2 It is important to appreciate that a clearance may only be granted in respect of a proposed agreement, arrangement or understanding, ie. the ERC cannot grant a clearance if the agreement, arrangement or understanding is entered into prior to the ERC making a determination in respect of the application for the clearance (Rule 8(34)).
- 4.6.3 Moreover, a clearance is not available in respect of giving effect to any provision of an existing agreement, arrangement or understanding. This is because the impact on competition of giving effect to a particular provision may well vary over time (eg. with changes to the level of competition in the market and the entry into other agreements, arrangements and understandings by market participants).
- 4.6.4 In addition, a clearance is not available in respect of an existing or potential agreement, arrangement or understanding that contains a price fixing provision. This is because agreements, arrangements or understandings that contain such a provision are prohibited per se and so they will only be permitted where they meet a “public benefit” test, ie. where they are the subject of a successful application for authorization.

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- 4.6.5 For so long as the clearance remains in force, the applicant may make the agreement or arrangement, or arrive at the understanding, in accordance with the clearance (Rule 8(10)). A clearance will expire 6 months after the date on which it is given unless the ERC determines a later expiry date). This does not mean that entry into the agreement, arrangement or understanding will violate the anti-competitive agreement prohibition on the expiry of the clearance. It simply means that, unless the agreement, arrangement or understanding is entered in within this time period, it may not be subsequently entered into under the protection of the clearance (Rule 8(8), (10)).
- 4.6.6 A person applying for a clearance must include, in its application, such particulars as are required for that purpose by the ERC and must provide such further information as the ERC requires for the purpose of determining whether or not to give the clearance (Rule 8(2), (3)(a)). The applicant must also pay the costs of any external consultants engaged by the ERC for the purpose of advising it on matters relating to the application for clearance (Rule 8(3)(b)).
- 4.6.7 Before determining whether or not to give a clearance, the ERC may consult with such persons as it considers appropriate (Rule 8(11)). The ERC might, for example, wish to consult with competitors, suppliers, customers, industry associations, governmental agencies and departments and consumer groups.
- 4.6.8 If, at any time after granting a clearance, it appears to the ERC that the clearance was given on the basis of information that was false or misleading or incomplete in a material particular, then the ERC may revoke or amend the clearance after providing interested persons with an opportunity to make comments in relation to that matter (Rule 8(35)-(37)). The knowing provision of false, misleading or incomplete information to the ERC may also result in a fine of up to P5 million (Rule 8(39), (41)(a)).
- 4.6.9 The ERC will endeavour to deal with applications for clearance as expeditiously as possible and will generally render its determination on an application for a clearance within 60 days of the application being made. However, this time period may be extended by the time taken for the applicant to provide such additional information as the ERC may require for the purpose of determining that application.
- 4.6.10 A person who has applied for a clearance must not make the relevant agreement or arrangement, or arrive at the relevant understanding, until that application has been determined by the ERC (Rule 8(5)) (although the application may be withdrawn at any time prior to its determination: Rule 8(4)). A person who violates this prohibition may be fined up to P5 million and may be required to do, or restrained from doing, a specified act or thing until the ERC has determined whether or not the anti-competitive agreement prohibition has thereby been violated (Rule 8(40), (41)).

#### Authorizations

- 4.6.11 Authorization is the process of granting immunity, on public benefit grounds, in relation to agreements, arrangements or understandings which would or might violate the anti-competitive agreement prohibition or the price-fixing prohibition. It

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is a public process in which any interested party may participate. Subject to certain protections for confidential information (see section 10 of this Guideline), both the application for authorization and any comments pertaining to it will be made available to the public.

- 4.6.12 The Competition Rules enable a person who proposes to make an agreement or arrangement, or to arrive at an understanding, to apply to the ERC for an authorization to do so where the agreement, arrangement or understanding contains a provision that has (or might have) the effect of substantially lessening competition in a market or that is (or might be) a price-fixing provision, and therefore might violate the anti-competitive agreement prohibition or the price-fixing prohibition (Rule 8(12)). The Competition Rules also enable a person to make an application for an authorization to give effect to such a provision (Rule 8(13)). The ERC must (and can only) grant an authorization if it determines that the making of the agreement or arrangement, the arriving at the understanding or the giving effect to the relevant provision will in the circumstances result, or be likely to result, in a benefit to the public which would outweigh the detriment to the public constituted by any resultant actual or likely lessening of competition (Rule 8(27)).
- 4.6.13 It is important to appreciate that an authorization to make an agreement or arrangement, or to arrive at an understanding, may not be granted if the agreement, arrangement or understanding has been entered into prior to the ERC making a determination in respect of the application for the authorization (Rule 8(34)). However, this is not the case with an authorization to give effect to a provision of an agreement, arrangement or understanding; such an authorization can be granted even if the relevant provision has already been given effect (Rule 8(29)).
- 4.6.14 For so long as the authorization remains in force, the applicant may enter into the relevant agreement, arrangement or understanding, or give effect to it, in accordance with the authorization (Rule 8(31), (32)).
- 4.6.15 A person applying for an authorization must include, in its application, such particulars as are required for that purpose by the ERC and must provide such further information as the ERC requires for the purpose of determining whether or not to grant the authorization (Rule 8(14), (18)(a)). The applicant must also pay the costs of any external consultants engaged by the ERC for the purpose of advising it on matters relating to the application for authorization (Rule 8(18)(b)).
- 4.6.16 The ERC must publish notice of such an application in at least two newspapers of general circulation and that notice must specify the manner in which, and the time by which, any comments in relation to the application must be made to the ERC (the ERC may separately give notice of the application to any person who, in the ERC's opinion, is likely to have an interest in the application) (Rule 8(16), (17)). Before determining an application for an authorization, the ERC may hold a hearing or may prepare a draft determination for public comment and, in any event, must take into account any comments made by the applicant or by any other

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person (Rule 8(22)). In addition the ERC may, for example, seek the views of government agencies and departments.

4.6.17 An authorization may be granted subject to such conditions as the ERC considers appropriate (Rule 8(25)).

4.6.18 If, at any time after granting an authorization, it appears to the ERC that:

- the authorization was granted on the basis of information that was false or misleading or incomplete in a material particular;
- a condition to which the authorization is subject has not been complied with; or
- there has been a material change of circumstances since that authorization was granted with the result that the test for authorization would no longer be met (see section 4.6.12)),

then the ERC may revoke or amend the authorization after providing interested persons with an opportunity to make comments in relation to that matter (Rule 8(35)-(37)). The knowing provision of false, misleading or incomplete information to the ERC may also result in a fine of up to P5 million (Rule 8(39), (41)(a)). In addition, a failure to comply with a condition to which an authorization is subject will render the offender subject to a range of punitive and remedial orders (Rules 8(38), 10).

4.6.19 A person who has applied for an authorization may not enter into the relevant agreement, arrangement or understanding, or give effect to any relevant provision, until that application has been determined by the ERC (Rule 8(20)) (although the application may be withdrawn at any time prior to its determination: Rule 8(19)). A person who violates this prohibition may be fined up to P5 million and may be required to do, or restrained from doing, a specified act or thing until the ERC has determined whether or not the anti-competitive agreement prohibition or the price-fixing prohibition (as the case may be) has thereby been violated (Rule 8(40), (41)). However, the ERC may permit a person to give effect to a provision of an existing agreement, arrangement or understanding in the period prior to the determination of the application for authorization if the ERC determines that the person would, or would be likely to, suffer exceptional hardship if it were not able to give effect to that provision (Rule 8(21)).

#### Public benefit test

4.6.20 As stated in section 4.6.12, the ERC is only to grant an authorization if it determines that the making of the agreement or arrangement, the arriving at the understanding or the giving effect to the relevant provision will in the circumstances result, or be likely to result, in a benefit to the public which would outweigh the detriment to the public constituted by any resultant actual or likely lessening of competition. In making this assessment, the Competition Rules (Rule 8(28)) require the ERC to regard as a benefit to the public:

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- any efficiencies that the ERC considers will result, or will be likely to result, from the course of action for which authorization is sought to the extent that those efficiencies will benefit the public; and
  - where one or more of the parties to the agreement, arrangement or understanding is a distribution utility or an affiliate of a distribution utility – improved reliability of service by, reduction of costs of, and compliance with any performance standards prescribed in the Implementing Rules and Regulations made under the EPIRA by, that distribution utility.

#### Efficiencies

4.6.21 Public benefits in the form of efficiencies are particularly important because increased efficiency results in lower unit costs and therefore the potential for lower prices. Efficiencies may take the form of, for example, economies of scale or scope, the introduction of more efficient technology or the combination of complementary research & development facilities. To qualify as a public benefit, the claimed efficiencies will need to be substantiated by factual material.

#### Distribution utilities

4.6.22 The requirement to regard, as a benefit to the public, improved reliability of service by, reduction of costs of, and compliance with performance standards by, a distribution utility flows from section 23 of the EPIRA which is designed to encourage distribution utilities to pursue structural and operational reforms so as to enable the achievement of economies of scale in utility operations.

#### Other public benefits

- 4.6.23 However, these are not the only forms of public benefit that the ERC may consider. In this context, public benefit will be given a broad meaning and may include matters such as the following:
- economic development, eg. through the encouragement of research and capital investment;
  - increased business efficiency;
  - industrial rationalisation resulting in more efficient resource allocation;
  - employment growth;
  - improvements in the quality and safety of goods or services;
  - the expansion of consumer choice;
  - the supply of better information to customers and businesses to permit informed choices; and
  - the promotion of industry cost savings resulting in contained or lower prices to consumers.

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In order for a benefit to be a public benefit it must benefit the public. Accordingly where, for example, it is only stockholders who receive the benefit (eg. through higher profits and dividends) this will not be a public benefit. Conversely, while lower prices are likely to be a public benefit (at least if the quality of, and services associated with, the relevant product are not diminished), a benefit may be a public benefit even if it does not manifest itself in lower prices to consumers. This is because, for example, the public may also benefit from the more efficient use of resources (eg. because this will enable those resources to be used in the production of other goods and services), better quality goods and services and a greater choice of goods and services.

#### Evaluation of public benefits

4.6.24 Applications for authorization must clearly set out the claimed public benefits, how they relate to the agreement, arrangement or understanding, and their likely magnitude, durability and timing. General statements about possible or likely benefits will not be given much weight unless they are supported by factual material. In addition, the applicant must be able to demonstrate that there is a connection between the claimed public benefits and the agreement, arrangement or understanding, ie. that the claimed public benefits are a direct result of the agreement, arrangement or understanding and not of some other circumstance.

#### Public detriment

4.6.25 The ERC is required to weigh the actual or likely public benefits against the detriment to the public that is constituted by any resultant actual or likely lessening of competition. This detriment is likely to be less if the provision in the agreement, arrangement or understanding that would cause the violation of the anti-competitive agreement prohibition or the price-fixing prohibition is carefully drafted so that:

- it imposes no greater restriction than is strictly necessary in the circumstances; and
- where it can achieve the same objective in more than one way, it adopts the least restrictive means of achieving that objective that is reasonably practical in the circumstances.

This means that, all other things (including the resultant benefits to the public) being equal, the test for authorization is more likely to be met where the relevant provision adopts the least restrictive means of achieving its objective that is reasonably practical and is no more expansive than is necessary to achieve that objective.

#### Timing

4.6.26 The ERC will endeavour to deal with applications for authorization as expeditiously as possible, while complying with the requirements of the Competition Rules. Accordingly, the ERC will generally render its determination on an application for an authorization within 120 days of the application being made (although a longer time may be required where the matter is particularly complex or the ERC holds a

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hearing, or prepares a draft determination, in relation to the application). This time may be further expanded by the time taken for the applicant to provide such additional information as the ERC may require for the purpose of determining the application.

