



## COMMERCE COMMISSION

### Decision No. 468

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

**FLETCHER CHALLENGE FORESTS LIMITED**

**and**

**CENTRAL NORTH ISLAND FOREST PARTNERSHIP**

**The Commission:** MJ Belgrave  
PR Taylor  
D Bates Q.C.

**Summary of Application:** The acquisition by Fletcher Challenge Forests Limited, through its wholly owned subsidiary Kaingaroa Timber Company Limited, from CITIC New Zealand Limited (BVI) (in receivership) and Forestry Corporation of New Zealand Limited (in receivership) (together the Vendors) of the operating assets of the partnership between the Vendors known as the Central North Island Forest Partnership.

**Determination:** Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition.

**Date of Determination:** 14 August 2002

**CONFIDENTIAL MATERIAL IN THIS REPORT IS CONTAINED IN SQUARE  
BRACKETS**

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## THE PROPOSAL

1. On 3 August 2002 the Commission registered a notice pursuant to section 66(1) of the Commerce Act 1986 (the Act) seeking clearance for the acquisition by Fletcher Challenge Forests Limited (FCF), through its wholly owned subsidiary Kaingaroa Timber Company Limited, from CITIC New Zealand Limited (BVI) (in receivership) and Forestry Corporation of New Zealand Limited (in receivership) (together the Vendors) of the operating assets of the partnership between the Vendors known as the Central North Island Forest Partnership (the CNIFP).

## THE PROCEDURES

2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was sought by the Commission and agreed to by the applicant. Accordingly, a decision on the application was required by 9 August 2002.
3. In its application, FCF sought confidentiality for specific aspects of the application. A confidentiality order was made in respect of the information for a period of 20 working days from the Commission's determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply.
4. The Commission's determination is based on an investigation conducted by staff.
5. The Commission's approach is based on principles set out in the Commission's *Practice Note 4*.<sup>1</sup>

## THE PARTIES

### FCF

6. FCF is an international company with operations and marketing activities in New Zealand, Australia, South America, North America, Asia and the Pacific Rim. FCF's activities include solid wood plantation forestry, with integrated manufacturing and distribution channels.
7. FCF's forest estate covers approximately 360,000 hectares in the Central North Island (CNI). Of that approximately 316,000 hectares are classed as productive for timber growth.
8. FCF owns three sawmills and four remanufacturing facilities.

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<sup>1</sup> Commerce Commission, *Practice note 4: The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in section 47 – A Test of Substantially Lessening Competition*, May 2001.

9. FCF (through its subsidiary Fletcher Challenge Forests Industries Limited) was contracted to manage the CNIFP assets for the CNIFP on an exact equivalent basis to that used for its own estate, subject to the management plan established by the CNIFP board.
10. FCF is listed on the New Zealand, Australian and New York Stock Exchanges. The largest single shareholding in FCF is owned by a subsidiary of Rubicon Limited (Rubicon), a New Zealand registered technology development company which is listed on the New Zealand Stock Exchange. Rubicon currently holds 17.6% of FCF's issued shares. Following the proposed acquisition, Rubicon will own less than 1% of FCF's shares.

## **CNIFP**

11. The CNIFP assets were acquired from the Crown in 1996. Various ownership changes have occurred since the original purchase leaving the Vendors as equal owners of the CNIFP assets. Forestry Corporation of New Zealand Limited (in receivership) is a wholly owned subsidiary of FCF. CITIC New Zealand Limited (BVI) (in receivership) is a subsidiary of CITIC.
12. The CNIFP estate consists of nine forests with a planted area of approximately 162,000 hectares in the central North Island of New Zealand (the CNI). Approximately 99% of the forests are held under Crown forestry licences. The CNIFP assets include a log processing plant at Kaingaroa and three solid wood manufacturing facilities: the Waipa sawmill, and two mouldings and millwork remanufacturing plants at Waipa and Mt Maunganui. These plants produce wood products such as structural Douglas fir lumber and components for the Japanese, Australasian and United States' markets in addition to a range of appearance, structural and industrial Radiata pine lumber products.

