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COMMERCE COMMISSION

# Decision No. 545

Determination pursuant to the Commerce Act 1986 in the matter of an application for clearance of a business acquisition involving:

**GALLAGHER HOLDINGS LIMITED**

**and**

**TRU-TEST CORPORATION LIMITED**

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| **The Commission:** | Paula Rebstock<br>Denese Bates QC<br>Peter JM Taylor |
| **Summary of Application:** | The acquisition by Gallagher Group Holdings Limited of up to 100% of the ordinary shares of Tru-Test Corporation Limited including the proposed divestment of the Stafix brand. |
| **Determination:** | Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission determines to decline to give clearance to the proposed acquisition. |
| **Date of Determination:** | 23 February 2005 |

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## EXECUTIVE SUMMARY

### The Proposal

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 15 November 2004 (the Application). The notice sought clearance for the acquisition by Gallagher Group Holdings Limited (Gallagher) of up to 100% of the ordinary shares of Tru-Test Corporation Limited (Tru-Test). The Application states that Gallagher would undertake to divest the Stafix brand of electric fencing post-acquisition.
2. An Application for a similar acquisition by Gallagher of Tru-Test was registered 19 May 2004. The difference between that application and the current Application is that the former involved a divestment undertaking to sell the PEL brand of electric fencing. On 26 August 2004 the Commerce Commission (the Commission) declined to give clearance to that previous application due to competition concerns in the national market for the manufacture and wholesale supply of rural and security electric fencing products ( the electric fencing market), *Decision 531: Gallagher Holdings Limited and Tru-Test Corporation Limited* (the Previous Gallagher Decision).

### Relevant Markets

3. The Commission adopts as the relevant markets those markets it identified and investigated in the Previous Gallagher Decision as there have been no material changes since that decision. In the Previous Gallagher Decision, the Commission found that the proposed acquisition would be unlikely to lead to a substantial lessening of competition in five of the six markets investigated. The Commission is not aware of any material changes to factors relevant to those five markets and therefore remains satisfied that the acquisition proposed in the Application is unlikely to result in a substantial lessening of competition in those markets.
4. The Commission's investigation of the acquisition proposed in the Application has focused on the likely effects it will have on the remaining market, the electric fencing market. This involves primarily an assessment on whether the Stafix divestment and other post-acquisition market related factors will provide a competitive constraint on the combined Gallagher/Tru-Test entity that is not substantially less than would exist if the acquisition did not proceed.

### Counterfactual & Factual

5. The Commission considers that the appropriate counterfactual continues to be the status quo, with two strong competitors (Gallagher and Tru-Test) competing for reseller shelf space through offering competitive terms and rebates, innovation, multiple brands and service.
6. In establishing the factual, the Commission has had to fully investigate the terms and nature of the Stafix divestment and assess all relevant risks associated with it. This is necessary as so much will rest on the divested Stafix business to be able to constrain the much larger combined entity. This is because (as outlined below) other potential constraints such as other competitors, potential competition and import substitution, and countervailing power of customers, are unlikely to constrain the combined entity.

7. In order to make this risk assessment, the Commission has considered:

- **composition risks**: these are risks that the scope of the divestiture package may be too constrained, or not appropriately configured, to attract a suitable purchaser, or may not allow a purchaser to operate effectively and viably in the market;
- **purchaser risks**: these are risks that a suitable purchaser is not available or that the merger parties will dispose to a weak or otherwise inappropriate purchaser; and
- **asset risks**: these are risks that the competitive capability of a divestiture package will deteriorate prior to completion of divestment, for example, through loss of customers or key members of staff.[1]

8. The Commission considers that the risk framework provides a useful way of clarifying risks that are inherent in divestment undertakings and ensures that the Commission has made a thorough analysis of all factors relevant to the factual.

9. In assessing the risks, the Commission reached the following views:

- **composition risks**: the Applicant would be committing to something over which currently it has no control and has little information about. Nonetheless, the Commission considers that the terms of the divestment include the asset base and other elements required by a new owner to operate Stafix as a separate business. However the Commission notes that the divestment will involve the extraction of assets and employees from an integrated manufacturing and sales operation. There are some risks associated with this, but the Commission does not regard these to be of primary concern.
- **purchaser risks:** post-acquisition, the Applicant would face conflicting incentives, both to obtain the highest price for Stafix, and to sell to a weak competitor. Interest in the Stafix business has been received from other rural product suppliers who can to various degrees bundle other products sold to rural resellers (complementary buyers). A complementary buyer seems to be a logical buyer for Stafix but the Commission can not rule out that a stand-alone, and potentially weaker buyer will make the purchase. The Commission concludes that there is uncertainty over the nature and strength of the buyer of the Stafix brand. The Commission has therefore investigated the risks associated with both a complementary and stand-alone buyer owning the Stafix business, post-acquisition.
- **asset risks:** the Stafix brand could weaken and its market share erode during the divestment period, for the following reasons:
  - the threat of minority shareholder action resulting in a period of uncertainty, where the Stafix brand would be likely to deteriorate;

[1] This framework is based on the approach used by the United Kingdom Competition Commission. The Commission recognises that the United Kingdom Competition Commission has greater power to recommend actions (structural and/or behavioural) to be taken by the applicant, to remedy, mitigate or prevent a substantial lessening of competition arising from the acquisition. Nevertheless, the Commission considers that this categorisation of types of risk provides a useful way for the Commission to ensure it has made a thorough assessment of all issues pertinent to the divestment and establishing the factual.

- reduced marketing and sales effort arising from employee related factors, including possible distraction from normal duties as a result of the sales process;
- the combined entity having an incentive to erode the assets of the Stafix brand, thereby reducing its market share and the ability of a new owner to provide a competitive constraint post divestment; and
- domestic and export customers stocking the Stafix brand may switch to other brands. [

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The Commission therefore considers the factual would be that the Stafix brand is:

- sold with an asset base to become a going concern, but there may be delays and complications over its establishment;
- likely to be sold to a business currently involved in the rural/agri-tech industry, although there is also a possibility that the buyer might not be involved in the rural/agri-tech industry; and
- [ ].

**Competition Analysis**

*Existing Competition*

10. The acquisition would lead to a significant change in the market structure, from one with two relatively strong competitors, to a situation where the strengthened combined entity would have around [ ]% of the market, with the new owner of Stafix having [ ]. Post-acquisition, fringe competitors would continue to have a market share of around [ ]. The Commission considers that these fringe competitors are unlikely to provide the combined entity with a competitive constraint.

11. The post-acquisition market share of the Stafix brand is based on its current sales as being part of Tru-Test. While Stafix was once a separate business before Tru-Test purchased it in 1998, and has a good reputation, there is no recent track record type information to help assess how market share will hold up under new and separate ownership.

12. Post-acquisition, the buyer would face competition from the combined entity with approximately [ ] times the market share and a high level of reputation and experience in the manufacture and supply of electric fencing products. Thus the Commission has analysed the barriers to expansion in order to assess the ability of the new owner of Stafix to restore, maintain and grow sales and thereby compete in a way that is not too dissimilar to that under the counterfactual.

13. Post-acquisition, a new owner of Stafix would need to continue to have access to the main rural resellers in order to stay competitive. Access to resellers should be easier if the new owner of Stafix is already involved in the rural/agri-tech industry (a complementary buyer). However, the Commission considers the following factors will undermine the new owner's ability to have ongoing access to resellers:

- not having multiple electric fencing brands to be used as ‘fighting brands’;
- difficulties supporting a sufficient R&D programme; and
- the need to offer competitive volume-based rebates.

14. In addition to the above factors, if the new owner of Stafix is not currently involved in the rural/agri-tech industry (a stand-alone buyer), it would also face the following factors in obtaining and maintaining access to resellers:
    - the need to re-establish distribution channels; and
    - the need to combat bundled product options.

15. The new owner of Stafix, whether complementary or stand-alone, would also face other disadvantages to maintaining and expanding sales because the combined entity:
    - would have a much larger market share, [ ];
    - would hold commercially sensitive trading information about Stafix;
    - could pursue a multi-brand strategy by offering resellers exclusive access to its various brands, whereas the new entrant would only be able to compete using the single Stafix brand;
    - could use its portfolio of multiple brands, to allow it to benefit from strong economies of scope and scale not enjoyed by the new entrant; and
    - would own Speedrite (which is virtually identical to the Stafix brand), which it could easily use to strategically undercut Stafix.

16. The Commission has taken into consideration the uncertainties and risks inherent in the Stafix divestment, including Stafix having no separate track record in the recent past or under the new ownership, and that post-acquisition there would be:
    - a significant change in the market structure to one being lop-sided, with the combined entity having about [ ] times the market share of the Stafix business;
    - a lack of competition from fringe competitors; and
    - high barriers to expansion faced by the new owner of Stafix and other disadvantages such that there is considerable doubt as to Stafix’s ability to recover any lost market share and provide a credible constraint to the combined entity in its first two years.

17. The Commission concludes that the combined entity is unlikely to face existing competition anywhere near to the degree and intensity that exists in the counterfactual

<u>Barriers to Entry and Potential Competition</u>

18. In the Previous Gallagher Decision, the Commission found that overseas suppliers were unlikely to enter the New Zealand market. The Commission considers that without access to a known brand and high joule energiser technology and other factors entry, whether by an overseas operator or from

within New Zealand, would not be likely to occur within the next two years on a sufficient scale as to provide a credible constraint to the combined entity.

19. Accordingly, the Commission does not consider there to be potential entry capable of preventing the combined entity from raising its prices, or reducing the quality of product and service it currently provides.

Countervailing Power of Buyers

20. The majority of electric fencing products sold in New Zealand are through the main rural resellers, such as RD1, Wrightsons, and Williams & Kettle. Losing an account and thereby not being able have product on sale at any such reseller would have a significant impact on overall sales and market share. Under the counterfactual, the resellers are able to apply buying pressure against the two suppliers because of their ability to switch supply if they are unhappy with the price, product or other terms of supply.

21. The Commission considered whether Stafix would be likely to be a credible alternative, and whether switching costs are likely to be incurred by resellers. The ability of Stafix to provide both a short and long term credible alternative to the combined entity depends largely on the level of support it receives from large resellers. [

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22. Under the factual, the resellers would have very limited options to switch between suppliers of a full range of electric fencing products, and thus would be unable to exert countervailing power that is currently available to them under the counterfactual. For these reasons, the Commission considers that proposed acquisition would likely lead to a substantial loss of countervailing power for resellers.

**Overall Conclusion and Determination**

23. In conclusion, the Commission is uncertain as to the nature of the buyer of the Stafix business, and it's level of market share post acquisition. Therefore, the Commission is uncertain as to whether the new owner would be able to sufficiently constrain the much larger combined entity to ensure that a substantial lessening of competition does not occur. The new owner of Stafix (whether complementary or stand-alone) would likely face a lower post divestment market share compared to pre-acquisition levels, and would face high barriers to expansion to recover the lost market share and grow sales in the future.

23. Therefore the Commission is not satisfied that, post-acquisition, the combined entity would be constrained by the combination of:

- the new owner of the divested Stafix business;
- the continued presence of the other small suppliers of electric fencing products;

- potential competition by de-novo entry or from overseas suppliers; and
- countervailing power of rural resellers,

to the degree necessary to maintain competition at the level and quality that is not substantially less than will exist if the acquisition does not proceed (the counterfactual).

24. For these reasons, the Commission is not satisfied that the proposed acquisition, with divestment of the Stafix brand, would not have, nor would be likely to have, the effect of substantially lessening of competition in the electric fencing market.

25. Accordingly, pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission determines to decline to give clearance for the proposal for Gallagher to acquire up to 100% of the ordinary shares of Tru-Test.

## THE PROPOSAL

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 15 November 2004. The notice sought clearance for the acquisition by Gallagher Group Holdings Limited (Gallagher) of up to 100% of the ordinary shares of Tru-Test Corporation Limited (Tru-Test). The Application states that Gallagher would undertake to divest the Stafix brand of electric fencing post-acquisition.

## PROCEDURE

2. Section 66(3) of the Act requires the Commerce Commission (the Commission) either to clear, or to decline to clear, the acquisition referred to in a s 66(1) notice within 10 working days unless the Commission and the person who gave notice agree to a longer period. An extension of time was agreed between the Commission and the Applicant. Accordingly, a decision on the Application was required to be made by 25 February 2005. The decision was made on 23 February 2005.