- 4.6.27 Because the Competition Rules enable parties to apply for a clearance or authorization if they are in doubt as to whether or not a proposed agreement, arrangement or understanding will violate the anti-competitive agreement prohibition, the ERC will not give “informal” approval to a transaction (including by way of the issue of a letter of comfort). However, ERC staff are available to discuss issues relating to the application of the Competition Rules with concerned parties.

#### Ancillary provisions

- 4.6.28 The Competition Rules contain ancillary provisions which are intended to facilitate the simultaneous consideration for authorization of, and granting of authorizations in relation to, a number of like agreements, arrangements and understandings (see Rule 8(15), (30), (33)).

### **4.7 Relationship with misuse of market power prohibition**

- 4.7.1 Rule 5 of the Competition Rules (discussed in section 5 of this Guideline) prohibits a person with a substantial degree of power in a market from misusing that power. That prohibition will typically apply to unilateral conduct engaged in by such a person which that person would not undertake in a competitive market. Such unilateral conduct may, for example, be constituted by a refusal to supply goods or services where the putative acquirer of those goods or services does not agree to enter into an agreement that contains a provision that has the effect or likely effect of substantially lessening competition in a market or that is a price fixing provision. In these circumstances, if the putative acquirer does enter into such an agreement, the acquirer will also violate the anti-competitive agreement prohibition or the price-fixing prohibition (as the case may be). Accordingly, market participants would be well advised not to succumb to pressure to enter into such agreements, arrangements or understandings but instead to report such misuses of market power to the ERC.
- 4.7.2 If a person with a substantial degree of power in a market enters into an agreement which violates the anti-competitive agreement prohibition or the price-fixing prohibition, that person might (in the course of doing so) also violate the misuse of market power prohibition. This will be the case if the entry into the agreement entails a misuse of that person’s market power, eg. as where the counterparty only agrees to enter the agreement under threat of a refusal to supply. However, the fact that this course of conduct constitutes a violation of both the anti-competitive agreement prohibition or the price-fixing prohibition, on the one hand, and the misuse of market power prohibition, on the other hand, will not expose that person to “double jeopardy” (ie. to penalisation twice for the same conduct) (see Rule 10(3)(f) of the Competition Rules).

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4.7.3 Conversely, if the making of an agreement or arrangement, the arriving at an understanding or the giving effect to a provision of an agreement, arrangement or understanding is permitted by virtue of a clearance or authorization (see section 4.6), then that action will not violate the misuse of market power prohibition (see Rule 5(7) of the Competition Rules).

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## 5. MISUSE OF MARKET POWER

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### 5.1 Introduction

- 5.1.1 Rule 5 of the Competition Rules prohibits a person that has a substantial degree of power in a market from misusing that power. This prohibition is referred to in this Guideline as the “misuse of market power prohibition”. It is discussed in more detail in section 5.2 and examples of the ways in which market power may be misused are given in section 5.3.
- 5.1.2 The misuse of market power prohibition does not apply in certain circumstances. These circumstances are set out in Rule 7 of the Competition Rules (see section 9 of this Guideline). Conduct amounting to a misuse of market power cannot be authorized by the ERC. However, in determining whether a person has misused its power in a market, it is necessary to take into account (among other things) whether, in all the circumstances, the person was reasonably justified in using its power in the way it did. Examples of situations in which a person might be reasonably justified in using its market power in a particular way are also given in section 5.3.
- 5.1.3 As explained in section 5.4, a person with a substantial degree of power in a market can misuse that market power either in the market in which the power is possessed or in a different market. In either case, such a misuse will violate the misuse of market power prohibition.
- 5.1.4 If a person violates the misuse of market power prohibition, the ERC may make certain orders against that person. The range of potential orders is extensive and a description of these orders, together with an indication of the circumstances in which they are likely to be made, is contained in section 7 of this Guideline.
- 5.1.5 The relationship between Rule 5 of the Competition Rules, on the one hand, and the anti-competitive agreement prohibition and the price-fixing prohibition (Rule 4), on the other hand, is addressed in section 5.5.
- 5.1.6 The misuse of market power prohibition is deliberately drafted in a broad manner. This is because it is not possible to be prescriptive as to all the kinds of behaviour which might constitute a misuse of market power. In particular:
- the misuse of market power prohibition is not defined by reference to the purpose of the particular conduct (although purpose may sometimes be relevant in establishing that market power has been misused) because it will often be very difficult to establish the purpose for which conduct was undertaken (often only circumstantial evidence of purpose will be available); and
  - the misuse of market power prohibition is not defined by reference to the effect on competition of the particular conduct because conduct that constitutes a misuse of market power (eg. predatory pricing) is deserving of punishment irrespective of its effect on competition.

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However, one of the purposes of this section of the Guideline is to indicate the general approach of the ERC in relation to the misuse of market power prohibition.

## **5.2 Misuse of market power: terms and concepts**

### General

5.2.1 In order to establish a violation of the misuse of market power prohibition, it is necessary to establish the existence of two elements:

- that the person has a substantial degree of power in a market; and
- that the person has misused that power.

5.2.2 Importantly, the prohibition is on the misuse of power in a market, not simply on the holding of a substantial degree of power in a market.

### Substantial degree of power in a market

5.2.3 Before assessing whether a person has a substantial degree of power in a market, the relevant market must be identified. The definition of “market” for these purposes, and the way in which the boundaries of a market are delineated, are discussed in section 2 of this Guideline. Once the relevant market has been identified, it is then necessary to assess whether that person has a “substantial degree of power” in that market.

5.2.4 For these purposes, the reference to “power” means “market power” (Rule 5(6) of the Competition Rules). In other words, the misuse of market power prohibition does not prohibit the use (or misuse) of power that is not market power, eg. it would not prohibit the use (or misuse) of a statutory power, such as a power conferred by statute on a State agency to issue (or refuse to issue) a licence to participate in a particular market.

5.2.5 “Substantial”, in the context of the misuse of market power prohibition, is intended to signify a considerable degree of market power, ie. one that is real or of substance. Where a person has a substantial degree of market power, that person is able to persistently behave independently of competitive pressures – that is, to persistently behave in a manner that is different from the behaviour that a competitive market would otherwise impose. This is recognized in Rule 5(3) of the Competition Rules which provides that, in determining the degree of power that a person has in a market, regard must be had to the extent to which the conduct of the person in that market is constrained by the conduct of:

- competitors or potential competitors; and
- customers and suppliers of that person or that person’s affiliates.

5.2.6 So, for example, where a supplier has a substantial degree of market power, that supplier will be able to profitably charge higher prices than if it faced effective competition. Conversely, where a buyer has a substantial degree of market power, that buyer will be able to extract lower prices than if it faced effective competition (thereby causing suppliers to reduce their output of the relevant goods or services to a sub-optimal level). However, market power is not solely manifested in pricing

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behaviour. It may, for instance, be manifested through the ability to restrict the quantity of goods or services produced, or to reduce the quality of those goods or services, to below the level that would prevail in a competitive market. A person with a substantial degree of market power could also use that market power to engage in anti-competitive conduct or to exclude other competitors from the market.

- 5.2.7 Whether a person has a substantial degree of power in a market will depend upon the nature and extent of competition in that market: the existence of effective competition will preclude the existence of such a degree of market power. The manner in which the ERC will assess the level of competition in a market, and therefore determine whether a person has a substantial degree of power in that market, is discussed in section 3 of this Guideline. As stated in that section, this analysis will entail a consideration of (among other things) the level of concentration in the market, the nature and effect of barriers to entry to the market, the degree of countervailing power in the market and the dynamic characteristics of the market.
- 5.2.8 As section 3.2.2 acknowledges, market share does not, on its own, determine whether a person has a substantial degree of power in a market. However, a person is more likely to have a substantial degree of power in a market if its competitors are relatively weak or if it has been able to maintain a high and stable market share over time. The ERC considers that a person who has a market share persistently above 40% can generally be presumed to have a substantial degree of power in the market (in the absence of evidence to the contrary). Conversely, the ERC considers it unlikely that a person will have a substantial degree of power in a market if the person's market share is persistently below 20%, although the requisite degree of market power could still be established if, for example, there are numerous other competitors in the market but each of them is relatively small.
- 5.2.9 If the relevant market in any particular case is defined by reference to goods or services supplied under an exclusive franchise (eg. as is the case in respect of electricity transmission and distribution), the existence of the franchise would normally be expected to confer a substantial degree of market power on the franchisee.<sup>8</sup> Conversely, a substantial degree of market power could arise, even where the relevant person has a small market share, as a result of specific market conditions – for example, as where one person controls the marginal generators for a particular region (and so can raise the wholesale price of electricity without any response from other suppliers when those other suppliers are operating at full capacity). In the electric power industry, inelastic supply and demand in the short term is also likely to result in volatile spot market prices that can provide opportunities for the misuse of market power (including market power that only arises for short periods of time due to particular market conditions).

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<sup>8</sup> In any event, it is likely that transmission and distribution networks will be natural monopolies and so will confer on their owners or operators a substantial degree of power in the market for services provided by those networks, although particular regulatory constraints might limit the exercise of such power.

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- 5.2.10 It should be noted that the Competition Rules provide that a person is to be taken to have a substantial degree of power in a market where that person and/or its affiliates together have a substantial degree of power in that market (Rule 5(2)). So, for example, in assessing whether a person has a substantial degree of power in a market the ERC will aggregate both that person's market share and that of its affiliates.
- 5.2.11 However, market power can also be acquired through agreements, arrangements and understandings. Power which is acquired in this way will be taken into account in determining a person's degree of power in a market, even though it is not aggregated by virtue of the "affiliate" provision referred to in section 5.2.10, ie. even though the power results from an agreement, arrangement or understanding with an unrelated entity.

#### Misuse

- 5.2.12 At the outset, it should be noted that the misuse of market power prohibition is intended to protect competition, as opposed to individual competitors. Competition by its very nature is deliberate and ruthless; its essence is that more effective competitors win customers away from those who are less effective. The purpose of the misuse of market power prohibition is to protect competition by preventing market power (which can only exist in the absence of effective competition) from being used in a way that is inconsistent with competitive outcomes or that is detrimental to competition.
- 5.2.13 The Competition Rules provide that, in determining whether a person has misused its power in a market, it is necessary to take into account (among other things):
- whether, if the person did not have a substantial degree of power in that market, that person would have acted in the way it did (Rule 5(4)(a)); and
  - whether, in all the circumstances, the person was reasonably justified in using its power in the way it did (Rule 5(4)(b)).
- 5.2.14 In determining whether a person was reasonably justified in using its power in the way it did, the ERC will also have regard to whether that use was proportional. For example, the imposition of terms in an agreement that are not reasonably necessary to achieve an otherwise permissible result may constitute an abuse of market power as may taking a disproportionate action (eg. refusing to supply a customer at all because the customer defaulted in payment to the supplier more than 12 months prior to that refusal).
- 5.2.15 Rule 5(5) of the Competition Rules makes it clear that a misuse of market power can occur in a variety of ways, including conduct by way of:
- doing an act;
  - refusing to do, or refraining (otherwise than inadvertently) from doing, an act;
  - making it known that an act will or will not be done;

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- refusing to do an act, or to offer to do an act, except on a condition or conditions;
  - making it known that an act will not be done except on a condition or conditions; or
  - making it known that an act will only be done on a condition or conditions.

5.2.16 The WESM Rules place restrictions on the conduct of generators trading through the WESM – for example, in the making of offers and in conforming with dispatch instructions. A breach of the WESM Rules would not necessarily imply a misuse of market power, not least because the relevant generator may not actually possess market power. Conversely, compliance with the WESM Rules does not protect a party from possible prosecution for misuse of market power.