## **OTHER RELEVANT PARTIES**

### **Carter Holt Harvey Limited (CHH)**

13. CHH is Australasia's leading forest products company and one of the largest forest product companies in the Southern Hemisphere. Its forest holdings throughout New Zealand exceed 332,000 hectares and it has an annual harvest of approximately 5 million m<sup>3</sup> of radiata pine.
14. CHH's wood products include sawn timber, medium density fibreboard (MDF), laminated veneer lumber (LVL) and plywood. It is New Zealand's largest manufacturer and recycler of pulp and paper. Its paper and pulp products include kraft pulps, linerboard and mediums, carton board, corrugated board, packaging papers, tissue products, and speciality and recycled papers.
15. CHH owns five sawmills and eight remanufacturing facilities.

## Other Forest Owners

16. The following larger forest owners are relevant to this application and were consulted during the investigation.

**Table 1: Relevant Forest Owners**

<b>Forest Owner</b>	<b>Region(s) of Productive Forest</b>
Crown Forestry	CNI
Ernslaw One Ltd	CNI, Hawke's Bay (HB)
Evergreen Forests Ltd	Northland (Nthld), CNI, East Coast (EC), Southern North Island (SNI)
Hikurangi Forests	EC
Huaguang Forests	EC
Juken Nissho Ltd (JNL)	Nthld, EC, SNI
Pan Pac Forest Products Ltd (Pan Pac)	HB
Rayonier NZ	HB
UBS	Nthld
Winstone Pulp International Ltd (WPI)	CNI

## Saw Millers

17. Twenty four independent sawmillers throughout the Auckland, CNI and Hawke's Bay regions were interviewed. Pan Pac, Juken Nissho and WPI were also consulted regarding their saw mill activities.

## PROPOSED ACQUISITION

18. Each of the Vendors was placed in receivership by their senior secured lenders in February 2001 as a result of breaches of certain loan ratios and covenants at 31 December 2000. Since that time, the receivers have been undertaking a sales process with the intention of selling the assets of the CNIFP in order to recoup the amount of the outstanding debt. FCF has continued to manage the CNIFP's forest estate during the period of receivership.
19. On 17 June 2002, FCF signed a conditional Agreement for Sale and Purchase with the receivers on behalf of the Vendors under which FCF (through its wholly owned subsidiary, Kaingaroa Timber Company Limited), proposes to purchase substantially all of the assets of the CNIFP and assume certain operational liabilities of the Vendors. In particular, the assets to be acquired include:
- all the freehold and leasehold interests in land owned by the Vendors;
  - business records associated with the CNIFP assets;
  - certain intangible assets including the benefit of the operational agreements relating to the CNIFP's business, intellectual property, book debts and resource consents;

- the Vendors' rights under Crown forestry licences together with the trees and improvements to which the Vendors are entitled under those licences; and
- the shares in Red Stag Wood Products Limited (in receivership) and its subsidiary Red Stag Mouldings Limited (in receivership) (together the Red Stag Companies). Red Stag Mouldings Limited is the registered proprietor of the land on which the Mt Maunganui remanufacturing plant is located. Red Stag Wood Products Limited is the registered proprietor of the land on which the Waipa Mill and remanufacturing plant is located.

20. The Agreement for Sale and Purchase is subject to satisfaction of a number of conditions including receipt of shareholder approval, FCF finalising a new debt facility, various regulatory and governmental approvals and the satisfaction of conditions relating to the associated arrangements.

21. The components of the Proposed Transactions can be summarised as follows:

- the CNIFP acquisition, under which FCF will purchase the CNIFP assets for a price estimated to be approximately US\$650 million, fund Kaingaroa to allow it to meet its obligations under the CNIFP Agreement for Sale and Purchase;
- the new debt funding arrangements, under which FCF and its guaranteeing subsidiaries will borrow, from a syndicate of banks, US\$665 million to refinance current bank funding and to assist in the funding of the CNIFP acquisition;
- the SEAWI share subscription, under which FCF will issue to SEAWI 369,600,369 FCF ordinary shares and 739,200,739 FCF preference shares at an issue price of NZ\$0.37, will enter into governance arrangements and make the consequential amendments to its constitution. South East Asia Wood Industries Holdings Limited (SEAWI), is a Bermuda incorporated company listed on the Hong Kong Stock Exchange. It has its head office in Hong Kong and has historically been involved in the manufacture and sale of plywood. It has now been positioned as an investment company with its principal investment currently proposed to be its shareholding in FCF;
- the Rubicon share buy-back and forest sale, under which FCF will sell its Tahorakuri forest (which comprises approximately 11,800 hectares of forest in the CNI) to Rubicon at a valuation of US\$64 million in return for buying back from Rubicon 75,000,000 FCF ordinary and 279,816,354 FCF preference shares; and
- the Rubicon share transfer to SEAWI, under which Rubicon will transfer 131,076,848 FCF preference shares to SEAWI.