3. The Applicant sought confidentiality for specific aspects of the Application and the provisions of the Official Information Act 1982 apply.

4. The Commission's approach to analysing the proposed acquisition is based on principles set out in the Commission's *Merger and Acquisition Guidelines*.[2]

## FRAMEWORK

5. Under s 66 of the Act, the Commission may grant clearance for an acquisition where it is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in a market. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.[3]

6. The Commission considers it is necessary to identify whether there is likely to be a real lessening of competition that is not minimal.[4] For the purposes of its analysis, the Commission is of the view that a lessening of competition and the creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.

7. If the Commission considers there is a lessening of competition it must determine whether the lessening is substantial. A substantial lessening of competition will be evidenced by the potential for the combined entity post-acquisition to achieve an increase in price or a reduction in service, quality, or innovation, sustained for a period of two years.

8. The substantial lessening of competition test was considered in *Air New Zealand & Qantas v Commerce Commission,* where the Court held:

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[2] Commerce Commission, *Mergers and Acquisition Guidelines*, January 2004.

[3] *Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission* (1992) 4 TCLR 713-722.

[4] See *Fisher & Paykel Limited v Commerce Commission* (1996) 2 NZLR 731, 758; Port Nelson Limited v Commerce Commission (1996) 3 NZLR 554.

> We accept that an absence of market power would suggest there had been no substantial lessening of competition in a market but do not see this as a reason to forsake an analysis of the counterfactual as well as the factual. A comparative judgment is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, i.e. dominance has been attained. We consider, therefore, that a study of likely outcomes, with and without the proposed Alliance, provides a more rigorous framework for the comparative analysis required and is likely to lead to a more informed assessment of competitive conditions than would be permitted if the inquiry were limited to the existence or otherwise of market power in the factual.[5]

9. Where the Applicant considers there may be a substantial lessening of competition post-acquisition, but that the lessening would be mitigated by employing a structural remedy, section 69A of the Act provides that the Commission may accept a written undertaking given by, or on behalf, of the Applicant to dispose of assets or shares. An undertaking given to the Commission is deemed to form part of the clearance.[6]

10. If, absent the divestment, the Commission considers that there would or would be likely to be a substantial lessening of competition, the Commission proceeds on the basis that the undertaking forms part of the application. In establishing the factual, the Commission assumes the Applicant will be under an obligation to divest the assets or shares, on the terms offered by the Applicant. The comparison between the factual and the counterfactual will test whether the divestment would, of itself, or in combination with other market conditions enable the Commission to be satisfied that there is not likely to be a substantial lessening of competition.

11. Divestments are to some extent uncertain as to their eventual impact on the market. In this particular case, the divestment offered by the Applicant will form the bases of the future main competitor to the combined entity. Later in this decision, the Commission has found (as it did in the Previous Gallagher Decision) that competition from other electric fence suppliers is fringe only, and there is little prospect of potential competition from de-novo entry or from overseas through the presence of high entry barriers. Where so much rests on the divestment, the Commission must be satisfied that the divested business will, on terms offered, be capable of constraining the combined entity at substantially the same level as applies in the counterfactual. If the divested business fails or ends up being an ineffectual competitor, then a substantial lessening of competition will inevitably occur, and consumers will be harmed. Thus it is important for the Commission to consider all the relevant risks associated with the divestment proposal.

12. In order to make this assessment, the Commission will consider:

    - **composition risks**: these are risks that the scope of the divestiture package may be too constrained, or not appropriately configured, to attract a suitable purchaser, or may not allow a purchaser to operate effectively and viably in the market;

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[5] *Air New Zealand & Qantas Airways Ltd v Commerce Commission,* unreported HC Auckland, CIV 2003 404 6590, Hansen J and K M Vautier, Para 42.

[6] Commerce Act, s69A(3).

- **purchaser risks**: these are risks that a suitable purchaser is not available or that the merger parties will dispose to a weak or otherwise inappropriate purchaser; and
- **asset risks**: these are risks that the competitive capability of a divestiture package will deteriorate prior to completion of divestment, for example, through loss of customers or key members of staff.[7]

13. These risk assessments are made and taken into account when establishing the factual, and in the competition assessment, particularly the section on existing competition.

## THE PARTIES

### Gallagher

14. Gallagher manufactures and supplies animal and security management systems in New Zealand and to over 100 countries around the world. Gallagher's key products are:
    - rural and security electric fencing products (its main brand is "Gallagher");
    - animal weighing systems;
    - contract manufacturing;
    - security access control products; and
    - fuel dispensing products.

15. Gallagher manufactures and supplies gates and gate hardware through its fully owned subsidiary Franklin Machinery Limited (Franklin). Gallagher has been operating in New Zealand since the 1930s, and employs around 450 staff in New Zealand. Gallagher's total group revenue for the year ending 30 June 2003 was $[ ], of which approximately [ ]% was derived from exports.

### Tru-Test

16. Tru-Test is a public unlisted company whose 200 shareholders include its management [ ] and a range of family trusts and private investors. Gallagher recently acquired [ ]% of Tru-Test's shares. Like Gallagher, Tru-Test manufactures and supplies animal and security management systems in New Zealand and to over 70 countries worldwide. Tru-Test's key products are:
    - rural electric fencing and security electric fencing (under the "Stafix", "PEL", and "Speedrite" brands);
    - conventional fencing (under the "Cyclone" brand);[8]
    - animal weighing systems;

[7] This framework is based on the approach used by the United Kingdom Competition Commission. The Commission recognises that the United Kingdom Competition Commission has greater power to recommend actions (structural and/or behavioural) to be taken by the applicant, to remedy, mitigate or prevent a substantial lessening of competition arising from the acquisition. Nevertheless, the Commission considers that this categorisation of types of risk provides a useful way for the Commission to ensure it has made a thorough assessment of all issues pertinent to the divestment and establishing the factual.

[8] Tru-Test recently sold its Cyclone Wire division to Pacific Wire Ltd. However, Tru-Test continues to manufacture and distribute Cyclone products under licence to Pacific Wire.

- contract manufacturing;
- milk metering equipment;
- shearing products; and
- brain monitoring equipment.

17. Tru-Test has been trading in New Zealand in its current form since 1963. Its group revenue for the year ended 31 August 2004 was $[ ].

## PREVIOUS DECISIONS

18. The Commission has previously considered electric fencing industries in four Commission investigations.[9] The most relevant and recent investigation is *Decision 531: Gallagher Holdings Limited and Tru-Test Corporation Limited* (Previous Gallagher Decision).

### Previous Gallagher Decision

19. A notice pursuant to s 66(1) of the Act was registered on 19 May 2004. This notice sought clearance for the acquisition by Gallagher of up to 100% of the ordinary shares of Tru-Test. This proposal was amended on 20 July 2004 to include a divestment undertaking whereby Gallagher undertook to divest the PEL brand of electric fencing.

20. On 26 August 2004, the Commission declined to give clearance to the proposed acquisition by Gallagher of Tru-Test because it considered that in the market for electric fencing, the loss of existing competition between Gallagher and Tru-Test as a result of the acquisition would be substantial. The Commission concluded that:

    - the combined entity would have had a market share of [ ]% in the electric fencing market before incorporating Gallagher's proposal to divest the PEL brand of rural electric fencing products;
    - there would be high barriers to expansion and entry, limited expansion by existing small competitors or new entrants, and limited countervailing power of rural resellers;
    - although the divestment of PEL would reduce the combined entity's market share in respect of rural electric fencing products from [ ]% to [ ]%, the proposed acquisition would still result in a very significant loss of existing competition. [

      ] further undermined its ability to act as an effective constraint on the combined entity post-acquisition;
    - in the counterfactual, Gallagher and Tru-Test would remain two relatively equally matched competitors that would continue to compete strongly in terms of price and innovation; and

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9 *Tru-Test Ltd / Stafix Electric Fencing Limited*, 27 May 1998 (BAE: 686 J2871); Tru-Test / PEL, 14 August 2001 (J4561); *Steel & Tube Holdings Limited / Hurricane Wire Products Limited*, 23 June 2003 (295213-1, J5800); and *Gallagher Holdings Limited and Tru-Test Corporation Limited*, 26th August 2004.

- the divestment of PEL would be unlikely to restore the strong existing competition in the factual within two years.

21. In the Previous Gallagher Decision, the Commission also considered a number of other markets in the agricultural industry, namely: the conventional wire fencing market; the fence posts market; the North Island gates market; the South Island gates market; and the animal weighing systems market. In each of these markets, the Commission found that the proposed acquisition would be unlikely to lead to a substantial lessening of competition due to sufficient existing competition

## INDUSTRY BACKGROUND

22. The current acquisition relates to rural and security electric fencing and to a range of other agricultural supplies. The nature of each of these products was discussed in detail in the Previous Gallagher Decision. The Commission adopts its description of the nature of the relevant products and industry background in the Previous Gallagher Decision as there as has been no material changes to the industry.[10]

23. Gallagher and Tru-Test are agri-tech businesses[11] that supply rural and electric fencing products to seven rural resellers and a large number of small independent resellers, that on-sell the products to farmers. These large rural resellers account for approximately 85% of all fencing retail sales. The remaining 15% is sold through independent rural resellers or building supply stores. The major rural resellers are:
    - RD1;
    - Wrightson;[12]
    - Williams & Kettle (W&K);
    - Allied Farmers Limited (Allied Farmers);
    - Pyne Gould Guinness (PGG);
    - CRT Society Limited (CRT); and
    - Farmlands Trading Society Limited (Farmlands).

## MARKET DEFINITION

24. The Commission adopts its analysis of the various markets in the Previous Gallagher Decision as there have been no material changes in the electric fencing market since the Previous Gallagher Decision.[13] Further, the Applicant and other industry participants have not suggested any alternative market definition for electric fencing, or asked the Commission to revisit the issue of market definition.

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[10] Previous Gallagher Decision, paragraphs 44-65.

[11] Agri-tech businesses are generally defined as those manufacturing electronic or technological agricultural or farming products such as electronic animal scales, automated milking machines, or milk meters.

[12] Wrightson is in the process of acquiring W&K.

[13] Previous Gallagher Decision, paragraphs 77-227.

25. The market that raises competition concerns is the national market for the manufacture and wholesale supply of rural and security electric fencing products (the electric fencing market).

26. The main focus of the Commission's analysis in respect of the electric fencing market is rural electric fencing, which represents [ ]% of the market. Security electric fencing, which makes up the remainder of the market, uses the same IP and manufacturing processes as are required to make rural electric fencing products. This is more fully discussed in the competition analysis below.

## COUNTERFACTUAL AND FACTUAL

27. As noted above, when determining whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a "with" and "without" comparison rather than a "before" and "after" comparison. The comparison is between two hypothetical future situations, one with the acquisition (the factual) and one without (the counterfactual).[14] The difference in competition between these two scenarios can be attributed to the impact of the acquisition, and helps to establish if there is likely to be a substantial lessening in competition.

### Counterfactual

28. The appropriate counterfactual is the status quo, as Tru-Test is unlikely to be sold, and would, but for the proposed acquisition, remain a strong competitor. While investigating the current Application, the Commission has obtained a large amount of up-to-date information that reinforces this conclusion**.**

29. Tru-Test confirmed to the Commission that it has no intention of ceasing to trade, and that it would continue to compete with Gallagher in the rural electric fencing market. In particular, Tru-Test would continue to compete [ ]

30. [ ]

31. [ ]

32. [ ] In the interim, it would continue to compete strongly with Tru-Test.

33. The Commission notes that Gallagher has followed Tru-Test and has commenced adopting a multi-brand strategy using two brands: Franklin and

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[14] Commerce Commission, *Decision 410: Ruapehu Alpine Lifts Ltd/Turoa Ski Resorts Ltd (in receivership),* 14 November 2000, paragraph 240, p 44.

Gallagher. At present, Franklin is sold only through Farmlands in the North Island. [

]

34. In September 2004, Gallagher was also actively competing for [ ] stated that:

> We are enjoying some of the most competitive offerings that we have ever had out of the two companies.

35. The Commission concludes that the appropriate counterfactual would be the continuation of the status quo, with two strong competitors strongly competing in the rural electric fencing market for customer sales through reseller's shelf space, competitive terms and rebates, innovation, a multi-brand strategy and service.