5.2.17 Examples of conduct that might constitute a misuse of market power are given in section 5.3.

### **5.3 Examples of misuse of market power**

5.3.1 The examples that follow are not exhaustive. They are simply examples of the kinds of conduct which might violate the misuse of market power prohibition. However, the circumstances of a particular case may mean that, even though it involves conduct of that type, that conduct does not violate that prohibition (eg. because, in the particular circumstances of that case, the person was reasonably justified in using its market power in the way it did). Equally, there will be instances of conduct not listed below which will violate the misuse of market power prohibition because of the nature of that conduct or because of the characteristics of the relevant market.

#### Excessively High Prices

5.3.2 The charging of an excessively high price (ie. a price that is higher than would otherwise be charged if there were effective competition) may constitute a misuse of market power.<sup>9</sup> For these purposes, the price that is charged by a person for goods or services will only be excessive if the profits earned by the person from the supply of those goods or services consistently exceed the person's risk-adjusted cost of capital (ie. the return which could be earned from investing elsewhere having regard to the risks incurred by investing in the existing business).<sup>10</sup> In the absence of that person's substantial degree of market power, it might be considered unlikely that the person would charge such prices because that behaviour would typically result in that person's customers switching to another supplier. Whether prices are excessive for these purposes must be evaluated having regard to all the circumstances. For example, in the case of peaking electricity generation, which is only required to operate on infrequent occasions,

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<sup>9</sup> Similarly, the extraction of an excessively low price by a buyer that has a substantial degree of power in a market may also constitute a misuse of market power. Note that the WESM Rules impose a price cap in the form of a nodal VoLL.

<sup>10</sup> The return that an entity is required to earn on capital raised by way of equity and borrowing is the entity's weighted average cost of capital (WACC).

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extreme prices will not necessarily lead to excessive profits since the generator must recover its fixed costs from a relatively small volume of output.

5.3.3 However, even where a person earns “excessive” (or supra-normal) profits, this does not necessarily mean that the person is misusing its market power. This is because:

- even in competitive markets there are likely to be periods when high profits can be earned – this may, for example, occur as a result of a competitor identifying and exploiting a particular competitive advantage or as a result of demand exceeding existing capacity (in such a case, the resultant increase in price and profits is an important part of the competitive process because it will encourage new entry into the market or investment in new capacity); and
- relatively high profits may result from relatively greater efficiencies - for example, where a supplier has acted innovatively by developing a lower-cost technique of production, a higher quality product or identifying and meeting a particular market opportunity (again, this is an important part of the competitive process because such relatively high profits reward, and therefore encourage, innovation).

Of course, in competitive markets supra-normal profits earned by one market participant are likely to be temporary as competitors undercut the high price and undertake their own innovations, and as new competitors enter the market.

5.3.4 Accordingly, the ERC is only likely to regard charging excessive prices as a misuse of market power where such high prices are persistent and new entry is unlikely within one year. On the other hand, the regulation of prices by an industry regulator (as is the case with the ERC in relation to transmission and distribution wheeling rates and the retail rate charged by distribution utilities to their captive markets) may constrain prices despite the existence of high barriers to entry and the absence of existing competitors or countervailing power.

#### Price and non-price discrimination

5.3.5 Price discrimination involves applying different prices to equivalent transactions – for example:

- charging different prices to different customers (or categories of customers) for the same product in circumstances where the differences in prices do not reflect the quantity, quality or any other characteristics of the products supplied; or
- charging the same price to different customers (or categories of customers) even though the costs of supplying the product are very different (eg. because of significant differences in transport costs).

Such price discrimination is likely to constitute a misuse of market power. This is because, if the relevant supplier did not have a substantial degree of market power, it would be unlikely that the supplier would price discriminate in this way as

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it would typically result in those customers who are being disadvantaged switching to another supplier. Such price discrimination could occur where the supplier sells its output to a participant in a downstream market on more favourable terms than it offers to sell that output to other competitors of that participant in that downstream market – for instance, as where a generator sells electricity to a supplier subsidiary on preferential terms.

5.3.6 Conversely, there will be no misuse of market power where, for example, the difference in the prices charged to different customers is justified:

- on the basis of differences in the cost of production, distribution, sale or delivery resulting from the differing places to which, the differing methods by which, or the differing quantities in which, the relevant product is supplied to those customers;
- on the basis that it is done in good faith to meet a price or benefit offered by a competitor of the supplier; or
- on the basis that it corresponds to the willingness of different customers to pay different prices for the product and therefore enables sales of the product to be increased beyond that which would be sold if a uniform price were charged (eg. peak electricity might be priced such as to recover a proportionally greater share of common costs than off-peak electricity because peak electricity demand is less price elastic than off-peak electricity demand).

5.3.7 Discrimination on grounds other than price, eg. in the quality of service provided where such quality differences are not reflected in price, may also constitute a misuse of market power.

5.3.8 Accordingly, discrimination by TRANSCO (or its buyer or concessionaire) or a distribution utility in the provision of network and connection services or in the charges applied for those services (including where such discrimination is in favour of an affiliate) may constitute a misuse of market power. Similarly, the provision by TRANSCO (or its buyer or concessionaire) or a distribution utility of a preference or advantage to a generator or retailer (including an affiliate) in processing a request for the transmission or distribution of electricity or in the dissemination of customer or network information might conceivably constitute a misuse of market power. Such behaviour might also violate the requirements of another regulatory instrument (such as the Grid Code or the Distribution Code, in relation to connections, or the Business Separation Guideline, in respect of the dissemination of customer and network information).

#### Predatory pricing

5.3.9 Predatory pricing occurs where prices are set low for the purpose of damaging existing competitors or deterring potential new competitors. It constitutes a threat to the competitive process itself and is to be distinguished from price reductions that are the result of legitimate competitive behaviour. As a general rule, the ERC will presume that a person is engaging in predatory pricing if the person prices at

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below the average variable cost of production. This is because, in such a case, the person will (on average) be making losses on each unit of output it supplies (the person would actually be able to reduce its losses by ceasing supply altogether). Evidence of predatory intent may be inferred from a price cut which is clearly targeted at a new entrant (eg. because it coincides with the entry of the new entrant into the market, only applies in areas where the new entrant competes with the person and is a “once-off” reduction that is not simply part of a pattern of aggressive pricing).

5.3.10 Conversely, such pricing behaviour might be reasonably justified (and therefore not an abuse of market power) if, for example:

- it is part of a policy of loss leading (ie. selling the relevant goods or services at below their cost to the acquirer so as to attract customers for other goods or services supplied by the acquirer);
- it is part of a short run promotion;
- it is done in good faith to meet a price or benefit offered by a competitor;
- it results in higher profits (or lower losses) than would otherwise be the case (eg. as where the price cut results in such an increase in demand that the resultant increase in revenue is sufficient to cover the additional costs incurred in meeting that greater demand); or
- it is done to off-load excess inventory – for instance, a generator subject to a take-or-pay fuel contract may sell its output at a low price, in order to burn the necessary fuel, if it has no option to store or otherwise dispose of the fuel.

5.3.11 In the course of normal trading, a generator may have a need to bid electricity into the WESM at a low, zero or even negative price in order to ensure dispatch – for example, as where the relevant generating unit is inflexible, has very high start-up costs (and therefore must ensure that it is not shutdown in the dispatch process) or needs to be dispatched to a particular output profile. For the purposes of identifying predatory pricing, the price at which a generator offers to the WESM will generally be irrelevant; it is the price that it actually receives (ie. the spot price) which is important. Accordingly, if a generator offers at a zero price but receives an average spot price in excess of its average variable cost, this would not generally constitute predatory pricing.

#### Resale price maintenance

5.3.12 Resale price maintenance occurs where a supplier specifies the price at which its goods or services may be re-supplied (typically by reference to a minimum or “floor” price). Both the supplier and the acquirer will be in violation of the price-fixing prohibition if they make an agreement or arrangement, or arrive at an understanding, which contains such a provision, or if they give effect to that provision (see section 4.4). However, if the acquirer does not agree only to re-supply the goods or services at a price that is greater than the specified floor price, the supplier might refuse to supply those goods or services to the acquirer

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(or might agree to do so but only on terms that are less favourable than those given to customers who agree to such a condition). In such a case, if the supplier has a substantial degree of power in a market in which the relevant goods or services are supplied, such a refusal to supply (or the supply of those goods or services on less favourable terms) may constitute a misuse of that market power.<sup>11</sup> In the absence of that market power, it might be considered unlikely that the supplier would refuse to supply the goods or services if the acquirer refused to agree to re-supply them at a price that was above the specified floor price (or that the supplier would even seek to impose such a condition) because the acquirer could simply acquire those goods or services from another supplier.

- 5.3.13 However, a refusal to supply goods or services in these circumstances would not constitute a misuse of market power if it was reasonably justified. A reasonable justification might be that the supplier reasonably believes that the acquirer intends to use those goods or services as “loss leaders”, ie. that the acquirer intends to re-supply those goods or services at less than their cost to the acquirer for the purpose of attracting customers for other goods or services supplied by the acquirer. Generally speaking, the ERC will consider it reasonable for a supplier to assume that a customer intends to engage in loss leading where that customer has, within the preceding 12 months, sold goods or services obtained directly or indirectly from the supplier at less than their cost to the acquirer, other than as part of a genuine seasonal or clearance sale of goods or services that were not acquired for the purpose of being sold at such a sale.

#### Full-line forcing and third-line forcing

- 5.3.14 One kind of full-line forcing occurs where a person supplies goods or services to another person on the condition that the other person will not acquire some or all of its requirements for goods or services from a competitor of the supplier. Third-line forcing occurs where a person supplies goods or services to another person on the condition that the other person will also acquire goods or services from a third person. Both the supplier and the acquirer will be in violation of the anti-competitive agreement prohibition if they make an agreement or arrangement, or arrive at an understanding, which contains such a condition (or if they give effect to that condition) and the effect or likely effect of the condition is to substantially lessen competition in a market in which the relevant goods or services are traded (see sections 4.2 and 4.3). However, if the acquirer does not agree to the condition, the supplier might refuse to supply those goods or services to the acquirer (or might agree to do so but only on terms that are less favourable than those given to customers who agree to such a condition). In such a case, if the supplier has a substantial degree of power in a market in which the relevant goods or services are supplied, such a refusal to supply (or the supply of those goods or

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<sup>11</sup> Indeed, the supplier may equally be found to have misused its market power where the relevant agreement, arrangement or understanding was entered into: see section 4.7 which describes the relationship between the misuse of market power prohibition and the price-fixing prohibition.

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services on less favourable terms) may constitute a misuse of that market power.<sup>12</sup> In the absence of that market power, it might be considered unlikely that the supplier would refuse to supply the goods or services if the acquirer refused to agree to the condition (or that the supplier would even seek to impose such a condition) because the acquirer could simply acquire those goods or services from another supplier.

5.3.15 However, a refusal to supply goods or services in these circumstances would not constitute a misuse of market power if it was reasonably justified. A reasonable justification might be that:

- in the case of such full-line forcing, the establishment of “dedicated” outlets enables the supplier to properly train the acquirer in demonstrating and servicing its product range, enables the supplier to achieve economies of scale in distribution (ie. the reduction of average costs as output increases) or enables the supplier to avoid “free-riding” (which may occur where an outlet leverages off the expertise and investment provided by the supplier to sell a competing supplier’s products); and
- in the case of such third-line forcing, the stocking of compatible products enables the acquirer to provide a complete product range to customers or to achieve economies of scope in production and distribution (ie. the reduction of average costs where two or more products are produced or distributed jointly rather than separately).