## INDUSTRY BACKGROUND

### Forestry in New Zealand

22. New Zealand's planted production forests cover an estimated 1.8 million hectares, with 71% situated in the North Island and 29% in the South Island. The Central North Island wood supply region, (refer Appendix A), accounts for approximately 33% of the total area.<sup>2</sup>
23. The most popular exotic species is radiata pine, with 1.608 million hectares planted in this species, of which approximately 1.1 million hectares are pruned. The Douglas Fir species is the next most popular species with 103,000 hectares. Other softwood species, which include macrocarpa, cypress and corsican, account for 34,000 hectares, whilst hardwood species such as Eucalyptus account for a further 54,000 hectares.<sup>3</sup>
24. Planted production forests are generally young with approximately 77% being 20 years or younger, 16% being between 21 and 25 Years and 7% being older than 25 Years. Radiata pine is generally harvested between the ages of 25 and 30 years.<sup>4</sup>
25. Approximately 230,000 hectares were planted in 2000. This is made up of 33,000 hectares of new planting and 35,700 hectares of restocking. It is estimated that 31,300 hectares of new planting occurred during 2001.
26. The total volume harvested in New Zealand for the year ended March 2001 was 19 million m<sup>3</sup>. It is estimated that 18.3 million m<sup>3</sup> came from clear felling 38,000 hectares of planted forest, and 0.7 million m<sup>3</sup> from production thinning. Based on the forests currently planted, forecasts show increases in potential wood supply in all parts of New Zealand. The largest increases are in Northland, the East Coast, Hawke's Bay, and the Southern North Island regions. These regions show very large increases in wood supply compared to current harvest levels. The large increases are forecast to occur over relatively short periods of time<sup>5</sup>

### Forestry regions

27. The North Island is divided into seven forestry regions – Northland, Auckland, Central North Island (CNI), East Coast, Hawke's Bay and Southern North Island (SNI).
28. Northland has growing conditions that allow radiata pine to produce logs with generally high wood density ideal for solidwood product. It also produces high-density pulplogs, which are required for certain products produced by mills in the Central North Island.
29. The CNI wood supply region is New Zealand's largest wood-producing region. It includes the Bay of Plenty region, the southern half of the Waikato region and the

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<sup>2</sup> Ministry of Agriculture and Forestry, *National Exotic Forest Description as at 1 April 2001* (Ministry of Agriculture and Forestry, 2002) 8.

<sup>3</sup> Op cit note 1

<sup>4</sup> Ibid

<sup>5</sup> NEFD National and Regional Wood Supply Forecasts 2000, 9.

northern part of the Manawatu-Wanganui region<sup>6</sup>. It is dominated by the virtually flat volcanic plateau, which is ideal for forest growing, harvesting and log transport. Planted production forests are extensive on the plateau near Tokoroa, Kawerau, Kaingaroa and the eastern side of Lake Taupo. Smaller forests and woodlots are situated throughout the region, but are more common in the central and eastern regions.