**Factual**

36. The Commission has to determine the likely factual position assuming the acquisition does proceed. The term "the combined entity" refers to the entity that comes into being if Gallagher acquires Tru-Test.

37. When an Applicant undertakes to divest shares or assets, the undertaking forms part of the clearance application. In establishing the factual, the Commission must therefore predict the likely state of the market subsequent to the proposed acquisition and divestment.

38. As outlined above, to make this assessment, the Commission has regard to the categories of composition risk, purchaser risk, and asset risk.

39. The Commission considers that the risk framework provides a useful way of identifying the risks that are inherent in divestment undertakings and ensures that the Commission has made a thorough analysis of all factors relevant to the factual.

*Composition Risks*

40. In examining the composition risks of the proposed divestment undertaking, the Commission has assessed whether the terms of the proposed divestment undertaking contain all the components integral to producing the product or operation being divested.

41. The Commission notes there is an important complication with this proposed divestment. The present Application involves a hostile takeover, and Gallagher is proposing to divest an asset it does not own. Gallagher stated:

> [
>
> ]

42. The Commission recognises that the Applicant is committing to something over which currently it has no control and has little information about. Nevertheless, the Commission accepts that the Applicant must divest, as it has undertaken to do so.

43. In the Previous Gallagher Decision, the Commission identified a number of concerns with the terms of the proposed PEL undertaking that led to doubt as to whether the divestment of PEL would be practical.[15] In the current Application, the terms of its new proposed Stafix undertaking go some way to address these concerns. The terms of Gallagher's undertaking to divest the Stafix brand are outlined in Appendix Two.

44. The Applicant submitted that the terms of the proposed Stafix divestment undertaking would be unlikely to hinder its practical divestment since:
    - the manufacture of Stafix could be outsourced;
    - there would be no scope for Gallagher to "cherry pick" any iconic or important Stafix products; [16]
    - there would be no restriction on export territories, meaning that the new owner would obtain sufficient critical mass; and
    - there would be royalty-free access to all intellectual property (IP) (where this is the property of Tru-Test) necessary to manufacture the Stafix Products.

45. The Commission accepts that it is practical to outsource the manufacture of the Stafix product for the reasons it concluded the manufacture of PEL could be outsourced.[17]

46. However, the Commission was concerned that the PEL undertaking contained a "cherry picking" clause that would have allowed the combined entity to keep key PEL products and replace them with alternative, and in some cases less well known products.[18]

47. In this proposed acquisition, the Applicant undertakes to divest any plant and equipment required to manufacture the Stafix range.[19] The Commission understands that Stafix, Speedrite, and PEL share common equipment in respect of accessories, energiser casings and electronics. The Applicant also undertakes to divest all injection moulding tools, dies and test jigs specific to Stafix. This seems to allow a purchaser to have all the necessary means to manufacture the product. Gallagher advised the Commission that where there would be overlap between Stafix, Speedrite and PEL, the assets relevant to the manufacture of Stafix would still be divested:[20]

    > As discussed, our intent is that where there is such an overlap the relevant assets would still be divested… This would result in any assets required for Stafix, even if used also for Speedrite, being divested.

48. In the Previous Gallagher Decision, the Commission was also concerned that the territory of the PEL divestment undertaking was limited to New Zealand and Australia, so that the scope of sales in other international markets could be reduced, as could the extent to which an acquirer of PEL would be prepared to

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[15] Previous Gallagher Decision, paragraphs 231-253.
[16] For a full discussion on cherry picking and iconic products please refer to the Previous Gallagher Decision (Decision 531), paragraphs 241-252.
[17] Ibid, paragraph 241.
[18] Ibid, paragraph 244.
[19] This does not include generic equipment where necessary capacity can be readily accessed through outsourcing.
[20] Gallagher submission dated 3 December 2004.

invest in research and development.[21] In this proposed acquisition, the Applicant has addressed this concern in the undertaking by having no such restrictions on Stafix's export territories.

49. The proposed divestment undertaking states that the new owner of Stafix would have free access to all available documentation in relation to technical know-how, together with royalty-free access to all IP associated with Stafix. Therefore, a new owner of Stafix would be free to develop Stafix products and develop its own IP and technology as it sees fit, using existing Stafix IP.

50. The Commission considers that the terms of the divestment include the asset base and other elements required by a new owner to operate Stafix as a separate business. However, the Commission also notes that the divestment requires assets being extracted from an integrated operation. There is also the matter of employees and whether necessary expertise will transfer to the new ownership structure, or remain with the combined entity, or be lost elsewhere as a result of the unsettling effect acquisitions normally have. It is not a situation of, for example, of an established subsidiary company being divested, along with management, operations, systems, a market track record and financial accounts. There are inherent risks and time delays associated with the form of divestment proposed in this case. Nevertheless the Commission does not regard these risks to be of primary concern.

*Purchaser Risks*

51. The Commission has assessed purchaser risks that could arise with the divestment of the Stafix brand, namely:

- finding suitable buyers for the Stafix brand; and
- the combined entity selling to a weak buyer.

Suitable Buyers

52. The Commission investigated whether there were any companies that might be willing and able to purchase the Stafix brand. There are two categories of potential purchasers:

- **complementary buyer**: a new entrant to the electric fencing market but currently selling to large rural resellers in the rural/agri-tech industry; and
- **stand-alone buyer**: a new entrant to the electric fencing market, not currently supplying products to large rural resellers.

53. [ ] The potential buyers informed the Commission that they had not conducted due diligence, and so their expressions of interest were based on intuitive knowledge about the Stafix business and its compatibility with their own existing operations. For example, [ ]

> We will be doing due-diligence first before we can say with confidence we can penetrate the markets.

[21] Previous Gallagher Decision, paragraphs 541-544.

54. All of the interested buyers are to some extent complementary businesses that, to varying degrees, already have a presence as suppliers in the retail rural market. The interested buyers the Commission contacted are listed and described in Table 1.

55. [ ]

56. The Applicant has stated that a complementary business will be the more likely buyer than a stand-alone purchaser.[22] [ ]. However, there is no certainty that this will occur, as the sale might attract interest from stand-alone buyers. The Commission must therefore assess the risks associated with a sale of the business to such a buyer.

<u>Sale to a Stand-alone Buyer</u>

57. The combined entity could strategically divest the Stafix brand to a stand-alone buyer with the knowledge that they are unlikely to be as strong a competitor as a purchaser which is able to bundle other rural product lines for sale to resellers. The Commission would include as a ‘stand-alone’ buyer those that are only small suppliers to rural resellers, or supply a product that is completely unrelated to the supply of electric fencing products. The Commission considers that a stand-alone buyer would face considerable challenges in meeting rural resellers' requirements for new electric fencing products suppliers (as identified in the Previous Gallagher Decision):

- an established rural brand and reputation;
- an extensive distribution infrastructure - sales, marketing and technical support;
- a complete product range, including accessories and a range of high and low joule energisers;
- an ongoing programme for R&D; and
- bundled packages and competitive rebates.

58. However, the combined entity, wanting to maximise value, could have an incentive to accept high bids, which would be more likely to come from the

[22] Application at paragraph 12.10

range of interested complementary buyers already identified by the Commission. It is likely that a complementary buyer would value the Stafix business more than a stand-alone buyer and would therefore be willing to tender a higher bid for Stafix. If Gallagher accepted a lower bid from a weaker competitor, there would be a risk that Gallagher might never recoup the revenue lost from choosing not to sell to the highest bidder. Gallagher also runs the risk of action by any remaining Tru-Test minority shareholders claiming their interests were not taken into account, if it accepts a lower bid.

59. The Commission notes that Gallagher's proposed divestment undertaking does not require it to accept the highest bid price. The Commission accepts that a prudent seller would not commit itself to accepting the highest dollar value bid because it may be subject to undesirable conditions. Nevertheless, the opportunity remains for Gallagher to sacrifice a higher price for the assets in order to sell to a rival that would not be a strong competitor in the future. A weak competitor might quickly lose market share to a well-resourced and aggressive combined entity to the point where Stafix might be forced to exit the market, which would eliminate any potential source of constraint on the combined entity.

60. The combined entity might prefer such a strategy to one involving sale to the highest bidder, with resulting strong competition and lower profits in the electric fencing market.

61. Industry participants [ ] had similar concerns:

> If {Gallagher} sell {Stafix} to someone who doesn't have nouse in the market, it will be advantageous to them and disadvantage to us.

62. Post-acquisition Gallagher would own Speedrite, which is more or less identical to Stafix. The combined entity could utilise Speedrite to undertake aggressive strategic behaviour against the new entrant in a bid to drive it out of the market. A poorly-resourced rival strategically selected by Gallagher would be particularly vulnerable to a price war, and would be more likely to exit the market early, or be reduced to an inefficient competitor.

63. The Applicant has attempted to address the Commission's concern under Clause 6 of the proposed divestment undertaking which states:

> In accepting any offer for the Stafix business as outlined in this undertaking, Gallagher will accept the best offer for the business, taking into account all offers received, the price offered for the business assets and the terms of such offer but without taking into account any future competitive threat to Gallagher in the markets relevant to this application. The Commission will have the right to access and review all relevant information from Gallagher for the purpose of verifying compliance with this clause for a period of four weeks from the date the divestment has been confirmed in writing to the Commission in accordance with clause 4.

64. This undertaking does not address the Commission's underlying concern that the sale could be made to a buyer that is weak by reason of being a stand-alone purchaser or having a limited or ineffective range of complementary products necessary to satisfy the requirements of many of the resellers. Notwithstanding this, the Commission is uncertain as to the practical enforcement of such an undertaking, and whether it represents a behavioural undertaking.

<u>Conclusion on Purchaser Risks</u>

65. Given that the combined entity would have conflicting incentives, both to obtain the highest price for Stafix, and to sell to a weaker buyer, which could be complementary or stand-alone, the Commission concludes that there is uncertainty as to whom it would sell the Stafix brand.

66. While the Commission considers that it may be likely that the purchaser would be a complementary buyer, it is also possible that a stand-alone buyer may purchase the divested assets. Accordingly, the competition analysis takes into account both possibilities.

*Asset Risks*

67. The Commission spoke with a number of industry participants including rural resellers, existing competitors, and potential buyers in respect of the Stafix brand and the quality of its assets (its product range and market reputation). In general, many were positive about the Stafix brand, describing it as a potentially credible candidate for divestment because:

- it is a quality or premium brand;
- it has a higher market share than PEL; and
- it has a full range of energisers and accessories.

68. [ ] considered the brand to be "immediately tradeable". [ ] believed Stafix was the "most effective brand to divest". [ ] the Commission that Stafix was "a strong, well-known brand [ ]

> Stafix is a strong brand representing quality and importantly is the brand of choice of many of our customers.

69. [ ]

70. Notwithstanding Stafix's reputation as a quality brand in the electric fencing market, the Commission identified a number of asset risks which are discussed below.

71. A major asset risk is that there would be potential for sales and therefore market share of the Stafix brand in the electric fencing market to erode during the divestment period (between the acquisition and the completion of the divestment). There will inevitably be some disruption to production as the assets are removed and relocated and new suppliers for components brought on stream. Such an outcome may impact on the viability and competitiveness of the proposed divestment asset.

72. The potential decline in Stafix's market share and competitiveness during the divestment period might also result from the following factors:

- the threat of minority shareholder action;
- reduced marketing effort caused by transferring staff and/or low staff morale, or staff being distracted by the sales process;

- Gallagher may have a disincentive to promote or maintain the Stafix brand after acquiring control of Tru-Test or it might be distracted by other post-acquisition concerns; and
- domestic and export customers stocking the Stafix brand may switch to other brands.

Each of these factors is considered in further detail below.

73. The terms of the proposed divestment undertaking require Gallagher to divest the Stafix brand within six months of it declaring the proposed offer closed pursuant to the Takeovers Code Approval Order 2000. The Commission considers that there are three phases of the proposed acquisition that would be likely to have a competitive impact on the electric fencing market:
    - post-clearance, pre-acquisition, where both Gallagher and Tru-Test remain competitors, but uncertainty remains over the future of the Stafix brand and there is likely to be some erosion of Stafix's market share;
    - post-acquisition, pre-divestment, where the combined entity has control over the Stafix brand; and
    - post-acquisition, post-divestment, where Stafix would be owned by another party.