#### Refusal to supply

5.3.16 Where a person with a substantial degree of power in a market refuses to supply goods or services to a customer, this may constitute an abuse of market power. This will particularly be the case where one of the purposes of that refusal is to damage an existing competitor or to deter a potential new competitor.

5.3.17 However, a refusal to supply goods or services will generally not constitute a misuse of market power if the supplier would have refused to supply those goods or services even if it did not have a substantial degree of power in the relevant market or if that refusal to supply is reasonably justified. So, for example, a refusal to supply on any of the following grounds is unlikely to constitute a misuse of market power:

- that the customer has poor creditworthiness;
- that the supplier is unable to supply the relevant goods or services because all of its capacity is fully utilised (or its stocks are fully committed) to meet existing orders; or
- that the supplier has chosen to supply those goods or services directly to particular wholesalers or retailers in order to enable the realisation of

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<sup>12</sup> Indeed, the supplier may equally be found to have misused that market power where the relevant agreement, arrangement or understanding was entered into: see section 4.7 which describes the relationship between the misuse of market power prohibition and the anti-competitive agreement prohibition.

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efficiencies in distribution and improvements in service quality (with the result that the relevant customer can only acquire the relevant goods or services from those particular wholesalers or retailers).

5.3.18 Accordingly, TRANSCO (or its buyer or concessionaire) or a distribution utility may well violate the misuse of market power prohibition if they refuse to connect a generator, distributor or other person other than for reasons of system security or reliability, reasonable financial or credit considerations pursuant to the Grid Code or the Distribution Code, or the commission of acts constituting grounds for suspension of the service under any applicable rule or regulation.

#### **5.4 Leveraging off market power**

5.4.1 It is conceivable that a person with a substantial degree of power in one market could violate the misuse of market power prohibition by misusing that power so as to affect a *different* market. This could be the case where, for example:

- the person is vertically integrated over an input market and an output market and exercises its substantial degree of power in the input market by only supplying that input to its affiliate in the output market and refusing to supply it to the affiliate's competitors in the output market; or
- the person exercises its substantial degree of power in the market in which a particular product is traded to require customers to purchase from it (or an affiliate) a product that is traded in a different market.

So, for instance, it is conceivable that an electricity distributor might misuse its substantial degree of power in the market for its distribution services where it ties connections to the use of its metering equipment and services.

#### **5.5 Relationship with anti-competitive agreement and price-fixing prohibitions**

Rule 4 of the Competition Rules prohibits a person from entering into an agreement, arrangement or understanding which contains a price fixing provision or a provision that has, or is likely to have, the effect of substantially lessening competition in a market. It also prohibits a person from giving effect to any such provision. The interaction between the misuse of market power prohibition and the prohibitions contained in Rule 4 is explained in section 4.7 of this Guideline.

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## 6. ACQUISITIONS, MERGERS AND CONSOLIDATIONS

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### 6.1 Introduction

6.1.1 Rule 6 of the Competition Rules prohibits a person from:

- directly or indirectly acquiring shares in the capital stock of a corporation;
- merging with another corporation;
- consolidating with another corporation to form a new corporation; or
- directly or indirectly acquiring assets of a person,

if the acquisition, merger or consolidation would have, or would be likely to have, the effect of substantially lessening competition in a market. This prohibition is referred to in this Guideline as the “merger prohibition”. It is discussed in more detail in section 6.2. Particular issues that are relevant to the application of the “substantial lessening of competition” test in the context of share and asset acquisitions, mergers and consolidations are addressed in section 6.3.

6.1.2 The term “merger” is sometimes used in this Guideline in relation to the merger prohibition. In this context it is to be understood as referring to an acquisition of shares or assets, a merger with another corporation or a consolidation of corporation to form a new corporation. Similarly, the term “merged entity”, when used in this Guideline, means:

- in the case of the acquisition of shares, the shareholder and the corporation in which the shares are held;
- in the case of the acquisition of assets, the business in which the assets are used;
- in the case of a merger between two or more corporations, the corporation into which the others have merged; and
- in the case of a consolidation between two or more corporations, the new corporation that is formed by the consolidation.

6.1.3 Mergers may have beneficial effects to the extent they enable the achievement of efficiencies such as economies of scale or scope, synergies (eg. cost savings through vertical integration) and risk spreading. The threat of takeover also imposes a competitive discipline on firms, ie. inefficient firms are likely to be the subject of takeover by those who consider they can operate them more efficiently. Moreover, a merger may enable a combination of resources of such a magnitude that allows the merged entity to operate more efficiently and to compete more effectively by lowering prices, improving quality, enhancing service or developing new products. However, mergers may also be detrimental to competition because, in the case of horizontal mergers (ie. mergers between competitors), they result in an increase in concentration in a market and, in the case of vertical mergers (ie. mergers between a supplier and a customer), they may result in the foreclosure of

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an upstream or downstream market to a competitor. Conversely, mergers between parties that neither compete in the same markets nor in vertically-related markets (ie. "conglomerate" mergers) are unlikely to raise competition concerns.

6.1.4 The merger prohibition differs from the anti-competitive agreement prohibition, the price-fixing prohibition and the misuse of market power prohibition in that it does not directly regulate anti-competitive conduct but instead regulates market structure. That is, the purpose of the merger prohibition is to prevent the creation of, or an increase in, market power in the first place and therefore to avoid the creation of a situation in which anti-competitive behaviour (such as collusion or predatory pricing) can successfully occur.

6.1.5 The merger prohibition does not apply in certain circumstances. These circumstances are set out in Rule 7 of the Competition Rules (see section 9 of this Guideline). In addition, the ERC may, on application by a person:

- give a "clearance" in respect of a proposed merger where it determines that the merger will not have, and will not be likely to have, the effect of substantially lessening competition in a market - while a clearance remains in force, the applicant may acquire shares or assets, or undertake the relevant merger or consolidation, in accordance with the clearance; or
- authorize that person to acquire shares or assets, or merge or consolidate with another corporation, where that acquisition, merger or consolidation would or might otherwise violate the merger prohibition – such an authorization must (and can only) be granted if the ERC determines that the acquisition, merger or consolidation will in the circumstances result, or be likely to result, in such a benefit to the public that it should be allowed to take place.

The clearance and authorization processes are contained in Rule 9 of the Competition Rules and are described in section 6.4. To a large extent this description is similar to that contained in section 4.6 in respect of agreements, arrangements and understandings (indeed Rule 9 of the Competition Rules bears considerable resemblance to Rule 8, which deals with clearances and authorizations in the context of such agreements, arrangements and understandings). However, there are some significant differences and so, for ease of reference and understanding, that description is set out in a full and self-contained manner in section 6.4.

6.1.6 There is no formal requirement that the parties to a proposed merger advise the ERC prior to entering into an agreement to effect that merger (unless they wish to apply for authorization or clearance). However, if a person violates the merger prohibition, the ERC may make certain orders against that person. The range of potential orders is extensive and a description of these orders, together with an indication of the circumstances in which they are likely to be made, is contained in section 7 of this Guideline. Accordingly, if there is any doubt that a proposed merger might violate the merger prohibition, the relevant parties would be well

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advised to approach the ERC for either a clearance or an authorization, as appropriate.

## **6.2 Merger prohibition: terms and concepts**

### Directly or indirectly acquire

6.2.1 “Acquire” refers to the acquisition of a legal or equitable interest in the relevant shares or assets (whether alone or jointly with another person) (Rule 6(4)) (but see section 6.2.10). That acquisition may, for example, occur by way of succession, purchase, barter or exchange, donation or (in the case of assets) lease, lease with an option to purchase and the like. However, an “acquisition” of shares or assets by way of a charge, or an acquisition of assets in the ordinary course of business, is not an acquisition to which the merger prohibition applies. So, for instance, the creation of an option over shares, which results in the creation of an equitable interest in those shares, is an “acquisition” for the purposes of the merger prohibition. A “direct” acquisition is one in which the person makes the acquisition itself. An “indirect” acquisition is one in which the person makes the acquisition through an intermediary such as an agent, nominee or trustee.

### Assets and shares

6.2.2 Assets includes intangible assets – for example, goodwill, intellectual property rights, customer lists, franchises and contractual rights. Shares are shares in the capital stock of a corporation.

### Merger and consolidation

6.2.3 The Corporation Code provides for the mechanism by which two or more corporations may merge into a single corporation and two or more corporations may consolidate into a single new corporation.

### Effect

6.2.4 Rule 6 of the Competition Rules is concerned with the effect or likely effect of the relevant merger on competition. The reference to “likely effect” means that the ERC must consider not just the actual effect of the merger on competition but also the possible effect on competition that the merger may have (taking into account factors such as the characteristics of the relevant market and the behaviour or anticipated behaviour of competitors or potential competitors in that market). For an effect to be “likely” there must be a real possibility that the effect will occur. This does not, however, mean that it must be more likely than not that the effect will occur.

### Substantial lessening of competition

6.2.5 Whether a merger would have, or would be likely to have, the effect of “substantially lessening” competition in a market will generally require a comparison of the nature and extent of competition in the market both with and without the merger. This will obviously involve a hypothetical comparison where the merger has not yet been effected. Rule 6(2) of the Competition Rules sets out

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a number of matters which must be taken into account in making this comparison, and these are discussed further in section 6.3.

- 6.2.6 In this context, “substantial” is a relative term and, for the merger prohibition to be violated, the lessening of competition must (for the purposes of this comparison) be real and not merely nominal or otherwise insignificant. In addition, the lessening of competition must not be merely transitory but must be likely to persist over a period of time – for these purposes the ERC will generally adopt two years as the relevant period of time.
- 6.2.7 The Competition Rules also provide that lessening competition includes preventing, restricting or hindering competition (Rule 3(3)). So, for example, if the merger results in the replacement of an unstable oligopolistic coordination of prices with a single firm, the fact that it is no longer possible for there to be a break down in price coordination (and a break out in competition between the merged firms) will constitute a lessening of competition as it prevents, restricts or hinders competition.
- 6.2.8 Section 6.3 discusses in more detail particular issues that are relevant to the application of the “substantial lessening of competition” test in the context of the merger prohibition.

#### Market

- 6.2.9 The definition of “market”, and the way in which the boundaries of a market are delineated, are discussed in section 2 of this Guideline.

#### Conditional agreements

- 6.2.10 An acquisition of shares or assets, a merger or a consolidation is deemed not to have taken place for the purposes of the merger prohibition if the agreement for it is subject to a condition that the provisions of the agreement relating to the acquisition, merger or consolidation will not come into force until a clearance or authorization has been granted, provided that an application for that clearance or authorization is made within 21 days of the agreement being made (Rule 6(3)).

#### Extraterritorial application

- 6.2.11 The merger prohibition applies not just to where the relevant acquisition, merger or consolidation occurs in the Philippines, but also to where they occur outside the Philippines in circumstances where that acquisition, merger or consolidation would have, or would be likely to have, the effect of substantially lessening competition in a relevant market in the Philippines (see Rule 18(3) of the Competition Rules). Moreover, this is the case irrespective of whether the acquisition, merger or consolidation involves a Philippine national. So, for example, if a foreign corporation (F1) holds all of the shares in a Philippines generation company (P1) and another foreign corporation (F2) holds all of the shares in another Philippines generation company (P2), then the merger prohibition would be violated if F1 acquired all of the shares in F2 and that acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market in the Philippines in which P1 and P2 trade the electricity which they generate. This is because such a foreign merger results in bringing P1 and P2 together in the same

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corporate group, and this will have the same effect as if P1 had acquired all of the shares in P2.