30. Five forestry companies and the Crown own most of the CNI planted forest. The balance is owned by numerous landowners, many with less than 1000 hectares.
31. The CNI has a well-established wood processing industry including two kraft pulp and paper mills, two chemical thermo-mechanical pulp mills, one mechanical pulp mill, 22 sawmills, two veneer plants, seven post and pole manufacturers and one combined particleboard and MDF plant.
32. The East Coast is dominated by stands of radiata pine less than 15 years old and extensive new plantings have considerably increased the forest area. Log quality is expected to be high due to extensive pruning and thinning.
33. Hawke's Bay has almost 7% of New Zealand's planted forests. It is dominated by radiata pine, which has medium to very high productivity on the hill country.
34. Most of the forecast wood supply from the SNI is likely to come from the Wanganui, Manawatu and Wairarapa. Over half the supply is expected to come from small forest growers. Tree growth rates vary widely and the wood is of relatively low density.
35. Table 2 shows the areas of planted production forest in the North Island by region.

**Table 2: North Island Planted Production Forest by Region (Hectares)**

<b>Region</b>	<b>All Species</b>	<b>Radiata Pine</b>
<b>Northland</b>	205,105	200,006
<b>Auckland</b>	54,940	52,800
<b>Central North Island</b>	577,385	522,845
<b>East Coast</b>	153,311	147,830
<b>Hawke's Bay</b>	123,367	117,818
<b>Southern North Island</b>	156,934	150,782
<b>Total</b>	1,271,042	1,192,081

Source: National Exotic Forest Description as at 1 April 2001

36. Tables 3 and 4 set out the age distribution of pruned and unpruned radiata in each of the North Island regions.

<sup>6</sup> NEFD National and Regional Wood Supply Forecasts 2000,19.

**Table 3: Age Class Distribution of Pruned Radiata in North Island (Hectares)**

Region	1 - 5 years	6 – 10 years	11 – 15 years	16 – 20 years	21 – 25 years	26 – 30 years	Over 30 years	Total
<b>Nthld</b>	19,287	22,532	17,708	19,967	18,868	8,175	1,929	108,466
<b>Akl</b>	4,450	9,568	4,310	4,122	4,186	1,903	239	28,778
<b>Cni</b>	61,124	49,044	59,699	76,681	66,942	19,790	1,680	334,960
<b>E.C.</b>	24,562	43,140	16,433	15,715	10,566	2,618	112	113,146
<b>H.B.</b>	21,331	33,346	6,460	13,098	14,075	5,645	399	94,354
<b>Sni</b>	35,550	47,438	14,206	13,005	12,077	4,121	1,080	129,088
<b>Total</b>	166,304	208,068	118,816	142,588	126,714	43,863	5,439	808,792

Source: National Exotic Forest Description as at 1 April 2001

**Table 4: Age Class Distribution of Unpruned Radiata in North Island (Hectares)**

Region	1 - 5 years	6 – 10 years	11 – 15 years	16 – 20 years	21 – 25 Years	26 – 30 years	Over 30 years	Total
<b>Nthld</b>	17,780	12,091	16,762	26,719	11,442	5,567	1,089	91,450
<b>Akl</b>	4,002	5,721	1,665	4,082	4,676	3,412	464	24,022
<b>CNI</b>	58,889	37,863	19,938	23,751	25,214	20,225	2,005	127,885
<b>E.C.</b>	11,675	5,834	5,107	6,376	2,740	2,713	239	34,684
<b>H.B.</b>	6,640	4,411	366	5,661	2,520	3,658	208	23,464
<b>SNI</b>	5,171	6,514	1,787	2,358	2,730	1,923	1,211	21,694
<b>Total</b>	104,157	72,434	45,715	68,947	49,322	37,498	5,216	383,289

Source: National Exotic Forest Description as at 1 April 2001

### Log Production

37. The quality of logs from plantation grown trees can be influenced by several different factors: generic selection, silviculture practice, site selection and rotation age. Log quality is generally a function of size (diameter and length), shape (straightness, roundness and taper). Branch related features such as size and distribution, and improvements achieved by pruning are also important features. The branch index of a tree is determined by the mean diameter of the four branches representing the largest branch in each of the four quadrants of a log. The size and distribution of knots in a log affect timber grade outturn.<sup>7</sup>

38. Wood basic density is also an important indicator of wood quality. This is a measure of the mass of dry wood substance per unit volume of green timber and is an important indicator of wood strength. Wood density is measured in units of kg/m<sup>3</sup>.<sup>8</sup> Within New Zealand, the Northland and Auckland regions produce high-density wood, the Central North Island produces medium density wood, whilst regions further south produce lower density wood.<sup>9</sup>

<sup>7</sup> *Properties and Uses of Radiata Pine* (Kininmonth and Whitehouse, vol 1, Ministry of Forestry, 1991 5-2.