74. The Commission has assessed the first two phases in respect of the factual, while the third phase is considered in the competition analysis.

<u>Minority Shareholders</u>

75. During the Commission's investigation, Tru-Test suggested that Gallagher was unlikely to be able to follow through with the proposed divestment due to the threat of a possible action by minority shareholders.

76. In the present case, Tru-Test submitted that Gallagher would need to acquire 90% of Tru-Test before it could compulsorily acquire the remaining 10% necessary to ensure that it could follow through with the proposed divestment undertaking. Tru-Test was of the opinion that Gallagher would not be able to acquire 90% of the shares because a number of shareholders, particularly managing shareholders, would be opposed to the takeover and would refuse to sell.

77. Tru-Test submitted that, in the event that Gallagher acquired less than 90% but more that 50% of the company, Gallagher would still not be in a position to effect the divestment. Tru-Test argued that even though Gallagher could replace the board of directors with its own nominees, s131 of the Companies Act 1993 requires the directors to act in the best interests of Tru-Test rather than the acquiring company, Gallagher. Tru-Test submitted that it would not be in its best interests to divest Stafix given that it would be an important brand for the success of the company. Any attempt to make the divestment would be oppressive to minority shareholders and subject to possible challenge in court.

78. Tru-Test asserted that as the Commission cannot be certain that Gallagher would acquire sufficient shares in Tru-Test to make the divestment, it could not be satisfied that the proposed acquisition would not be likely to have the effect of substantially lessening competition in the market and should, therefore, decline to grant the clearance.

79. When the Commission approached Gallagher for a response to Tru-Test's submission, Gallagher indicated that it was aware of the issues. Counsel for Gallagher stated:

> With respect, Mr Dunning's submissions under the heading "Unconditional not defined", raise issues that are issues for Gallagher to consider in progressing with a takeover offer and should be of little or no consequence to either the Commission or Tru-Test. If Gallagher are unable to comply with the undertaking to divest it will be Gallagher that is ultimately responsible and potentially liable should it proceed with the takeover regardless.

80. The Commission has formed the view that a minority shareholder action is possible but it is not able to predict with confidence how the issues raised above will eventually be played out if the acquisition was able to proceed. However, what is relevant for the present purposes is that there are uncertainties over how and when the divestment will proceed. This in turn creates risk that the Stafix brand and its business may deteriorate in the process. Potential buyers may lose interest and existing rural resellers of Stafix may also reconsider supporting a brand that has uncertainty, and switch to another.

81. The Commission considers that this would be an asset risk.

<u>Reduced Marketing Effort and Staff Considerations</u>

82. Mergers and acquisitions create uncertainties for employees, particularly those employed by the target company. In this case, the combination of a hostile takeover situation, and that part of the target business is to be sold off to an unknown buyer, would be very unsettling for the employees involved in the manufacture and marketing of the Stafix products. The loss of key staff during the divestment period is a possibility that can not be discounted, or controlled by the parties. Those that remain may have low morale affecting their work. Erosion of production and sales effort can also occur through unintended neglect on the part of the Applicant while it would be preoccupied with integrating Tru-Test's various (non-electric fencing) business lines with its own. The Commission considers these factors can ultimately harm sales and brand reputation.

<u>Combined Entity's Incentives To Maintain Stafix</u>

83. The Commission considered whether there would be any incentive for the combined entity to erode the market share of the Stafix brand during the divestment period.

84. Post-acquisition, the combined entity may have an incentive to reduce the level of service and marketing support for Stafix while under its control, instead promoting the Speedrite range, which is more or less identical.[23] This would give Stafix a weaker starting point relative to Speedrite, making it easier for the combined entity to win market share from the new entrant, post-divestment. The Applicant may strategically choose to maintain the Stafix brand only to a level that ensures it is a saleable asset, that is to the extent where it might be sold, rather than investing additional resources to further develop the brand. However, such a strategy is dependent on the combined entities desire or otherwise to obtain the best price for Stafix as possible.

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[23] Speedrite and Stafix are almost identical in all respects (technology and features, extent of range, accessories), differing only the appearance of a few energisers.

85. The Commission notes that Clause 2 of the proposed divestment undertaking states that the combined entity would not rationalise the management, staff, plant and machinery of Gallagher and Tru-Test's electric fencing businesses (ring-fencing) during the divestment period. The Applicant considered that this would provide a motivation for itself to divest the Stafix business as soon as possible in order to integrate the electric fencing businesses, and to achieve any available synergies

86. The result of any neglect on the part of the Applicant, intentional or otherwise, could be detrimental to the Stafix brand. Stafix would not enjoy the full support available to other products in the Applicant's portfolio of brands, which would place it at an immediate disadvantage relative to the combined entity.

87. In summary, the combined entity would have opposing incentives to obtain the highest price for Stafix, and therefore to preserve its present market share, and to erode the assets of the Stafix brand, thereby reducing its market share and the ability of a new owner to provide a competitive constraint post divestment. In addition, the Stafix brand could be unintentionally neglected while under the control of the Applicant, and may fail to enjoy the full support available to the Applicant's other brands.

88. Given these conflicting incentives, the Commission concludes that there would be uncertainty over Stafix's share in the electric fencing market being maintained and the longer term impact it may have on its reputation as a quality brand, post divestment.

<u>Resellers Switching</u>

89. The Commission acknowledges that with the sale of any business, customers may use the opportunity to seek out other supply options. It therefore examined the likelihood of this occurring in this case and the likely competitive impact.

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100. The Commission acknowledges that some resellers would prefer the strong competitive tension that currently exists because, in their view, prices are currently at their most competitive. [

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101. There are numerous examples of industries in New Zealand where buyers have tended not to support an entrant bringing significant new competition to a market, even though failure of the entrant through lack of support was likely to lead to a resumption of less competition and higher prices. This is discussed further in the Countervailing Power of Buyers section in the competition analysis.

102. [

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Export Customers Switching

103. [

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104. [

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105.

**Table 3: Breakdown of Stafix's Total Domestic and Export Sales 2004**

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106. [

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107. [

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108. [

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109. [

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110. [

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111. [

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112. [

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113. [

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114. [

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Conclusion on Asset Risks

115. In the factual there is what the Commission considers to be a real asset risk that in the market for electric fencing, the Stafix brand could deteriorate, and that its market share would erode during the divestment period. The potential decline in Stafix's market share during the divestment period would be likely to result from:

- the threat of minority shareholder action resulting in delay and uncertainty;
- reduced marketing and sales effort arising from employee uncertainty and related factors including being distracted by the sales process;
- the combined entity having some incentive to erode, or to neglect, the assets of the Stafix brand, thereby reducing its market share and the ability of a new owner to provide a competitive constraint post divestment;
- [ ].

116. These risks are relevant to the Commission's assessment of the likelihood of the divested Stafix business constraining the combined entity, which is further discussed in the Existing Competition section below.

*Conclusion on the Factual*

117. In assessing the composition, purchaser, and asset risks, the Commission has reviewed all matters relevant to the divestment, considered how they relate to each other, and identified several areas of uncertainty.

118. The terms of the proposed divestment undertaking offered by the Applicant go some way to ensuring that Stafix could be practically divested. However, the divestment requires disaggregating a production and sales operation; it is not currently operated as a separate entity or company, which would make for a

cleaner and more robust separation. Accordingly there exists some composition risk.

119. In respect of purchaser risks, the Applicant would have conflicting incentives, both to obtain the highest price for Stafix, and to sell to a weak competitor, which could be a complementary buyer or a standalone buyer. The Commission concludes that there is uncertainty over the strength of the buyer the Applicant may divest the Stafix brand to. Accordingly, the competition analysis will take into account both buyer scenarios.

120. The asset risks are that the Stafix brand could erode during the divestment period. The potential decline in Stafix's market share during the divestment period would be likely to result from:

- the threat of minority shareholder action resulting in delay and uncertainty;
- reduced marketing and sales effort arising from employee and related factors;
- the combined entity having an incentive to erode the assets of the Stafix brand, thereby reducing its market share and the ability of a new owner to provide a competitive constraint post divestment; and
- domestic and export customers stocking the Stafix brand may switch to other brands.

121. The risks discussed above will be taken into account in the following Competition Analysis section.

122. The Commission considers the factual would be that the Stafix brand would be:

- sold with an asset base to become a going concern, but there may be delays and complications over its establishment;
- sold to a business currently involved in the rural/agri-tech industry , although there is also a possibility that the buyer might not be involved in the rural/agri-tech industry; and
- [ ]

## COMPETITION ANALYSIS

### Existing Competition

123. Existing competition occurs between those businesses in the market that already supply the product, and those that could readily do so by adjusting their product-mix (near competitors). Supply-side substitution by near competitors arises either from redeployment of existing capacity, or from expansion involving minimal investment, in both cases involving a delay of no more than one year.

124. An examination of concentration in a market can provide a useful indication of the competitive constraints that market participants may place upon each other, providing there is not significant product differentiation. Moreover, the increase in seller concentration caused by a reduction in the number of competitors in a market by an acquisition is an indicator of the extent to which competition in the market may be lessened.

125. A business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

- the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is below 70%, the combined entity (including any interconnected or associated persons) has less than in the order of a 40% share; or
- the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is above 70%, the market share of the combined entity is less than in the order of 20%.

126. The Commission considers the appropriate measure to determine market share in this market is the revenue earned from the sales of the products represented in the electric fencing market. Table 4 sets out the estimated market shares of the combined entity and other competitors in the electric fencing market, based on figures provided by the Applicant and information obtained in the course of the Commission's investigation.[24]

**Table 4: Estimated Market Shares for the Rural and Security Electric Fencing Market 2003/04**

| **Company** | **2002/03 ($)** | **Market share (%)** | **2003/04 ($)** | **Market share (%)** |
|---|---|---|---|---|
| Gallagher | [ ] | [ ] | [ ] | [ ] |
| Tru-Test | [ ] | [ ] | [ ] | [ ] |
| **Combined Entity** | **[ ]** | **[ ]** | **[ ]** | **[ ]** |
| Stafix | [ ] | [ ] | [ ] | [ ] |
| Others | [ ] | [ ] | [ ] | [ ] |
| **Total** | **[ ]** | **100** | **[ ]** | **100** |

127. Based on current market shares, the combined entity would have a market share of [ ]%, while Stafix would have a market share of [ ]%. Fringe competitors represent around [ ]% of the market. The market shares in the electric fencing market would therefore be outside the Commission's safe harbours guidelines.

128. Security electric fencing products represent only [ ]% of the total market for electric fencing. In the Previous Gallagher Decision, the Commission found there to be supply-side substitution between security and rural electric fencing products. The new owner of Stafix would have the relevant IP and documentation to manufacture security energisers. As the new owner of Stafix would already be producing rural energisers, due to the strong supply-side substitutability, it would likely be able to adapt its manufacturing to supply security energisers within a one year time-frame.

129. If the new owner of Stafix were unable to provide a credible constraint in respect of rural electric fencing, it would be unlikely to provide a sufficient constraint in security electric fencing. The Commission's analysis in terms of

[24] The market share figures are based on Gallagher's year end of 30 June 2003 and Tru-Test's year end 30 August 2003. O'Brien is now active in the electric fencing market and as at June 2004 had sold approximately $[ ] worth of electric fencing accessories.

existing competition will therefore focus on rural electric fencing products, which account for [ ]% of the market, as this would capture any substantive competition issues that may arise from this proposed acquisition.

130. Table 5 sets out the brand shares for rural electric fencing products. It shows that, compared to the counterfactual, the proposed acquisition would alter the market structure from two major competitors, to a stronger entity with around [ ]% and a weaker competitor, namely Stafix, with market share of around [ ]%. However what is important to the Commission's assessment in this case is that Stafix's existing market share is based on sales made as being part of Tru-Test. It does not presently operate as an independent competitor, with a business and market track record. (It was operated as a separate business before it was purchased by Tru-Test in 1998.) It will be the creation of a divestment, and the risk associated with this have been outlined in the factual. Furthermore Stafix's market would be likely to erode, and might drop to as low as [ ]%, while the combined entity's could increase to as much as [ ]%.