- 6.2.12 However, in the case of such a foreign merger, the nature of the orders that may be made by the ERC will be somewhat different to those that could be made if the share acquisition was effected in the Philippines, eg. an order of the ERC that F1 must divest its shares in F2 is unlikely to be enforceable in a practical sense. The kinds of orders that are likely to be made by the ERC in these circumstances are outlined in section 7 of this Guideline.

### **6.3 Application of “substantial lessening of competition” test**

#### Share acquisitions

- 6.3.1 The merger prohibition applies to any acquisition of shares which would have, or would be likely to have, the effect of substantially lessening competition in a market, ie. the application of the merger prohibition in respect of the acquisition of shares is not dependent on the application of any particular threshold shareholding.
- 6.3.2 The acquisition of a controlling interest by one entity in another will generally permit the two entities to effectively operate as a single unit (although this may depend on the precise contractual terms of the merger). Accordingly, in assessing the actual or likely effect of such an acquisition, the ERC will typically treat the two entities as if they were the same entity (eg. for the purpose of calculating market share or concentration and for the purpose of evaluating their likely behaviour in the market).
- 6.3.3 However, it is important to note that one entity may obtain control over another even if it does not have a majority shareholding (ie. greater than 50%) in that other entity. In considering whether a less-than-majority shareholding vests effective control of an entity in a particular shareholder, the ERC will take into account factors such as:
- the ownership distribution of the remaining shares;
  - the distribution of voting rights;
  - whether other shareholders are active or passive participants at shareholder meetings of the entity;
  - special rights attaching to shares in the entity;
  - the existence of pre-emption rights in relation to the sale of shares in the entity;
  - the composition of the board of directors of the entity;
  - the rules in the entity’s constitution; and
  - contracts or arrangements between the shareholder and the entity or their affiliates (eg. long term supply contracts or contracts of strategic significance).

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6.3.4 Moreover, the merger prohibition may also apply where the acquisition of shares does not confer control (or even influence) on the acquiring entity. This is because the acquisition of such a shareholding may still substantially lessen competition in a market. For example:

- If the acquisition is of shares in a competitor, it may reduce the competitive tension between the two competitors (competition between them will simply result in the transfer of revenue from one to the other) and correspondingly increase the motivation and capacity for the two entities to coordinate their conduct (so as to maximise their joint profits). Indeed, partial shareholdings in, and common directorships between, competitors will also make it easier to ensure compliance with any collusive agreement (or to detect breaches of such an agreement) and will facilitate the exchange of information between those competitors.
- If the acquisition is of shares in a supplier, the customer-shareholder may have an incentive to favour that supplier over other suppliers (so as to increase the profitability of the shareholding), thereby foreclosing the opportunities for competitors of the supplier to sell their goods or services to the customer. Similarly, if the acquisition is of shares in a customer, the supplier-shareholder might be able to induce the customer to purchase its requirements for goods or services from that supplier, thereby foreclosing the opportunities for competitors of the supplier to sell such goods or services to the customer.
- Horizontal and vertical acquisitions may also provide access to commercially sensitive information in relation to competitors (eg. information about costs, revenues, bids, contracts, forward supply estimates, marketing campaigns and new product plans). The level of information available will depend upon the nature and level of the shareholding and, if the shareholding is sufficient to secure a position on the board of directors, more information is likely to be available.

6.3.5 The ERC will also consider the collective effect of shareholdings that are acquired incrementally over a period. While the initial acquisition may not raise substantial competition concerns, and each incremental acquisition might not give rise to a substantial lessening of competition in its own right, it may be that collectively the acquisitions give rise to a substantial lessening of competition in a relevant market. Finally, if the acquisition of shares in an entity by one person is accompanied by the acquisition of shares in that same entity by another person, the ERC will take into account any apparent coordination or other relationship between those two persons which suggests that the two acquisitions should effectively be treated as a single acquisition for competition purposes.

#### Factors relevant to the effect of a merger on competition

6.3.6 Whether a particular merger will have the actual or likely effect of substantially lessening competition in a market will depend on the nature and extent of competition in that market. Rule 6(2) of the Competition Rules requires the ERC,

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in determining whether a merger would have the effect, or would be likely to have the effect, of substantially lessening competition in a market, to take into account the following matters:

- the level of concentration in the market;
- the nature and effect of barriers to entry to the market;
- the degree of countervailing power in the market;
- the dynamic characteristics of the market, including growth, innovation and product differentiation;
- the likelihood that the merger would result in the removal from the market of a vigorous and effective competitor; and
- the nature and extent of vertical integration in the market.

The first four of these factors have been discussed in section 3 of this Guideline. The following paragraphs discuss some aspects of these four factors which are peculiar to mergers, as well as the application of the additional two factors in relation to mergers. It should be noted that this list is not exhaustive and other factors that may be relevant are also referred to in these paragraphs.

#### Market concentration

6.3.7 Market concentration is considered generally in section 3.2 of this Guideline. The following paragraphs set out various thresholds of market share and concentration such that, if a merger falls below those thresholds, the ERC will generally not regard the merger as violating the merger prohibition. However, measures of market share and concentration are critically dependent on the definition of the relevant market – a matter on which judgments may well differ. Moreover, there may be circumstances in which a proposed merger would not result in these thresholds being exceeded but instead, because of the characteristics of the market, the ERC might nevertheless consider that the merger would have the actual or likely effect of substantially lessening competition in a relevant market. Conversely, the fact that a proposed merger would result in these thresholds being exceeded does not mean that the merger would violate the merger prohibition – it merely means that other factors relevant to the nature and extent of competition in that market will need to be examined.

6.3.8 A merger may result in an entity being able to unilaterally and sustainably exercise market power despite the existence of competitors acting independently in the market. This is more likely to be the case where the result of the merger is that the entity acquires a large market share, because the entity may then be able to generate a given increase in price with a smaller proportional decrease in its output, and that reduction in output might not be able to be met by a corresponding increase in the output of the merged entity's competitors within a reasonable time. Accordingly, if the merger will result in the merged entity acquiring a market share of 20% or more, the ERC will want to give further consideration to the merger

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before accepting that it will not result in a substantial lessening of competition in a relevant market.

6.3.9 A merger may also result in market participants being more easily able to coordinate their behaviour and, through such coordination, exercise market power by reducing their joint output and increasing price. Such coordination does not necessarily involve collusion which violates the anti-competitive agreement prohibition or the price-fixing prohibition, but may simply involve price signalling, conscious parallelism or price leadership. This is more likely to be the case where:

- the result of the merger is to significantly increase market concentration (ie. so that only a relatively small number of firms participate in the market), with the result that it is easier to reach a collusive agreement (and to detect and punish deviations from the collusive agreement) or to recognize the mutual benefits of cooperation;
- there are no small or fringe competitors who are able to expand their output and undercut the price charged by the colluding firms;
- the demand for the relevant goods or services is inelastic, thereby enhancing the opportunity for a profitable price increase;
- the relevant goods or services are homogenous and/or the market participants are similar (eg. in relation to the cost of inputs), thereby making it easier to reach a collusive agreement and to detect and punish deviations from that agreement;
- sales are made frequently and comprise small quantities, with the result that it is easier to detect deviations from the agreed price and there is less profit incentive to deviate from that price in any event; or
- details of prices, bids or quantities sold are readily available, thereby making the monitoring of compliance with a collusive agreement easier.

Accordingly:

- if the merger involves a moderately concentrated market (ie. where the post-merger HHI<sup>13</sup> is between 1500 and 2500) and the merger produces an increase in the HHI of more than 200 points; or
- if the merger involves a highly concentrated market (ie. with a post-merger HHI of above 2500) and the merger produces an increase in the HHI of more than 100 points,

then the ERC will want to give further consideration to the merger before accepting that it will not result in a substantial lessening of competition in a relevant market.

#### Barriers to entry

6.3.10 The nature and effect of barriers to entry is considered generally in section 3.3 of this Guideline.

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<sup>13</sup> HHI refers to the Herfindahl-Hirschman Index: see section 3.2.6.

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6.3.11 If the relevant market is characterized by low barriers to entry, then the behaviour of the incumbent market participants is likely to be constrained by the threat of potential competition, and so such incumbents are likely to behave in a manner consistent with competitive outcomes. Where barriers to entry are low, prices set above, or output, quality, service or innovation which is below, competitive levels should attract new entry into the market and restore such prices, output, quality, service or innovation to their competitive levels. However, if there are significant barriers to entry to a market, then an increase in market concentration as a result of a merger is likely to give rise to a substantial lessening of competition because the incumbent market participants will be able to engage in conduct that is (to some degree) free of competitive constraints. For these purposes, entry may occur through a variety of means, eg. the utilisation of excess capacity, the construction of new production facilities, the development of alternative products or technologies or the identification of new sources of supply of the relevant goods or services.

6.3.12 Barriers to entry will be low (and so the anti-competitive effect of any merger will be correspondingly reduced) if it is likely that new entrants can establish themselves in the market on a sufficient scale within a reasonable time to inhibit the exercise of market power by the merged entity. For these purposes, the ERC will generally consider entry to be:

- timely, if it can be achieved within three years from initial planning;
- likely, if it can be achieved profitably at pre-merger prices<sup>14</sup> (taking into account any sunk costs that need to be incurred and the need to earn an appropriate rate of return on invested capital) and if the new entrant is able to secure such prices – entry will not be likely for these purposes if the minimum viable scale (ie. the smallest average annual level of sales that the new entrant must persistently achieve for profitability at pre-merger prices) is larger than the likely sales opportunities available to entrants because, in such a case, the production of the necessary quantity of output will depress prices further (in evaluating the available sales opportunities regard will need to be had to the likely reaction of the incumbent market participants, eg. in increasing their output or reducing their prices); and
- sufficient, if it would return market prices to their pre-merger levels – whether entry is sufficient will depend upon the scale of entry (whether by one or more potential entrants), the availability of essential assets or facilities and the substitutability of the potential entrants' goods or services for those of the merged entity (for these purposes, low volume, localised entry or entry into a particular product or geographic niche is unlikely to be sufficient unless subsequent expansion can be fairly readily achieved within the three year time frame).

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<sup>14</sup> This is because entry that is sufficient to inhibit the exercise of market power by the merged entity will at least cause prices to fall to their pre-merger levels (see the third element referred to above).

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In evaluating barriers to entry the ERC will generally not attempt to identify specific firms that might enter the market; instead, it will assess the likelihood of entry in a generic sense.

Countervailing power

6.3.13 Countervailing power is considered generally in section 3.4 of this Guideline.

Dynamic characteristics of the market

6.3.14 The dynamic characteristics of markets are considered generally in section 3.5 of this Guideline.

6.3.15 A merger may involve the acquisition of technology, intellectual property and/or research & development facilities which may in turn prevent or hinder new competition. (Conversely, it may result in the combination of complementary technologies so as to create a stronger competitor and to increase competition in the relevant market).

Removal of a vigorous and effective competitor

6.3.16 The acquisition of a small competitor may result in a small increase in concentration. However, where that competitor has played a significant role in maintaining a competitive market (eg. by being particularly competitive, by being particularly innovative or by undermining attempts to coordinate market conduct through its independent behaviour), then the merger may have a significant adverse effect on competition in the relevant market which is considerably greater than might otherwise be expected on the basis of that competitor's relative market share. (Conversely, the merger of two small competitors may result in the creation of a more efficient business which is able to compete more effectively with larger competitors. However, in such a case, the ERC will need to be persuaded that this positive effect on competition is likely to be sustained and will not simply result in the merged entity being able to obtain higher market share or to coordinate its conduct with existing competitors).

6.3.17 At the other end of the scale, a merger might not have an anti-competitive effect if, in the absence of the merger, the target business would fail and its assets would exit the relevant market. However, for the ERC to be persuaded that this is the case (and that a competitor should be allowed to acquire those assets solely on this basis) the ERC will need to be persuaded that:

- the business is highly likely to fail (it not being possible to successfully reorganise it); and
- there is no other viable buyer whose acquisition of the assets would not raise competition concerns, and there is no likelihood of such a buyer emerging, so that the assets are indeed likely to exit the market (and not be redeployed in it) following the failure of the business.

Conversely, it may be that the exit of those assets from the market is likely to have a less anti-competitive effect than allowing those assets to be purchased by the relevant competitor.

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### Vertical integration

- 6.3.18 Vertical mergers may involve no increase in concentration but may enable the extension of market power into a vertically-related market. A vertically integrated entity which has a substantial degree of power in either an upstream or a downstream market might foreclose supply or customers to competitors: where a supplier with market power acquires a customer, competing suppliers may be deprived of the opportunity to supply goods or services to that customer; where a customer with market power acquires a supplier, competing customers may be deprived of the opportunity to acquire goods or services from that supplier. In such a case there might be a substantial lessening of competition in that vertically-related market. Alternatively, vertical integration might result in the elimination of a vigorous and effective competitor in a downstream market, thereby facilitating collusion in an upstream market.
- 6.3.19 Vertical integration might also preclude the development of competition where the vertically integrated incumbent can discriminate in providing access to an essential input or can gain access to commercially sensitive information regarding the activities of its competitors in the downstream market.
- 6.3.20 Finally, where vertical integration closes off independent sources of supply or outlets for distribution, this may increase barriers to entry because new entrants will be required to enter at all stages of the production/distribution process.

### Other factors

- 6.3.21 The list of factors discussed above is not exhaustive and the relevant factors in any particular case will depend upon the circumstances of the market which is being considered. For example, it may be that in a particular market the existence of imports will provide a competitive discipline on the merged entity and prevent it from exercising domestic market power. Conversely, the degree of competition in a market might be tempered because of historical links, contractual relationships or ownership structures (eg. common shareholders or directors) which reduce the rivalry between apparent competitors.
- 6.3.22 Moreover, a merger may result in efficiencies that have a positive effect on competition, eg. through enabling the merged entity to compete more effectively in the market as a result of it being able to realise economies of scale or scope (thereby enabling a reduction in unit costs and prices), to combine different capabilities or resources (eg. to combine a special technical expertise with a production process so as to improve and/or lower the cost of that process), to produce new or improved goods or services, or to enhance levels of service. In order to be taken into consideration, the magnitude, benefit and timing of the relevant efficiencies will need to be substantiated using credible evidence. The realisation of efficiencies is, however, unlikely to result in such a positive effect on competition in a market that a merger which results in a monopoly or near monopoly will not substantially lessen competition in that market. It should be noted that the mere fact that the merger will result in efficiencies that will enable

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that entity to compete more effectively will not suffice as a “public benefit” in the context of the authorization process (see section 6.4.20).

- 6.3.23 A merger between two entities that produce a differentiated product, albeit that those products are close substitutes, may also reduce competition in the market in which those products are traded because it results in the elimination of two close rivals.

## **6.4 Clearances and authorizations**

### Clearances

- 6.4.1 The Competition Rules enable a person who proposes to directly or indirectly acquire shares or assets, or to merge or consolidate with another corporation, to apply to the ERC for a determination that the acquisition, merger or consolidation will not violate the merger prohibition (Rule 9(1)). Such a determination is referred to as a “clearance” and enables the parties to a proposed acquisition, merger or consolidation to obtain certainty as to whether or not the acquisition, merger or consolidation will violate the merger prohibition on the grounds of its actual or likely effect on competition. The ERC must (and can only) give a clearance if it determines that the acquisition, merger or consolidation will not violate the merger prohibition (Rule 9(9)).
- 6.4.2 It is important to appreciate that a clearance may only be granted in respect of a proposed merger, ie. the ERC cannot grant a clearance if the relevant person has acquired the shares or assets, or undertaken the merger or consolidation, prior to the ERC making a determination in respect of the application for the clearance (Rule 9(29)).
- 6.4.3 For so long as the clearance remains in force, the applicant may acquire shares or assets, merge or consolidate in accordance with the clearance (Rule 9(10)) (but see section 6.4.5). A clearance will expire 6 months after the date on which it is given unless the ERC determines a later expiry date. This does not mean that the acquisition, merger or consolidation will violate the merger prohibition on the expiry of the clearance. It simply means that, unless the acquisition, merger or consolidation is effected within this time period, it may not proceed under the protection of the clearance (Rule 9(8), (10)).
- 6.4.4 A person applying for a clearance must include, in its application, such particulars as are required for that purpose by the ERC and must provide such further information as the ERC requires for the purpose of determining whether or not to give the clearance (Rule 9(2), (3)(a)). The applicant must also pay the costs of any external consultants engaged by the ERC for the purpose of advising it on matters relating to the application for clearance (including in connection with the collection and assessment of competition-related information during the period referred to in section 6.4.5) (Rule 9(3)(b)).
- 6.4.5 Because a clearance will typically be applied for before the proposed merger becomes public, and therefore the ERC will be prevented from making market inquiries at that stage without the applicant’s consent (Rule 9(13)), the applicant is

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precluded from acquiring the relevant shares or assets, or undertaking the relevant merger or consolidation, until the expiry of:

- 60 days after the proposed acquisition, merger or consolidation has been made public; or
- such shorter period as is permitted by the ERC (Rule 9(11)).

This will give the ERC the opportunity to make market inquiries prior to the merger taking effect (but after the proposed merger has become public) and therefore the opportunity to revoke or amend the clearance in the limited circumstances set out in section 6.4.7 below. The type of market inquiries the ERC may wish to make could, for example, include enquiries of competitors, suppliers, customers, industry associations, governmental agencies and departments and consumer groups. A person who acquires shares or assets, or undertakes a merger or consolidation, prior to the expiry of the relevant period in violation of this prohibition may be fined up to P5million and may be required to do, or restrained from doing, a specified act or thing until the ERC has determined whether or not the merger prohibition has thereby been violated (Rule 9(36), (37)).

6.4.6 In giving a clearance, the ERC may accept a written undertaking given by the applicant to dispose of specified assets or shares (Rule 9(30)). Such an undertaking may be given to address any concerns raised by the ERC that the proposed merger would have the effect or likely effect of substantially lessening competition in a relevant market.

6.4.7 If, at any time after granting a clearance, it appears to the ERC that:

- the clearance was given on the basis of information that was false or misleading or incomplete in a material particular; or
- an undertaking of the kind referred to in section 6.4.6 has not been complied with,

then the ERC may revoke or amend the clearance after providing interested persons with an opportunity to make comments in relation to that matter (Rule 9(31)-(33)). The knowing provision of false, misleading or incomplete information to the ERC may also result in a fine of up to P5 million (Rule 9(35), (37)(a)). In addition, a failure to comply with such an undertaking will render the offender subject to a range of punitive and remedial orders (Rules 9(34), 10).

6.4.8 The ERC will endeavour to deal with applications for clearance as expeditiously as possible and will generally render its determination on an application for a clearance within 60 days of the application being made. However, this time period may be extended by the time taken for the applicant to provide such additional information as the ERC may require for the purpose of determining that application.

6.4.9 A person who has applied for a clearance must not acquire the relevant shares or assets, or undertake the relevant merger or consolidation, until that application has been determined by the ERC (Rule 9(5)) (although the application may be withdrawn at any time prior to its determination: Rule 9(4)). A person who violates

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this prohibition may be fined up to P5million and may be required to do, or restrained from doing, a specified act or thing until the ERC has determined whether or not the merger prohibition has thereby been violated (Rule 9(36), (37)).

#### Authorizations

- 6.4.10 Authorization is the process of granting immunity, on public benefit grounds, for mergers which would or might violate the merger prohibition. It is a public process in which any interested party may participate. Subject to certain protections for confidential information (see section 10 of this Guideline), both the application for authorization and any comments pertaining to it will be made available to the public.
- 6.4.11 The Competition Rules enable a person who proposes to directly or indirectly acquire shares or assets, or to merge or consolidate with another corporation, to apply to the ERC for an authorization to acquire those shares or assets, or to undertake that merger or consolidation, where the acquisition, merger or consolidation would have (or might have) the effect of substantially lessening competition in a market and therefore might violate the merger prohibition (Rule 9(14)). The ERC must (and can only) grant an authorization if it determines that the acquisition, merger or consolidation will in the circumstances result, or be likely to result, in such a benefit to the public that it should be allowed to take place (Rule 9(26)).
- 6.4.12 It is important to appreciate that an authorization may only be granted in respect of a proposed merger, ie. the ERC cannot grant an authorization if the relevant person has acquired the shares or assets, or undertaken the merger or consolidation, prior to the ERC making a determination in respect of the application for the authorization (Rule 9(29)).
- 6.4.13 For so long as the authorization remains in force, the applicant may acquire shares or assets, or undertake the merger or consolidation, in accordance with the authorization (Rule 9(28)). An authorization will expire 6 months after the date on which it is granted unless the ERC determines a later expiry date. This does not mean that the acquisition, merger or consolidation will violate the merger prohibition on the expiry of the authorization. It simply means that, unless the acquisition, merger or consolidation is effected within this time period, it may not proceed under the protection of the authorization (Rule 9(24), (28)).
- 6.4.14 A person applying for an authorization must include, in its application, such particulars as are required for that purpose by the ERC and must provide such further information as the ERC requires for the purpose of determining whether or not to grant the authorization (Rule 9(15), (18)(a)). The applicant must also pay the costs of any external consultants engaged by the ERC for the purpose of advising it on matters relating to the application for authorization (Rule 9(18)(b)).
- 6.4.15 The ERC must publish notice of such an application in at least two newspapers of general circulation and that notice must specify the manner in which, and the time by which, any comments in relation to the application must be made to the ERC (the ERC may separately give notice of the application to any person who, in the

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ERC's opinion, is likely to have an interest in the application) (Rule 9(16), (17)). Before determining an application for an authorization, the ERC may hold a hearing or may prepare a draft determination for public comment and, in any event, must take into account any comments made by the applicant or by any other person (Rule 9(21)). In addition the ERC may, for example, seek the views of government agencies and departments.

6.4.16 An authorization may be granted subject to such conditions as the ERC considers appropriate (Rule 9(24)) and, in granting an authorization, the ERC may accept a written undertaking to dispose of assets or shares (Rule 9(30)). Such an undertaking may be given to address any concerns raised by the ERC that the proposed merger would have the effect or likely effect of substantially lessening competition in a relevant market.

6.4.17 If, at any time after granting an authorization, it appears to the ERC that:

- the authorization was granted on the basis of information that was false or misleading or incomplete in a material particular; or
- a condition to which the authorization is subject (including compliance with an undertaking of the kind referred to in section 6.4.16) has not been complied with,

then the ERC may revoke or amend the authorization after providing interested persons with an opportunity to make comments in relation to that matter (Rule 9(31) – (33)). The knowing provision of false, misleading or incomplete information to the ERC may also result in a fine of up to P5 million (Rule 9(35), (37)(a)). In addition, a failure to comply with a condition to which an authorization is subject will render the offender subject to a range of punitive and remedial orders (Rules 9(34), 10).

6.4.18 A person who has applied for an authorization must not acquire the relevant shares or assets, or undertake the relevant merger or consolidation, until that application has been determined by the ERC (Rule 9(20)) (although the application may be withdrawn at any time prior to its determination: Rule 9(19)). A person who violates this prohibition may be fined up to P5million and may be required to do, or restrained from doing, a specified act or thing until the ERC has determined whether or not the merger prohibition has thereby been violated (Rule 9(36), (37)).