**Table 5: Estimated Brand Market Shares for Rural Electric Fencing Products, 2002/03 and 2003/04**

| Brand | 2002/03 ($) | Market Share (%) | 2003/04 ($) | Market Share (%) |
|---|---|---|---|---|
| Gallagher | [ ] | [ ] | [ ] | [ ] |
| Franklin* | [ ] | [ ] | [ ] | [ ] |
| Speedrite | [ ] | [ ] | [ ] | [ ] |
| PEL | [ ] | [ ] | [ ] | [ ] |
| **Combined Entity** | **[ ]** | **[ ]** | **[ ]** | **[ ]** |
| | | | | |
| Stafix | [ ] | [ ] | [ ] | [ ] |
| Others | [ ] | [ ] | [ ] | [ ] |
| **Total** | **[ ]** | **100** | **[ ]** | **100** |

* Gallagher introduced the Franklin range of electric fencing products as a house brand supplied to Farmlands only in January 2004.

131. In the Previous Gallagher Decision, the Commission assessed the extent of competition between Gallagher and Tru-Test, in the factual and counterfactual, in terms of shelf space, price, product range and innovation.[25] The prospective loss of competition between Gallagher and Tru-Test was considered to be significant as the two currently compete strongly. The substantial loss of existing competition evident in the factual relative to the counterfactual was considered unlikely to be restored by the divestment of the PEL brand, or by the activities of fringe competitors. The Commission concluded that the proposed acquisition in that case was likely to lead to a very significant reduction in existing competition, despite the proposed divestment.[26]

132. Table 5 shows that in the rural electric fencing market, fringe competitors such as Taragate, O'Brien, and Robertson Engineering have a market share of [ ]%. Gallagher stated in its Application that the combination of a new owner of Stafix and other existing suppliers would provide sufficient constraint on the combined

[25] Previous Gallagher Decision, paragraphs 282-295.
[26] Previous Gallagher Decision, paragraphs 303-305.

entity. In the Previous Gallagher Decision, the Commission considered that the small existing competitors would be unlikely to prevent the combined entity from raising prices or reducing quality post-acquisition. In this case, the Commission has found no evidence or reason to change this conclusion.

133. The Commission spoke with a number of industry participants about the Stafix brand, including rural resellers, existing competitors and potential buyers. In general, many were positive about the Stafix brand, describing it as a potentially credible constraint on the combined entity because:

- it is a quality or premium brand;
- it has a higher market share than PEL; and
- it has a full range of energisers and accessories.

134. However, resellers also expressed concern that a significant loss of competition would arise, post-acquisition, notwithstanding the divestment of Stafix. Resellers said that their concerns about the loss of competition expressed in the Previous Gallagher Decision had not substantially altered in considering Stafix as a competitor. For example, [ ]

> In summary, there is healthy competition in the market at present. Under the new Gallagher proposal I see that there is too high a risk of this changing.

*Expansion of Stafix*

135. The market share of the combined entity would be nearly [ ] times larger than the current market share of Stafix. As discussed in the factual, Stafix's market share could be eroded to as low as [ ], which would move over to the combined entity, thereby growing the disparity. Even if evidence of this erosion was not available, the Commission would still have concerns arising from the lop-sided nature of the post-acquisition market. This is primarily because the Stafix business has no trading history or track record as an independent business and the other risk factors surrounding the divestment outlined earlier.

136. As the High Court said in *Air New Zealand & Qantas v Commerce Commission,* the Commission is required to focus " *on a possible change along the spectrum of market power"*[27], which requires comparing the factual against a counterfactual where two equally sized competitors ( Gallagher and Tru-Test) strongly compete in all respects in the supply of electric fencing.

137. It is therefore important to consider the market conditions that may affect Stafix's ability to restore, maintain and expand sales of its products following its purchase by either a complementary or a stand-alone entity. This is discussed in the next section which considers whether there are barriers to expansion.

Expansion of Stafix

138. The Commission has considered the barriers to expansion a new owner of Stafix would face, post-acquisition. As discussed in the analysis of the factual, Stafix's market share could be eroded to as low as [ ]%, but at the very least is expected to have a post-divestment market share less than the pre-acquisition market share. In order to recover eroded market share and to provide an ongoing

[27] Air NZ & Qantas, above at n.5.

credible constraint to the combined entity, the new owner of Stafix would need to expand sales.

139. In the Previous Gallagher Decision the Commission identified potential barriers to entry and expansion:[28]

- gaining access to resellers, which includes:
  - brand and reputation;
  - multiple brands;
  - infrastructure;
  - full product range / R&D, IP, and the potential lack of critical mass;
  - bundling;
  - volume-based rebates; and
- strategic barriers or incumbent response.

140. The Commission considers that the above barriers to expansion still hold. Therefore the Commission has considered these barriers to expansion in respect of the new owner of Stafix.

*Access to Resellers*

141. In the current Application, the Applicant stated that resellers would have an incentive to support the new owner of Stafix in order to maintain competition between two competitors. The Applicant stated that the Stafix brand has a full product range, including a 36 Joule energiser, which meets reseller's desire to stock a complete product range. For these reasons, the Applicant considered that resellers "would give such support (to Stafix), or would at least be more likely to give support to Stafix as compared to PEL."

142. In the Previous Gallagher Decision, the Commission concluded that obtaining access to the large resellers was a significant barrier to entry and expansion.[29] [

] This is more fully discussed in the Countervailing Power of Buyers section of this Decision.

143. Further, as discussed in paragraphs 88-101 of the factual, the Commission found that [

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144. The Commission accepts that it is possible that support for the new owner of Stafix may be given once it becomes known and, if the resellers' criteria were met. The extent to which a new owner of the Stafix brand could meet these criteria is assessed in the following sections.

[28] Ibid, paragraph 473.
[29] Ibid, paragraph 408.

<u>Brand & Reputation</u>

145. The Applicant submitted that a new owner of Stafix would not need to establish and build up a brand because it considered Stafix to have strong brand awareness and reputation.

146. As stated above in the factual, the Stafix brand currently has a good reputation as a quality product. However, the Commission considers that in the circumstances of this case there is a real risk that sales of Stafix will deteriorate. in the period pending divestment, causing damage to the brand. If this occurs, the new owner of Stafix would need to maintain its reputation and grow the brand through intensive marketing and R&D, which are discussed in detail below.

<u>Multiple brands</u>

147. In the Previous Gallagher Decision, the Commission found that Tru-Test had a multi-brand strategy, whereby it used PEL, Stafix and Speedrite in order to compete with Gallagher.[30]

148. Gallagher has also adopted a multi-brand strategy, to the extent that it has developed the Franklin brand of electric fencing for exclusive use in Farmland's North Island stores. [ ].

149. Compared to the counterfactual, where both Gallagher and Tru-Test are able to compete with multiple and well recognised brands, the new owner of Stafix would (in the critical early days at least) have only one brand with which to compete. Whether the new Stafix owner can quickly establish its own fighting brand is unknown, so too is whether the market has room for another electric fence brand. In the factual, the combined entity would have four brands.

150. The Commission notes that not all large rural resellers favour buying multiple brands from one supplier. For example, [ ].

151. However, some large resellers such as [ ] prefer to deal with one supplier that can offer a choice of brands and bundled products because they satisfy different customer requirements and yet at the same time they gain efficiencies from dealing with one supplier. Stafix would therefore be at an immediate disadvantage because it could only offer such resellers one brand (although a complementary buyer would likely be able to offer a bundle of different products, depending on who it is).

152. The Commission considers that Stafix's inability to offer a choice of electric fencing brands places it at a disadvantage because some large resellers value purchasing multiple brands of electric fencing products from one supplier. Accordingly, this would represent a moderate to high barrier to it maintaining and expanding market share.

[30] Ibid, paragraphs 477-479.

Infrastructure

153. In the Previous Gallagher Decision, the Commission concluded that in the electric fencing market, existing and potential competitors would, at a minimum, need to demonstrate to resellers they have a robust nationwide support structure in place. The Commission considered that this would require at least a moderate to high initial investment on the part of the new entrant or existing competitor, which could be disproportionate to expected sales.[31] Nothing has changed to alter the Commission's view on this issue.

154. The Commission notes that, in the factual, establishing a comprehensive distribution system and supporting infrastructure would be unlikely to represent a high barrier to expanding or recovering market share for a complementary buyer that would already have such facilities in place, but is likely to be a high barrier for a stand-alone. [

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155. While the new owner would be able to offer some distribution structure through acquiring the already established Stafix brand, there would be some doubt as to whether this would be at the same level as Tru-Test's or sufficient to provide a credible constraint on the combined entity. Establishing a credible and comprehensive infrastructure for a new owner, that is facing a number of other sunk costs and barriers, such as R&D, could represent a moderate barrier to expanding or recovering market share.

Full Product Range / Research and Development

156. In the Previous Gallagher Decision the Commission found that resellers, when making stocking decisions, placed great importance on suppliers of electric fencing products being able to offer a full range.[32] In general, resellers told the Commission that currently Stafix, unlike PEL, has a complete range of energisers and accessories.

157. Gallagher did not consider the new owner of Stafix would need to immediately invest in R&D or to develop new products in order to maintain its brand. It considered that Stafix's existing product range would secure its position in the market for up to five years. Gallagher argued that:

- high-end energisers are designed for very large farms, which represent a small proportion of total farms in New Zealand;
- [
  ];[33]
- Stafix M36 could be upgraded relatively easily to 60 joules-stored within seven months for an R&D investment of around $[ ];[34] and

[31] Previous Gallagher Decision, paragraph 341.
[32] Previous Gallagher Decision, paragraph 342.
[33] Tru-Test disputed this, noting that the contractual arrangements do not preclude the companies from stocking products that are not offered by the Tru-Test range.
[34] Tru-Test has noted that high-end energisers include a number of other features not offered by any of the Stafix products. The R&D budget suggested by Gallagher may therefore be significantly understated.

- MX7500 has reached the upper limit of energy output that could be safely and economically utilised in rural electric fencing, [ ].

158. Gallagher acknowledged that its electric fencing business has a history of innovation and R&D, and that this was a key reason for its success.

159. As previously highlighted, resellers said that the new owner of Stafix would need to invest in R&D in order to leapfrog Gallagher and to continue to be a credible alternative. For example, [ ].

160. [ ]

161. [ ]

162. The Commission found a history of 'tit for tat' innovation between Gallagher and Tru-Test over the last twelve years. For instance, PEL launched a 33 Joule energiser in 1992 that had the best power output but only basic features. Gallagher responded to this by releasing the M5000 in 1995 that had slightly less power but more functionality. Gallagher improved the M5000 in 1996 by releasing the MX5000 which included a remote control. Tru-Test released the M36/3000 range in 1999 to compete with Gallagher's MX5000 series. In 2001, Tru-Test added a remote control system to its range. [ ]

163. [ ] While only measured by a three month period, the apparent decline in Stafix's high joule energiser is evidence of the importance in this market to have an on-going R&D programme in place. An R&D programme will not be acquired by the buyer of Stafix.

164. The Commission found that the leapfrogging of products between Gallagher and Tru-Test has occurred at intervals of about three years.

165. In the Previous Gallagher Decision, the Commission found that Tru-Test had not invested in R&D in the PEL brand for over four years, and had positioned it as a secondary or "bookend" brand in the market.[35] As a result, PEL's market share dropped from [ ] in 2001 to [ ] in 2004. The Commission considers that PEL also highlights the key relationship between continuing innovation and

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[35] Previous Gallagher Decision, paragraphs 481-483.

maintenance and/or growth of market share. It therefore does not agree with the Applicant that the new owner of Stafix need not innovate for five years to maintain sales and brand reputation.

166. [

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167. Based on the evidence, the Commission considers that it would be important from a competition perspective that the new owner of Stafix maintain its status as a premium brand by investing in a robust R&D programme in order to keep pace with, and eventually leapfrog the technology of the combined entity. In assessing whether establishing an R&D programme would be a barrier to expansion for the new owner of Stafix, the Commission has considered the following factors:

- the costs a new owner would need to incur, and the timeframe, in carrying out R&D on the Stafix brand;
- access to IP; and
- critical mass.

Development Cost and Timeframe

168. Most of the critical technology in electric fencing is found in the energisers, while the accessories tend to be commodity-type products. The Commission spoke with a variety of industry participants about future innovation in energisers. Generally, most considered that innovation in the electric fencing market would manifest itself in the following three ways:

- the output of high-end energisers could be increased in order to power longer distances of fence lines. However, a number of industry participants told the Commission that energisers had almost reached their peak in terms of power. Increased power might result in serious safety issues;
- energisers could be adapted to have more "functionality". While the power output would remain the same, the energiser could have more different features of value to the farmer; and
- reducing the manufacturing costs of the energisers by, for example, developing more effective transformers.

169. Both Gallagher and Tru-Test have a number of on-going R&D projects in electric fencing that show that innovation is likely to occur as outlined above. [

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170. [

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171. [

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172. [

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173. The Commission estimates that over the past two years, both Gallagher and Tru-Test had spent approximately [ ] of their total sales of rural electric fencing on R&D, as outlined in Table 6.

**Table 6: Proportion of Total Revenue Spent on R&D Expenditure in 2004**

| | Tru-Test | Gallagher |
|---|---|---|
| Total revenue (incl. domestic and export revenue) | [ ] | [ ] |
| R&D expenditure | [ ] | [ ]* |
| Proportion of Total Revenue Spent on R&D | [ ] | [ ] |

- Notes: [

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174. The Commission considers that a potential acquirer of Stafix would require a sufficiently large export market, in addition to a domestic one, to justify the required investment in R&D.[36] Therefore, in Table 6, total export and domestic revenue is considered in calculating what proportion of Gallagher and Tru-Test's total revenue is spent on R&D.

175. The Commission considers that the new owner of Stafix would need to spend at least [ ] of Stafix's total revenue on R&D. Based on 2004 figures, this would amount to [ ]. In addition, most industry participants said that the Stafix brand is in need of further development, making it likely that the R&D expenditure required would be greater than [ ]% of sales. Gallagher and Tru-Test currently benefit from economies of scale in R&D. Post-divestment, the new owner of Stafix, being a relatively small supplier of rural electric fencing, would suffer from diseconomies of scale.

176. Based on the information available, the Commission conservatively estimates that it may take [ ] to develop a new Stafix energiser that would leapfrog the combined entity's products.

177. [ ]. A complementary buyer would most likely utilise existing facilities and obtain some synergies. However, it would still need to invest in additional engineering expertise and equipment. A stand-alone acquirer, depending on the nature of its existing business, may incur higher set up costs and would also be likely to need to invest in additional expertise.

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[36] Previous Gallagher Decision, paragraph 549.

178. Both a complementary and a stand-alone buyer would likely be slowed down in their development of any new product as they would not have existing engineering expertise. The Commission considers that a new owner would need to invest in an R&D programme and engage engineers that would have specialist electric fencing knowledge, or up-skill any existing engineers they have on staff.

179. The proposed divestment undertaking provides for the new owner of Stafix to have access to all available documentation with respect to the technical know-how necessary to manufacture the Stafix products. This should make it at least easier for engineers to up-skill. In the Previous Gallagher Decision, the Commission concluded that a wide range of professionals with training in electrical engineering, electronics or knowledge of wave technology, could up-skill enough to begin development work on the PEL energiser range within the relatively short time frame of two to three months. While the combined entity might tie up the most experienced engineers in this field, it was only likely to slow the development of the PEL brand for a short time.[37] In this proposed acquisition, the Commission considers that this conclusion still holds.

180. [

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181. The Commission concludes that post-acquisition, the new owner of Stafix would need to establish and maintain an R&D programme, which would be a barrier to expansion for both a complementary and a stand-alone buyer. The extent of the barrier is dependent on who becomes the new owner and its current operation, and the level and type of engineering R&D (if any) undertaken as part of its current operations. The Commission considers that a complementary buyer, as it is already involved in the rural/agri-tech industry, is more likely to have some relevant engineering expertise than a stand-alone buyer. However, it may not. Bearing this in mind, the Commission's view is the cost and timeframe involved in conducting R&D would represent a high barrier for a stand-alone buyer, and at least a moderate barrier for a complementary buyer meaning that it would be lacking initial technical expertise and would need to "catch up" to the combined entity.

Intellectual Property

182. In the Previous Gallagher Decision, the Commission considered that the patented high technology features of the high-joule energisers may represent a significant barrier to expansion.[38]

183. The new owner of Stafix would be acquiring royalty-free access to the IP relating to Stafix products. Unlike PEL, this would include access to the IP in respect of Stafix 36 Joule or high-end energisers. Further, the new owner of Stafix would be free to develop new products from its access to Stafix IP. Accordingly, the Commission considers that IP is unlikely to represent a barrier to expansion for the new owner of Stafix.

[37] Previous Gallagher Decision, paragraph 378.
[38] Ibid, paragraph 390.

Critical Mass

184. In the Previous Gallagher Decision, the Commission considered that due to the limited market a new owner would have from being restricted to sales in New Zealand and Australia, there was real doubt as to whether it would be able to invest enough in R&D for the PEL range to be a competitive constraint on the combined entity.[39]

185. With the current proposed divestment undertaking, the Applicant states that the new owner would have the use of the Stafix brand worldwide, and that this would overcome any concerns the Commission might have in respect of Stafix achieving sufficient critical mass to be a credible competitor.

186. However, and as Gallagher itself confirmed, the new owner of Stafix would not have the critical mass or run volumes that will be available to the combined entity. It follows that the combined entity would be able to achieve a higher margin and/or offer its electric fencing products at lower prices to resellers. This could result in the combined entity increasing its market share at the expense of Stafix.

187. [

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188. Although such economies of scale and scope are unlikely to be achieved by any of the prospective buyers for electronics manufacturing capabilities needed to manufacture energisers, the Commission considers that there would be ample opportunity to outsource the manufacturing process to contract manufacturers, who would be likely to achieve economies of scale and scope.

189. [

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190. [

], there would be doubt as to whether the new owner would have enough critical mass to achieve the margins required to adequately invest in R&D, distribution and technical support, and still maintain competitive pricing through trade terms or rebates.

191. [

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[39] Ibid, paragraph 544.

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192. A number of industry participants said that it has been extremely difficult for New Zealand electric fence manufacturers to gain distribution in the major US and European rural supply stores. The overseas markets tend to be dominated by local suppliers that produce low cost, "low frills" products. Indeed, [

] The Commission concludes that it is unlikely that a new owner, whether complementary or stand-alone, would be able to restore Stafix's current level of export sales within two years.

193. The new owner of Stafix would need to look to the domestic market in order to guarantee sufficient critical mass to be an effective competitor. As discussed in the factual section, [ ]. Thus, the new owner of Stafix would be unlikely to achieve sufficient critical mass from the domestic market to achieve the necessary revenue to support investment in R&D.

194. In light of these factors, the Commission has real doubts as to whether, post-acquisition, the new owner would invest in the R&D required to properly support the Stafix range, as exists under the counterfactual. Post-acquisition, it is likely that the new owner would experience a reduction in domestic and export sales, limiting its critical mass and ability to invest in the necessary R&D. Accordingly, the difficulties in achieving sufficient critical mass is considered to be a moderate to high barrier to expanding Stafix's market share sufficiently to act as a constraint upon the Applicant.

Conclusion on Full Product Range and R&D

195. The Commission considers that in the factual Stafix would have a complete product range that would be acceptable to resellers. However, the new owner of Stafix would need to invest in R&D to maintain Stafix's reputation as a quality brand and 'leapfrog' Gallagher, in order to constrain the combined entity in the long term.

196. The [ ] would make it difficult for the new owner of Stafix to achieve sufficient critical mass. This in turn would make it even more difficult to invest in a sufficient R&D programme to maintain Stafix as a premium brand.

197. The Commission therefore considers that, on balance, post-acquisition, establishing and maintaining a robust R&D facility, and the need to leapfrog the combined entity in the face of declining critical mass, would cumulatively represent a moderate to high barrier to expansion.

<u>Bundling</u>

198. In the Previous Gallagher Decision the Commission concluded that in some cases the practice of bundling the supply of products could constitute a barrier to expansion.[40] Resellers such as [

[40] The term 'bundling' here refers to a firm's ability to supply products across multiple categories and, potentially, tie its terms of trade (i.e., pricing, volume-driven rebates) to the bundle of products rather than individual product categories. Resellers benefit from reduced transaction costs in being able to

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199. By acquiring Tru-Test, the Applicant would be able to offer resellers two new products, shearing equipment and milk meters (in addition to four electric fencing brands). It would also increase its volume of sales into resellers across a range of related categories. A new owner of Stafix would need to match or better this with its own bundled package in order to maintain or increase access for its electric fencing products to large rural resellers.

200. [

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201. [

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202. Given the ability of potential complementary buyers to offer bundled products, the wide spread practice of bundling the supply of products is unlikely to represent a significant barrier to expansion. Should a stand-alone business acquire Stafix, however, it would be unlikely to be able to bundle products. In the Previous Gallagher Decision, the Commission accepted that potentially a stand-alone acquirer could 'partner' with other rural suppliers. How commercially feasible this is will depend on factors which can not be assessed at this time. A stand-alone buyer unable to bundle products would face increased costs to achieve an expansion of sales for the reasons given earlier. Bundling is therefore likely to represent a high barrier to a stand-alone buyer expanding or recovering.

<u>Rebates</u>

203. In the Previous Gallagher Decision, the Commission found that, post-acquisition, the practice of volume-based rebates would represent a barrier to expansion.[41] All major rural resellers in New Zealand operate under volume-driven rebate schemes. Under these schemes, the level of rebate paid back to the reseller increases (in a stepped fashion) once the level of purchases from a supplier meets a target threshold. This incentivises resellers to purchase as much volume from a single supplier as possible.

204. Hence, choosing a supplier who can offer a bundled product range would be advantageous for resellers because higher rebate thresholds are reached sooner if

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deal with a single (or few) supplier(s) when sourcing a variety of products, as opposed to several individual suppliers each specialising in a particular product.

[41] Previous Gallagher Decision, paragraph 407.

all purchases (across a range of categories) can be done through a single supplier.

205. Resellers with such rebate schemes in place (e.g., [ ]) would incur loss of discounts when switching away from the combined entity (which would have a broad product offering) in favour of alternative suppliers, such as Stafix. As a result of switching costs, resellers could become "tied" to the combined entity, thus foreclosing the market to new entrants.

206. Volume-based rebates would be a high barrier to expansion for stand-alone purchasers, given their inability to bundle products. Complementary buyers, however, may be able to match rebates through bundled product offerings.

207. However, a complementary buyer would need to match or better the extremely competitive terms currently being offered by Gallagher in an environment where Stafix would be [ ].

208. While trying to match these competitive rebates, a new owner would also be burdened with [ ] (through aggressive marketing, etc.), investing in sufficient R&D to keep pace with the combined entity, re-establishing export sales, and facing possible strategic action from Gallagher.

209. While it is possible that a well resourced complementary buyer might match the volume-based rebates offered by the combined entity in the absence of these difficulties, the Commission considers these factors, cumulatively, would undermine its ability to do so.

<u>Conclusion on Access to Resellers</u>

210. The Commission concludes that post-acquisition, a new owner of Stafix would need to have access to the major rural resellers in order to maintain and expand its sales in the rural electric fencing market. Such access would require the new owner to meet the reseller's criteria. The Commission considers that while both complementary and stand-alone buyers face difficulties in obtaining ongoing access to resellers it would be easier for a complementary buyer. In addition, both a complementary or stand-alone buyer would also face the following factors that would undermine its ability to obtain ongoing access to resellers:

- not having multiple electric fencing brands to be used as fighting brands;
- difficulties in investing in R&D; and
- the need to offer competitive volume-based rebates.

211. As the Stafix business will be the outcome of a divestment to an unidentified purchaser, the Commission must take into account the additional uncertainties and risks presented by the proposed acquisition.

*Strategic Barriers to Expansion*

212. The Commission has assessed the strategic barriers to expansion that could arise as a result of the proposed acquisition in the electric fencing market. Strategic barriers can arise when the incumbent firms engages in exclusionary behaviour and includes the ability to deny a new entrant market share.

213. The Applicant considered that it would be precluded from engaging in strategic behaviour. Gallagher acknowledged that, post-acquisition, it would control a

number of strong brands, and that it has a reputation for being innovative, but considered that this would not prevent a new entrant from competing.