#### Public benefit test

6.4.19 As stated in section 6.4.11, the ERC is only to grant an authorization if it determines that the merger will in the circumstances result, or be likely to result, in "such a benefit" to the public that the merger should be allowed to take place. The "such a benefit" test does not simply entail weighing benefits against anti-competitive detriment (as is the case with the test for authorization that applies in respect of the anti-competitive agreement and price-fixing prohibitions). The "such a benefit" test requires a greater degree of public benefit to be demonstrated because a merger will generally remove competition between the two parties for all

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time. In applying the “such a benefit” test, the Competition Rules (Rule 9(27)) require the ERC to regard as a benefit to the public:

- any efficiencies that the ERC considers will result, or will be likely to result, from the merger to the extent that those efficiencies will benefit the public; and
- where one of the parties to the merger is a distribution utility or an affiliate of a distribution utility – improved reliability of service by, reduction of costs of, and compliance with any performance standards prescribed in the Implementing Rules and Regulations made under the EPIRA by, that distribution utility (or its successor).

#### Efficiencies

6.4.20 Public benefits in the form of efficiencies are particularly important because increased efficiency results in lower unit costs and therefore the potential for lower prices. Efficiencies may take the form of, for example, economies of scale or scope, the introduction of more efficient technology or the combination of complementary research & development facilities. To qualify as a public benefit, the claimed efficiencies will need to be substantiated by factual material.

#### Distribution utilities

6.4.21 The requirement to regard, as a benefit to the public, improved reliability of service by, reduction of costs of, and compliance with performance standards by, a distribution utility flows from section 23 of the EPIRA which is designed to encourage distribution utilities to pursue structural and operational reforms so as to enable the achievement of economies of scale in utility operations.

#### Other public benefits

6.4.22 However, these are not the only forms of public benefit that the ERC may consider. In this context, public benefit will be given a broad meaning and may include matters such as the following:

- economic development, eg. through the encouragement of research and capital investment;
- increased business efficiency;
- industrial rationalisation resulting in more efficient resource allocation;
- employment growth;
- improvements in the quality and safety of goods or services;
- the expansion of consumer choice;
- the supply of better information to customers and businesses to permit informed choices; and
- the promotion of industry cost savings resulting in contained or lower prices to consumers.

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In order for a benefit to be a public benefit it must benefit the public. Accordingly where, for example, it is only stockholders who receive the benefit (eg. through higher profits and dividends) this will not be a public benefit. Conversely, while lower prices are likely to be a public benefit (at least if the quality of, and services associated with, the relevant product are not diminished), a benefit may be a public benefit even if it does not manifest itself in lower prices to consumers. This is because, for example, the public may also benefit from the more efficient use of resources (eg. because this will enable those resources to be used in the production of other goods and services), better quality goods and services and a greater choice of goods and services.

#### Evaluation of public benefits

- 6.4.23 Applications for authorization must clearly set out the claimed public benefits, how they relate to the proposed merger, and their likely magnitude, durability and timing. General statements about possible or likely benefits will not be given much weight unless they are supported by factual material. In addition, the applicant must be able to demonstrate that there is a necessary connection between the claimed public benefits and the proposed merger, ie. that the claimed public benefits are a direct result of the merger and not of some other circumstance.

#### Public detriment

- 6.4.24 In assessing whether the “such a benefit” test is met, the ERC will also consider any public detriment that may result from the merger (eg. a reduction in consumer choice due to the rationalisation of product lines). In this context, public detriment is wider than the notion of anti-competitive effect although any adverse effects on competition will be a primary consideration.

#### Timing

- 6.4.25 The ERC will endeavour to deal with applications for authorization as expeditiously as possible, while complying with the requirements of the Competition Rules. Accordingly, the ERC will generally render its determination on an application for an authorization within 120 days of the application being made (although a longer time may be required where the matter is particularly complex or the ERC holds a hearing, or prepares a draft determination, in relation to the application). This time may be further expanded by the time taken for the applicant to provide such additional information as the ERC may require for the purpose of determining the application.
- 6.4.26 Because the Competition Rules enable parties to apply for a clearance or authorization if they are in doubt as to whether or not a proposed merger will violate the merger prohibition, the ERC will not give “informal” approval to a proposed merger (including by way of the issue of a letter of comfort). However, ERC staff are available to discuss issues relating to the application of the Competition Rules with concerned parties.

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## **7. PENALTIES**

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### **7.1 Orders where violation of the Competition Rules**

7.1.1 Rule 10 of the Competition Rules provides for an extensive range of remedial and punitive orders that the ERC may make against a person who violates a “primary provision” of the Competition Rules. For these purposes, a “primary provision” includes the anti-competitive agreement prohibition, the price-fixing prohibition, the misuse of market power prohibition, the merger prohibition, a condition of an authorization, a divestiture undertaking or a remedial or punitive order itself (Rule 3(1)).

7.1.2 The orders that may be made in such a case include:

- a cease and desist order;
- an order requiring rectification of the violation or remediation or mitigation of its consequences – for example, an order requiring the rescission or variation of an agreement that violates the anti-competitive agreement prohibition or the price-fixing prohibition, an order not to enforce such an agreement or specified provisions of it, an order requiring the refund of money or return of property, and an order requiring a person to (or not to) carry on a particular business or to (or not to) undertake particular operations;
- an order requiring the payment of a fine or penalty of up to P50 million;
- an order requiring the disgorgement of profits;
- an order requiring an offending electric power industry participant to separate its business activities into different juridical entities;
- an order fixing or controlling the price at which electricity (or related goods or services) may be supplied or acquired by the offender;
- an order revoking or modifying a certificate of public convenience and/or necessity, or a licence or permit, held by the offender; and
- an order requiring the offender to divest assets or shares.

7.1.3 Where a person has violated a primary provision, the ERC will make the order or orders that it considers are apt to deal with the particular violation.

7.1.4 Accordingly, the ERC will generally only make a divestiture order where the merger prohibition has been violated or in the case of the most serious violations of the misuse of market power prohibition. Similarly, only serious violations will warrant the revocation of a certificate of public convenience and/or necessity or of some other licence or permit held by the offender. Conversely, less serious violations are more likely to render the offender liable to just a pecuniary penalty. Indeed, in the case of minor violations, the ERC might choose to issue a warning notice to the

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offender, while indicating that a subsequent violation will be dealt with more severely.

- 7.1.5 In the case of a foreign merger which results in a violation of the merger prohibition (see section 6.2.11), it may well be that the issue of a divestiture order by the ERC is of little practical effect – at least to the extent that it would otherwise require the divestiture of shares or assets that are located outside the Philippines and so its enforcement would be dependent upon a foreign jurisdiction making the required orders. In such a case, the ERC is more likely to make an order that an entity in the merged corporate group which is located in the Philippines cease to conduct a particular business, or an order revoking or modifying a certificate, licence or other authority held by such an entity, at least where this results in a reduction in the market power of the merged corporate group that was obtained through the merger.
- 7.1.6 The ERC will generally only make an order regulating the price of electricity (or of other related goods or services) as an interim measure (eg. pending a divestiture) because ongoing price control is time-consuming, resource-intensive and likely to have a distortionary effect on the market.
- 7.1.7 Most orders are also likely to be at least accompanied by a cease and desist order, ie. an order requiring the offender to stop engaging in the conduct that constitutes the violation.

## **7.2 Matters to be taken into account in making orders**

- 7.2.1 In determining the orders that should be made where the Competition Rules have been violated, the ERC will have regard to the need:
- to punish and deter violations (by ordering the payment of fines and penalties);
  - to ensure that offenders do not profit from their violations (by making an order for the disgorgement of profits); and
  - to ensure that any such violation is rectified, and that the consequences of that violation are, as far as practicable, remedied (by making an order for rectification and/or remediation).
- 7.2.2 Rule 10(3) of the Competition Rules lists some of the matters to which the ERC must have regard in determining the appropriate order or orders to make.
- 7.2.3 So, for example, the ERC will impose heavier punitive penalties (ie. fines) the more serious the violation (see Rule 10(3)(a), (c)). Consistently with this, “hard core cartels” – such as price fixing, bid rigging and market sharing – are likely to be the subject of severe penalties. This is because such agreements, arrangements or understandings are inherently anti-competitive and will generally have a direct detrimental effect on both consumers and the broader economy. Similarly, repeat offenders will also be the subject of more severe punitive penalties (see Rule 10(3)(e)).

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- 7.2.4 The ERC is also required to have regard to the conduct of the person since the violation occurred (see Rule 10(3)(g)). Accordingly, the ERC may choose to impose a lesser penalty (or even no penalty at all) where:
- a member of a cartel discloses the existence of the cartel to the ERC in circumstances where the ERC is not already aware of its existence (or alleged existence) and that party cooperates fully and frankly in any investigation of the cartel, and in any proceedings against members of the cartel, under the Competition Rules; or
  - a person who has violated the Competition Rules has promptly redressed the consequences of that violation.
- 7.2.5 In addition, the ERC must take into account the circumstances in which the violation took place (Rule 10(3)(d)). For instance, a retailer who enters into an agreement with a supplier under which the resale price for a particular product is fixed will violate the price-fixing prohibition. However, if the retailer only entered that agreement because the supplier (who had a substantial degree of power in the market in which the product is traded) threatened to withhold supply of the product to the retailer in the absence of such an agreement, then the ERC is likely to impose a smaller penalty than if the retailer had voluntarily entered into a price-fixing arrangement. This will particularly be so if the retailer promptly reports the matter to the ERC and cooperates in any subsequent investigation of, and proceedings against, the supplier. Equally, if the ERC determines that the primary purpose of action which amounts to a violation of the Competition Rules is not an anti-competitive purpose then it might take this into account in determining the level of any punitive penalty that is to be imposed. However, it should be reiterated that an anti-competitive purpose is generally not a prerequisite to a violation of the Competition Rules. Moreover, ignorance of the Competition Rules is no defence and will not be considered to be a mitigating factor.
- 7.2.6 Another of the matters to which the ERC must have regard in determining the appropriate order or orders to be made, at least where the offender is a corporation, is whether the corporation exercised due diligence to prevent the violation (including through the creation and maintenance of a corporate culture that requires compliance with the Competition Rules) (Rule 10(3)(h)). One of the ways in which due diligence can be evidenced is through the implementation of an effective compliance program. At the very least a compliance program will need to meet the following requirements to be effective:
- it must enjoy clear and ongoing support and personal commitment from senior management;
  - it must be underpinned by a clear policy commitment to compliance with the Competition Rules (perhaps reinforced through incentives for compliance, through disciplinary arrangements for non-compliance and through compliance with and knowledge of the Competition Rules being an element of individual performance appraisal);

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- it must include procedures that enable employees to check whether or not a particular course of action is likely to violate the Competition Rules (eg. through nominating a compliance officer who can be contacted for this purpose);
  - it must be communicated to all relevant employees (eg. through the issue of a manual or handbook);
  - all relevant employees must be trained on compliance with the Competition Rules and with the firm's internal policies and procedures which are designed to ensure that compliance, and periodic refresher training courses must be undertaken; and
  - procedures must be implemented (and followed) to enable the regular evaluation of the effectiveness of the compliance program (these should include formal audits of compliance, both with and without warning).

### **7.3 Pre-emptive orders**

7.3.1 Where the ERC has reason to believe that a person is likely to violate a primary provision, it may issue an order requiring that person not to engage in conduct in violation of that provision (Rule 10(5)). This will enable the ERC to act to prevent a violation of the Competition Rules rather than having to wait until the violation has occurred and then try to redress the consequences. Such a power is particularly important in the context of mergers where it will be preferable to restrain the merger from being effected rather than to impose divestiture or business conduct requirements to address the consequences of that merger.