214. In the Previous Gallagher Decision, the Commission considered that the strategic barriers to entry or expansion were likely to be significant given that the combined entity would be in a strong position to engage in strategic incumbent responses.[42] Such potential responses may have included refusing to supply; offering exclusive deals; large volume-based rebates; and/or potential leveraging of its market power in the electric fencing market into other markets.

215. Since the Previous Gallagher Decision, the approach to be taken when examining the likely behaviour of incumbents to market entry or expansion was considered by the High Court in *Air New Zealand & Qantas v Commerce Commission* [43] The Court stated that in most cases it is preferable not to treat incumbent's responses as potential barriers to entry, but to examine the likely behaviour "*in the context of a broader enquiry into the constraints'* entry or expansion will have on the incumbent(s).[44]

216. In the factual in the present Application, the combined entity's market share would be large [ ] with an increase in aggregation of [ ]. Compared to the counterfactual, this would be a significant change in market structure which would provide the combined entity with potential advantages. Further, [ ].

217. During the divestment period the combined entity would have access to vital Stafix sales information, including its present terms of trade with large resellers. The asymmetry in commercial information (where the combined entity has full knowledge of Stafix's starting point in the market, but not vice versa) would enable Gallagher to target resellers with attractive offers. This would put Stafix at an immediate disadvantage relative to the combined entity when competing for access to resellers.

218. In addition, the combined entity would be in a position to pursue a multi-brand strategy, which the new entrant would not be able to do initially. Gallagher would have a portfolio of four electric fencing product brands positioned at both the premium and 'shelf-filler' ends of the market. In contrast, the new entrant would only have the premium Stafix brand. The combined entity could guarantee the major resellers exclusive access to certain brands as a means of creating a point-of-difference in the reseller market. Given the highly competitive nature of the rural retail market, this would be viewed as very attractive by some resellers, and likely could give the combined entity a competitive advantage.[45] This is a significant difference between the factual and the counterfactual.

219. An alternative strategy that the combined entity could employ would be to use its newly-acquired Speedrite product range, which is to all intents and purposes

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[42] Previous Gallagher Decision, paragraph 425.
[43] *Air NZ & Qantas* above n.5.
[44] Ibid at paragraph 105.
[45] There is already some evidence that resellers prefer exclusive access to electric fencing brands. As noted earlier, Wrightson presently has exclusive access to Speedrite, and Farmlands has exclusive access to Franklin.

identical to the Stafix range,[46] to undercut the new owner in an attempt to force Stafix to exit the market. The electronic features and technology of the two Tru-Test brands are nearly identical: for almost every Stafix product, there is a technically equivalent Speedrite product. The internal componentry of the energisers in both brands are currently identical, and all IP in the two brands is shared. It is also well recognised by resellers that the two brands are technically identical.

220. Finally, the combined entity could retain its existing ([ ]) brands – Gallagher and Franklin – in an uneroded position while using Speedrite to fight a price war.

221. As concluded in the section on critical mass, post-acquisition, the new owner of Stafix would have limited critical mass as it would suffer from an [ ]. Therefore, the new owner would be at a disadvantage. Further, given that the Applicant has stated that it currently benefits from economies of scale, the combined entity would also benefit from economies of scale as it would acquire additional electric fencing brands, which could give it a cost advantage over the new entrant.

222. The combined entity would have the production capacity to quickly meet any increase in demand generated by lower pricing. [ ]

223. A number of industry participants expressed concern that, post-divestment, the Applicant would have both the incentive and means to use its newly-acquired product lines to drive the new owner of Stafix out of the market. [ ]

224. The new owner of Stafix would simultaneously have to: battle to maintain reseller support during the transitional period when ownership is transferred (both in domestic and export markets)); sink considerable investment into R&D to meet Gallagher's recent advances in its high-end energiser range; and fight a possible price war with the incumbent firm. Some industry participants considered that all these factors cumulatively may be too much for a new entrant to the rural/agri-tech industry, no matter how well-resourced it was.

225. In response to this concern, the Applicant considered that [ ] It said, remaining resellers would likely take the long-term view of preserving competition by lending support to Stafix.

226. [ ]

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[46] The exceptions to this are the appearance of some low-mid range energisers that have different shaped casings, and the colours of the Speedrite range (black and red) in comparison to the Stafix range (green and yellow).

227. [

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228. This issue might be mitigated to some extent if a complementary buyer were to acquire Stafix. A complementary buyer that could bundle and offer volume-based rebates might give resellers sufficiently competitive terms and confidence to switch to Stafix, or at least to use Stafix as a credible alternative when negotiating with the combined entity. On the other hand, the combined entity may have a greater range of products to bundle post-acquisition.

229. It is possible that, post-acquisition, the new owner of Stafix may not exit the electric fencing market as a result of strategic behaviour by Gallagher. Instead, the new owner of Stafix could become a passive rival. Under such a scenario, whilst the new owner might remain in the market, it might not provide any form of competitive constraint to the combined entity. It might choose to pursue its own business strategies in different markets involving its core products, and simply price-follow the combined entity in the market for electric fencing products, which it might consider to be a non-core product.

230. The consequence of this would be an overall increase in the price of all electric fencing products as, post-acquisition, the combined entity would be able to introduce price increases unilaterally, in the knowledge that the new owner would simply follow and raise its prices too.

231. Overall, it is unclear whether the potential strategic barriers to expansion created by the proposed acquisition would result in a greater likelihood of the Stafix brand exiting the market, or remaining in the market as a price follower to the combined entity. Under either scenario the new owner is unlikely to provide a significant constraint to the combined entity, and therefore would not remedy the loss of competition created by the acquisition.

232. In summary, the new owner of Stafix may have difficulty restoring and expanding sales because the combined entity:

- would have a much larger market share, [
  ];
- would hold commercially sensitive trading information about Stafix;
- could pursue a multi-brand strategy by offering resellers exclusive access to its various brands, whereas the new owner would only be able to compete using the single Stafix brand;
- could use its portfolio of multiple brands, to allow it to benefit from strong economies of scope and scale not enjoyed by the new owner; and
- would own Speedrite (which is virtually identical to the Stafix brand), which it could easily use to strategically undercut Stafix.

*Conclusion on Expansion of Stafix*

233. The Commission has reached the view that for Stafix to credibly constrain the combined entity post-acquisition, it must be satisfied that the new owner (whoever that may be) can maintain (or restore quickly) market shares at near

pre-acquisition levels, and further, be able to compete (expand) sales away from the combined entity. In other words, it should not be too dissimilar from the counterfactual.

234. The Commission has therefore assessed the barriers to expansion for both a complementary buyer and a stand-alone buyer of Stafix. As a starting point, it records the uncertainties and risks inherent with Stafix being the outcome of a future divestment, with no recent independent track record.

235. [ ] would be likely to impact on the new owner of Stafix's ability to invest in R&D, provide competitive rebates, and meet resellers' criteria, irrespective of whether the new owner is a complementary buyer or a stand-alone. The Commission regards that cumulatively these barriers are high. Further, the possibility of strategic incumbent response in the form of a price war utilising the Speedrite brand and with Gallagher having obtained vital Stafix trading terms, would add to the difficulties of expanding sales and thereby constraining the combined entity.

*Overall Conclusion on Existing Competition*

236. The Commission concludes that compared to the counterfactual, the acquisition would lead to a significant change in the market structure, from one with two relatively strong competitors, to a situation where the strengthened combined entity would have around [ ]% of the market, with the new owner of Stafix having [ ]. Post-acquisition, fringe competitors would continue to have a market share of around [ ]. The Commission considers that these small competitors are unlikely to provide the combined entity with a competitive constraint.

237. Given the lack of existing competition from fringe competitors, and the fact that the market share of Stafix post-divestment would be less than pre-acquisition, the Commission has analysed the barriers to expansion in order to assess the ability of the new owner of Stafix to provide the combined entity with sufficient existing competition.

238. The Commission concludes that the new owner of Stafix would be likely to face high barriers to expansion. It should be noted that for the purposes of this assessment, given the anticipated decline in Stafix's market share post-acquisition, reference to barriers to expansion includes barriers to recovery of market share.

239. Post-acquisition, a new owner of Stafix would need to have access to resellers in order to expand. Access to resellers is likely to be easier to achieve for a new owner of Stafix that is already involved in the rural/agri-tech industry. However, the following factors would undermine its ability to obtain ongoing access to resellers:

- not having multiple electric fencing brands;
- difficulties in investing in R&D; and
- the need to offer competitive volume-based rebates.

240. In addition to the above factors, a new owner of Stafix that is not currently involved in the rural/agri-tech industry would also face the following factors in obtaining and maintaining access to resellers:

- the need to establish distribution channels; and
- to offer bundled product options.

241. The new owner of Stafix, whether it is in the rural industry or not, would also face significant disadvantages to expansion because the combined entity:

- would have a much larger market share, [

  ];
- would hold commercially sensitive trading information about Stafix;
- could pursue a multi-brand strategy by offering resellers exclusive access to its various brands, whereas the new entrant would only be able to compete using the single Stafix brand;
- could use its portfolio of multiple brands, to allow it to benefit from strong economies of scope and scale not enjoyed by the new entrant; and
- would own Speedrite (which is virtually identical to the Stafix brand), which it could easily use to undercut Stafix.

242. The Commission has also factored in the uncertainties and risks inherent in the proposed main competitor, Stafix, being the product of a potentially difficult divestiture process, with no recent independent track record, and sold to an as yet unknown buyer. It concludes that post-acquisition, the combined entity would not face existing competition to anywhere near the degree and intensity that exists in the counterfactual. This is because post-acquisition there would be:

- a significant change in the market structure, with the combined entity being stronger;
- a lack of competition from fringe competitors (the fringe competitors also face the same barriers and other disadvantages that limit expansion); and
- high barriers to expansion faced by a new owner of Stafix and other disadvantages such that there is considerable doubt as to Stafix's ability to recover any lost market share, let alone be able to expand sales, in its first two years.

**Potential Competition**

243. In the Previous Gallagher Decision, the Commission found that companies from Australia, the United States and Europe stated that they were unlikely to enter the market with rural electric fencing products for the following reasons:

- the capital investment required to develop high-joule energisers, for which there is little to no demand in their home markets;
- freight costs associated with supplying the New Zealand market; and
- inherent risks and strategic barriers that they would face in entering a market where the incumbent has a very high market share, and where it is difficult to persuade rural resellers to stock an overseas brand that is unproven in New Zealand.

244. The Commission considers that entry by overseas suppliers would be unlikely. In addition, given the barriers to entry identified in the Previous Gallagher Decision, the Commission does not consider that without access to an existing brand entry, whether by an overseas operator or from within New Zealand, would be likely to occur within the next two years on a sufficient scale as to provide a credible constraint to the combined entity. Accordingly, the Commission does not consider there to be potential entry capable of preventing the combined entity from raising its prices or reducing the quality of product and service it currently provides.

245. There have not been any significant changes in the electric fencing market since the Previous Gallagher Decision to alter the Commission's view on potential competition.

**Countervailing Power of Buyers**

246. The potential for a business to wield market power may be constrained by countervailing power in the hands of its customers, or when considering buyer market power (oligopsony or monopsony), its suppliers. In some circumstances, this constraint may be sufficient to eliminate concerns that an acquisition would be likely to lead to a substantial lessening of competition.

247. In this case, the combined entity will still supply, or be capable of supplying, the major rural resellers listed in paragraph 23. While none of the resellers on that list individually may be dominant buyers in the relevant market, they do comprise a significant group of substantially sized businesses. As such, losing an account at any of these resellers will have a significant impact on overall sales and market share. This fact provides a degree of countervailing power for the resellers, but this can only be realised in a market where a credible alternative exists and there are relatively low switching costs .

248. The Commission has analysed the degree of countervailing power held by the rural resellers by examining two major factors that determine the extent of bargaining power these resellers may enjoy:

- **credible alternative(s):** buyers must have at least one credible alternative to its existing supplier(s) in the market for the threat of customer-switching to be perceived as real;[47] and
- **switching costs:** high switching costs will undermine the credibility of a buyer's threat to switch.

*Credible Alternative*

249. In the Previous Gallagher Decision the Commission concluded that the proposed acquisition would significantly reduce the extent of countervailing power held by resellers because: [48]

- the existing competitive tension between Gallagher and Tru-Test that enabled large rural resellers to exert countervailing power would be lost;
- PEL was unlikely to become a competitive constraint within the two years immediately following the acquisition;

[47] If for instance alternative suppliers can only offer inferior, or incomplete, products or services, the threat of switching may not be perceived as being credible.

[48] Previous Gallagher Decision, paragraph 587.

- [

  ]; and
- the likelihood or extent of expansion by any other existing or potential entrant was limited.

250. The cumulative effect of all these factors was the elimination of any credible alternative to Gallagher in the electric fencing market.

251. [

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252. The ability of Stafix to provide both a short and long term credible alternative to the combined entity depends largely on the extent of support it receives from resellers. [

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253. However, the difficulty that a new owner of Stafix would face is that some resellers may have a disincentive to be the first to support the brand because of the irreversible nature of costs and uncertainty associated with this decision, and because the nature of competition in the reseller market produces asymmetric risks and payoffs for the first reseller to support the brand, i.e. to be the 'first-mover'. If enough resellers adopted a similar 'wait-and-see' strategy to one another, then it is possible that Stafix may not receive enough support to be a credible alternative to, or a sufficient constraint on, the combined entity.

254. The decision to support a new owner of Stafix could be a costly one. It might involve allocating valuable shelf-space to a brand with uncertain ownership support at the expense of an established product and supplier, and increasing the level of retailer provided brand promotion (specials) to maintain pre-divestment levels. These costs, once incurred would be largely irrecoverable.

255. Secondly, the decision to support a new owner of Stafix would involve uncertainty. [

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256. Under these two conditions of irrecoverable costs and uncertainty, some resellers may choose to delay supporting a new owner until the future revealed whether or not it is worth doing so.[49] This would involve observing the success achieved by competitors that supported the new owner and then acting accordingly. As the combined entity has near identical product on sale, there would be no risk from the delay from this quarter.

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[49] See for instance Dixit, A., Pindyck, R., *Investment Under Uncertainty* (Princeton University Press: Princeton, 1994).

257. Furthermore, the payoffs to resellers from supporting a new owner are likely to be asymmetric. If the new owner failed to become a credible alternative, then the reseller who lent support would bear the full cost of deciding to do so. If the new owner succeeded, then other resellers could free-ride by using the new owner's success to credibly threaten the incumbent supplier with switching unless favourable terms of trade were secured, i.e. to increase bargaining power. These asymmetric payoffs would contribute to a reseller's overall reluctance to be the first to lend support.

258. The outcome of all these factors may be that the major resellers wait for their rivals to make the first move, and assuming all resellers hold the same expectations and beliefs, it is possible that Stafix receives very little support.

259. Resellers, by not lending support, may collectively undermine the success of the new owner of Stafix and therefore, its ability to act as a credible alternative to the combined entity. This may occur even though it would be in every reseller's individual long-term interest to encourage a second competitor in the market, to improve their own bargaining position.

*Switching Costs*

260. The credibility of a buyer's threat to switch suppliers will be reduced if that buyer faces high switching costs. Switching costs can arise in many ways. For instance, buyers may be bound by contractual obligations that preclude them from seeking alternative suppliers; buyers may face transaction costs in negotiating with new suppliers; buyers may face strong price disincentives to switch; and/or buyers may fear future repercussions if there a chance they may be forced to deal with their current supplier at a later date.

261. As discussed earlier in the Rebates section, volume-based rebates, which are common in the rural retail industry, deter resellers from switching between suppliers: resellers are strongly incentivised (by the promise of higher rebate levels) to maximise the volume of purchases through a single supplier. If resellers switch suppliers, they forego further discounts.[50] Hence, volume-based rebate schemes raise resellers' switching costs, and potentially reduce their bargaining power against their current supplier.

262. However, the Commission recognises that the magnitude of switching costs will reduce as the frequency of the rebate payout increases. This is because the volume of accrued purchases (towards a particular target that secures a rebate

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[50] Suppose a hypothetical reseller will receive a 2% rebate if the value of purchases through the combined entity reaches a threshold of $200,000 and an 8% rebate if purchases reach $500,000. Suppose also that the reseller has already purchased $300,000 worth of inventory so has secured the lower rebate. At this point, even if Stafix offered an identical rebate scheme, the reseller might be reluctant to switch suppliers because by purchasing a further $200,000 worth of inventory through the combined entity they would achieve the next rebate tier of 8%. However, to reach the same rebate level through Stafix, the reseller would have to spend a further $500,000. Hence, the reseller would achieve the next rebate tier sooner by remaining with the combined entity. By switching away from the incumbent supplier, the reseller forgoes rebates for a period of $n$ periods, where $n = (T_s - T_c)$; $T_s$ is the time at which the 8% rebate level is reached through Stafix; and $T_c$ is the time at which the 8% rebate level is reached through the combined entity. The cost of switching (*SC*) here is the cost of foregoing these rebates (i.e., the time value of money determined by some discount/compound rate $r$) over $n$ periods. If $x$ is the value of the rebate that the reseller can expect to earn once it crosses the higher purchasing threshold, it is possible to calculate the present value of the switching costs as: $PV_0(SC) = e^{-rT_s}[\quad]$.

payout) is reset to zero by the supplier every time a rebate is paid. Resellers typically receive rebate payouts reasonably frequently (annually), so the Commission considers that any switching costs created by volume-driven rebates are unlikely to be very high.

263. [

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264. Finally, [

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265. [

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266. The Commission therefore considers that resellers might face higher switching costs under the factual than under the counterfactual. This might limit the extent of countervailing power large resellers would be able to exert in constraining prices.

*Short-run gains vs. long-run considerations*

267. The nature of competition between resellers, and the potential costs they may face when negotiating with the combined entity, provides valuable insights into seemingly irrational behaviour on the part of resellers. The Applicant has argued on a number of instances that resellers have a strong incentive to support the new owner of Stafix in order to maintain competitive tension in the market.

268. On its face, this claim seems plausible. However, the analysis above identifies a number of opposing reasons why resellers might choose to seek supply from the combined entity rather than support a new owner, even if this strategy were to lead to weaker competition in the long-run.

269. The rural retail industry is presently so competitive that resellers appear to prefer risk-averse strategies. It may be safer to remain with a well-established existing supplier (Gallagher) than lend full support to a new owner, that could potentially fail. If all resellers adopted this strategy, the combined entity might raise prices but resellers could safely pass the price rise on to retail customers knowing that their rivals would all be facing similar price rises. On the other hand, to be the only supporter of Stafix would be highly risky because failure of the new owner means being placed at an immediate disadvantage to one's rivals.

270. [

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271. There are numerous examples of industries in New Zealand where buyers tend not to support an entrant bringing significant new competition to a market, even though failure of the entrant through lack of support was likely to lead to a resumption of lesser competition and higher prices:

- **wood preservative chemicals:** even with a well known ex-CEO of the incumbent firm running the new entrant, and significantly lower prices being offered by the new entrant, the price-matching tactics of the duopoly incumbents, along with strong relationships between customers and agents for the incumbent service, resulted in many customers opting to remain with incumbent;
- **domestic electricity:** retail purchasers mostly stay with their original incumbent retailer;
- **burnt lime:** purchasers were suspicious of the new entrant in respect of quality, service and whether the entrant would remain in the market, and so remained with the otherwise near-monopoly incumbent;
- **domestic airlines:** air travelers in New Zealand have a preference to fly on Air New Zealand, making it difficult for an entrant (e.g., Qantas, Ansett New Zealand and Origin Pacific) to gain a sustainable market share;
- **cement:** a new importer found it difficult to persuade buyers to switch from the entrenched domestic duopoly, despite the prospect of sustained lower prices; and
- **refined sugar:** when new shipping technology allowed the importation of refined sugar in bulk from Australia, prices fell but industrial buyers largely stayed with the former monopoly incumbent.

272. For the reasons already discussed in this Decision, the Commission considers that there are real doubts as to whether the new owner of Stafix would be a credible alternative for the resellers.

273. If the new owner of Stafix does not become a credible alternative to the combined entity, resellers would be unlikely to maintain in the factual the countervailing power they currently enjoy and would retain in the counterfactual.

274. The ability of the new owner of Stafix to emerge as a credible alternative to the combined entity depends on the level of support it receives from resellers. However, resellers may be unwilling to support a new owner, to the same extent as they currently support the Stafix brand, due to the potential switching costs and risks associated with purchasing from an untested new entrant to the market for electric fencing products, despite the fact that the new owner may be a complementary buyer with an established electric fencing brand. [ ]. As a result, it would appear highly unlikely that any reseller would commit to Stafix unless other resellers also provide support. This is another uncertainty that the Commission has had to take into account in the context of the Application and the divestment proposal.

275. For these reasons, the Commission considers that the proposed acquisition would likely lead to a substantial loss of countervailing power for resellers. The Commission does not consider the extent of countervailing power resellers

might hold, post-acquisition, would be sufficient to constrain the combined entity.

**OVERALL CONCLUSION**

276. A summary of the issues and reasons appears as the Executive Summary at the beginning of this decision. In conclusion, the Commission is uncertain as to the nature of the buyer of the Stafix business and its level of market share post acquisition. Therefore, the Commission is uncertain as to whether the new owner would be able to sufficiently constrain the much larger combined entity to ensure that a substantial lessening of competition does not occur. The new owner of Stafix (whether complementary or stand-alone) would likely face a lower post divestment market share compared to pre-acquisition levels, and would face high barriers to expansion to recover the lost market share and grow sales in the future.

277. Therefore the Commission is not satisfied that the combined entity would be, post-acquisition, constrained by the combination of;

- the new owner of the divested Stafix business,
- the continued presence of the other small suppliers of electric fencing products,
- potential competition by de-novo entry or from overseas suppliers, and
- countervailing power of rural resellers,

to the degree necessary to maintain competition at the level and quality that is not substantially less than will exist if the acquisition does not proceed (the counterfactual).

278. For these reasons, the Commission is not satisfied that the proposed acquisition, with divestment of the Stafix brand, would not have, nor would be likely to have, the effect of substantially lessening of competition in the electric fencing market.

## DETERMINATION ON NOTICE OF CLEARANCE

279. Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission determines to decline to give clearance for the proposed acquisition by Gallagher Group Holdings Limited of all the ordinary shares of Tru-Test Corporation Limited.

Dated this day of April 2005

Paula Rebstock
Chair
Commerce Commission

## APPENDIX ONE

*Quantitative Analysis on the Viability of the Stafix Brand*

1. In order to assess the composition, purchaser and asset risks associated with the proposed divestment of the Stafix brand, the Commission modelled a forward-looking, year-on-year, net cash flow analysis over a five year period. This allowed the Commission to assess the likely operational profitability of the Stafix business.
2. The quantitative analysis took a range of factors into account and made a number of assumptions, based on information gathered by the Commission. The following factors were considered:
   - different buyer scenarios and prospects for synergies with respect to existing infrastructure and distribution channels;
   - likely customer confidence or diffidence, and resulting potential for sales attrition;
   - [ ]
   - [ ]
   - research and development costs;
   - the likelihood of new product development; and
   - the underlying growth of domestic and export markets.
3. The Commission essentially considered two possible commercial scenarios for Stafix: a best-case scenario, and a worst-case scenario.
4. [ ]
5. [ ]
6. The analysis suggested that under the best-case scenario, a complementary buyer's expected Earnings Before Interest Taxation and Depreciation (EBITDA) might be [ ] in the first year, growing to approximately [ ] in year five.
7. In the worst-case scenario however, a complementary buyer might expect to face [ ] in year one growing to [ ] in year five). The [ ].

8. [

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9. The projections obtained from the analysis showed that the outcome for a stand-alone buyer would likely be significantly less profitable than for a complementary buyer under all scenarios considered. Hence, if the divested Stafix brand were considered a non-viable proposition for a complementary buyer, it would be more likely to be even less viable for a stand-alone buyer.

10. While there is a possibility Stafix may prove to be a viable enterprise, this is heavily conditional on the extent of support from domestic resellers and export customers.

11. [

] Given this uncertainty, the Commission concludes it likely that Stafix's viability would more closely resemble the "worst case scenario" discussed above.

## APPENDIX TWO

*Gallagher's Proposed Divestment Undertaking.*