7.3.2 A breach of such a "pre-emptive" order is punishable by a fine of up to P5 million (Rule 10(6), (7)).

### **7.4 Other offenders**

7.4.1 It should be noted that it is not only persons who violate a primary provision who will be subject to the orders described above. The ERC may also make such orders against those who attempt to violate such a provision or who are in some other way involved in or associated with the violation (Rule 10(1), (5)).

### **7.5 Procedure**

7.5.1 The Complaint Procedure Rules set out the requirements with which the ERC must comply in determining whether the Competition Rules have been violated and in making any punitive or remedial order under the Competition Rules.

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## **8. INFORMATION GATHERING**

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### **8.1 Introduction**

8.1.1 The Competition Rules confer extensive powers on the ERC in connection with the investigation of actual or potential violations of them. The purpose of these powers is to enable the ERC to obtain the information which it needs to apply and enforce the prohibitions in the Competition Rules. Effective powers of investigation are critical to deterring violations of the Competition Rules.

### **8.2 Provision of information, production of documents and giving of evidence**

8.2.1 Rule 12(1) of the Competition Rules provides that, if the ERC has reason to believe that a person is capable of providing information, producing documents or giving evidence relating to a matter that constitutes (or may constitute) a violation of the Competition Rules, then the ERC may, by written notice, require that person to provide that information, produce those documents or give that evidence (see also Rules 12(2)-(6) which contain ancillary provisions). A person who does not comply with such a notice without lawful excuse may be fined up to P5million (Rule 12(9)(a), (d), (11), (12)). A lawful excuse would, for example, include the exercise of the privilege against self incrimination. In addition:

- a person who, pursuant to a notice, knowingly provides false or misleading information or knowingly gives false or misleading evidence; and
- a person who destroys or disposes of, conceals or alters or falsifies documents that are required to be produced pursuant to a notice (or who causes or permits such destruction, disposal, concealment, alteration or falsification),

will also be liable to such a fine (see Rule 12(9)(b), (c)).

8.2.2 A notice requiring the provision of information, the production of documents or the giving of evidence may be served on a person at any time during the course of an investigation (including before or after documents are inspected pursuant to the power of entry and inspection described in section 8.3). For example, a notice requiring the provision of information may be served on a person where the ERC requires explanation of a document that it has obtained under a previous notice (or pursuant to the exercise of the power of entry and inspection described in section 8.3). Indeed, more than one such notice may be served on a particular person during the course of an investigation (eg. as where the ERC requires further information after considering material produced pursuant to an earlier notice).

8.2.3 A notice requiring the provision of information, the production of documents or the giving of evidence may be served on any person, not just the person who is believed to have violated the Competition Rules. For example, the notice may be served on suppliers, customers or competitors of that person if the ERC has reason to believe that they are capable of providing information, producing documents or giving evidence relating to the actual or possible violation.

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8.2.4 For these purposes a “document” is widely defined, eg. it includes information recorded or stored on a computer (Rule 3(1)). Moreover, the information that can be required to be provided is not confined to information that is already compiled or that is already in a recorded form – for instance, the ERC could require a person to provide market share information, which might require the compilation of a range of sales data. In setting the time within which information must be provided, the ERC will consider the amount and complexity of the information required and the urgency of the case.

### **8.3 Entry into premise and inspection of documents**

8.3.1 Rule 12(7) of the Competition Rules provides for the ERC to authorize its representatives to enter any premise, and to inspect and copy any documents, where the ERC has reason to believe that a person has (or may have) violated the Competition Rules (see also Rule 12(10)). However, in the absence of a warrant, such entry requires the consent of the person who occupies or is in charge of the premise (Rule 12(8)). A person who, without lawful excuse, refuses or fails to make the relevant documents available for inspection or copying may be fined up to P5million (Rule 12(9)(e), (11), (12)). It is not necessary that the person who occupies or is in charge of the premise be suspected of a violation of the Competition Rules for the ERC to exercise this power of entry and inspection.

8.3.2 As a matter of practice, before entering the premise, the ERC representative or representatives will produce evidence of their identity and authorization and will advise the person who occupies or is in charge of the premise of his or her right not to consent to entry. That person will also be advised of their right to contact a lawyer to obtain advice as to whether or not to consent to the entry (and subsequent inspection of documents).

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## 9. EXCLUSIONS

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- 9.1 Rule 7(1) of the Competition Rules sets out various matters that are to be disregarded in deciding whether the Competition Rules have been violated. These matters include:
- things specifically authorized or required by any law or the rules and regulations issued implementing such a law;
  - things relating to employment;
  - contractual provisions in an agreement for the sale of a business relating to the protection of the goodwill of that business;
  - licence conditions relating to patents, utility models, industrial designs, layout designs of integrated circuits or copyrights – these kinds of intellectual property are the subject of statutory monopolies granted under the Intellectual Property Code and the Competition Rules are not intended to impinge on those monopoly rights;
  - contractual provisions relating to the use of trademarks, service marks or collective marks in so far as they relate to the kinds, qualities or standards of goods or services that may be produced or supplied under those marks – this exception recognizes that the value of such a mark is dependent on maintaining the standard of the goods or services which are supplied under it; and
  - things done in concert by consumers of goods or services (otherwise than in the course of trade or commerce) against the suppliers of those goods or services – this recognizes the right of consumers to collectively exercise “consumer power” (eg. through boycotting goods or services for political, health, safety or environmental reasons).
- 9.2 In addition, neither the anti-competitive agreement prohibition nor the price-fixing prohibition applies to:
- the WESM Rules in the form in which they were initially promulgated;
  - the Grid Code or the Distribution Code as amended from time to time with the ERC’s approval; or
  - a transition supply contract that is made in accordance with section 67 of the EPIRA and approved by the ERC (Rule 7(3)).
- 9.3 The exemption of the Grid Code and the Distribution Code, at least in so far as amendments to them are approved by the ERC, is on the basis that the ERC can, prior to approving any amendment to them, consider whether that amendment would violate the anti-competitive agreement prohibition or the price-fixing prohibition and, if so, whether that amendment would meet the test for authorization (see section 4.6). If an amendment would not meet that test, the ERC would be likely to reject it.
- 9.4 The exemption of the WESM Rules in the form in which they were initially promulgated “grandfathers” them from the application of the Competition Rules. So, for example,

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because this version of the WESM Rules allows zonal pricing (under which each customer in a zone faces the same price for electricity consumed) there is no question of this being prohibited by the price-fixing prohibition. However, unlike the Grid Code and the Distribution Code, amendments to the WESM Rules are not generally subject to ERC approval. Accordingly, any subsequent amendment to them will need to comply with the Competition Rules and, if it does not, will (where appropriate) need to be the subject of an application for authorization to the ERC.

- 9.5 The exemption of transition supply contracts approved by the ERC is consistent with the requirement under section 67 of the EPIRA that National Power Corporation negotiate such contracts with distribution utilities. Because these contracts require the approval of the ERC, the ERC is able to take into account competition matters when determining whether or not to approve them.

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## 10. CONFIDENTIALITY

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- 10.1 Rule 13 of the Competition Rules deals with the confidentiality of information provided to the ERC.
- 10.2 The general rule is that all applications, documents, information and comments made or provided to the ERC for the purposes of the Competition Rules may be disclosed by the ERC, and that copies of all determinations made by, and details of all undertakings accepted by, the ERC must be made available to the public by the ERC (Rule 13(1), (2)). The exception is a determination by the ERC not to grant a clearance.
- 10.3 However, a person who makes an application or provides any comments, documents or information to the ERC may, at that time, notify the ERC that all or some of the contents of such application, comments, documents or information are confidential. In such a case, the ERC must not disclose those confidential contents without that person's consent unless such disclosure is necessary to enable a determination by the ERC to be properly understood or unless the ERC considers that the advantages of disclosure outweigh the prejudice caused by it (Rule 13(3), (4)). In the latter case, the ERC must give 10 days written notice of its intention to disclose those contents.
- 10.4 In addition, applications, documents, information, comments, determinations and undertakings made, provided or given in relation to a clearance for a share or asset acquisition, or a merger or consolidation, are required to be kept confidential by the ERC until the time (if any) the relevant acquisition, merger or consolidation is made public (Rule 13(5)).

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## **11. OTHER PROHIBITIONS AND REPORTORIAL REQUIREMENTS**

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### **11.1 Other prohibitions**

11.1.1 The EPIRA (s.45) and the Implementing Rules and Regulations issued pursuant to the EPIRA (r.11):

- prohibit a company, related group or IPP administrator, singly or in combination, from owning, operating or controlling more than 30% of the installed generating capacity of a grid or more than 25% of the national installed generating capacity;
- prohibit a distribution utility from sourcing more than 50% of its total demand from an affiliated generator through bilateral power supply contracts; and
- prohibit a distribution utility (for the first 5 years from the establishment of the WESM) from sourcing more than 90% of its total demand through bilateral power supply contracts.

11.1.2 Rule 14 of the Competition Rules defines certain terms that are relevant to these prohibitions – namely, the installed generating capacity of a grid (Rule 14(2)), the national installed generating capacity (Rule 14(3)), bilateral power supply contracts (Rule 14(5)(a)), total demand (Rule 14(5)(b)) and an isolated grid (Rule 14(6)). Rule 14 also deals with the notional attribution of generating capacity to entities for the purposes of these prohibitions where relevant (Rule 14(4)).

11.1.3 The Business Separation Guideline effectively prohibits TRANSCO (or its buyer or concessionaire) and distribution utilities from:

- cross-subsidizing the cost of providing unregulated services through the prices charged for regulated services; and
- (subject to certain exceptions) encumbering their network assets.

11.1.4 The prohibitions described in sections 11.1.1 and 11.1.3 are deemed to be incorporated in the Competition Rules with the consequence that a violation of them is also a violation of the Competition Rules (Rules 14(7), 15(2)). As a result, and by virtue of the definition of “primary provision” in Rule 3(1), the provisions of the Competition Rules relating to penalties and information gathering (Rules 10 and 12, described in sections 7 and 8 respectively) apply to violations of these prohibitions.

### **11.2 Compliance with conditions and orders**

11.2.1 The ERC may require a person to provide it with information regarding that person’s compliance with a condition of an authorization or clearance (see sections 4.6 and 6.4) or with an order made by the ERC (see section 7) (Rule 16(1)). A failure to provide that information may result in a fine of up to P5million (Rule 16(6)),

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(7)). The exercise of this information-gathering power is an important means by which the ERC can monitor compliance with its determinations.

### **11.3 Reportorial requirements**

11.3.1 In order to enable the ERC to monitor compliance with certain requirements of the EPIRA (namely, the prohibitions described in section 11.1.1 and the requirement that shareholdings in distribution utilities must be dispersed), and in order to enable the ERC to monitor potential anti-competitive behaviour, the Competition Rules require the relevant electric power industry participants to periodically file specified information with the ERC (Rule 16(2)-(5)).

11.3.2 A failure to comply with these information filing requirements is punishable by a fine of up to P5 million (Rule 16(6), (7)).

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## **12. AMENDMENT OF COMPETITION RULES**

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- 12.1 Rule 17 of the Competition Rules provides that, subject to the provisions of any other applicable law, they may be amended from time to time by the ERC. This may be necessary, for example, to take account of relevant developments in the electric power industry.
- 12.2 However, before making any revisions to the Competition Rules, the ERC will generally undertake a process of consultation with relevant persons.
- 12.3 In accordance with Rule 17 of the Competition Rules, no amendment made to them by the ERC may operate retrospectively.
- 12.4 In addition, the Competition Rules are required to be applied by the ERC consistently with such policies relating to the electric power industry as the Department of Energy may promulgate from time to time (Rule 18(4)).