<sup>8</sup> Ibid 6-3

<sup>9</sup> <[http://www.insights.co.nz/products\\_processes\\_tc.asp](http://www.insights.co.nz/products_processes_tc.asp)>

39. If trees are pruned, the core of the wood containing defects can be restricted to a relatively small cylinder in the butt log (the first log produced from the tree). Thinning will promote rapid growth of clearwood outside the knotty core. In this situation, clear timber or veneer is produced instead of grades containing knots. Pruning is normally conducted in years 5 to 10 of the tree's growth, however this is also dependent on the site.
40. The outerwood of a radiata pine tree is referred to as mature wood. It is mainly sapwood, has a higher density, fewer knots and narrower growth rings. It is used as high quality structural timber, as clear lengths for furniture and decorative boards. The corewood or juvenile wood is mainly heartwood, is of lower density and is less stable than the outerwood. It is used in industrial packaging, as low strength structural timber and in reconstituted products such as MDF and particle board.<sup>10</sup>
41. Log quality is a more important issue to the solid wood processing industry than it is to the reconstituted wood industries. This is because the economics of log conversion in solid wood processing are dependent on log size and shape. The grade of timber produced is a function of the defects present. Manufacturers of reconstituted wood products are predominantly supplied from sawmill residues and log size and shape is not a great concern.<sup>11</sup>
42. Log grade specifications for radiata pine have been developed, and these specifications are based on the characteristics for determining value in processing. The specifications for domestic log grades are outlined below in Table 5.

**Table 5: Domestic Log Specifications**

Log Grade	Log Type	Small end Diameter (mm)	Maximum Knot (mm)	Sweep Class
P1	Pruned	400+	0	1
P2	Pruned	300-399	0	1
S1	Unpruned	400+	60	1
S2	Unpruned	300-399	60	1
S3	Pruned or unpruned	200-299	60	1
L1	Unpruned	400+	140	1
L2	Unpruned	300-399	140	1
L3	Unpruned	200-299	140	1
Pulp	Unpruned	100	N/a	2

Source: Ministry of Agriculture and Forestry

43. Pruned logs are generally distinguished on the basis of external characteristics. Internal quality characteristics such as the defect core, are not included in the specifications. The quality and potential value of pruned logs can vary greatly, depending on the silviculture regime.<sup>12</sup> Pruned logs are generally used to produce appearance grade timber.

<sup>10</sup> New Zealand Pine Remanufacturers Association, *New Zealand Pine User Guide* (Neilson Scott Limited, 1996) 10.

<sup>11</sup> Op cit note 7 at 5-3.

<sup>12</sup> Ibid 5-19

44. Unpruned logs are generally used to produce timber for construction and industrial uses.
45. The pulp log is a low value product, which is generally produced from the top of the tree or from production thinnings. It is characterised by a high moisture content, high sapwood content and low wood density. It is used, along with wood chips, in the manufacture of MDF and particleboard, and in the manufacture of pulp and paper.

### **The Structure of the Log Supply Market**

46. The saw log supply market is characterised by several different strategic groups of competitors. The first group involves large vertically integrated, forestry companies that are involved in forest ownership and log production, log trading, and downstream wood processing facilities. These processing operations include sawmilling to produce sawn timber, panel products such as particleboard and MDF, and engineered wood products such as plywood and LVL. CHH and FCF are included within this group, along with the CNIFP.
47. The next strategic group is also characterised by a vertically integrated structure. However, the scale of business operations is considerably smaller than for the first group and these businesses are generally net purchasers of logs. These competitors are involved in downstream wood processing activities including sawmilling, pulp making, MDF and LVL production. This group includes Pan Pac and WPI within the Central North Island, and Juken Nissho, and Rayonier situated on the East Coast.
48. The third group is characterised by forest ownership or management on a large scale, with no downstream processing activities. These competitors are smaller privately owned or publicly listed companies or partnerships whose core competencies are forest ownership and log production on a smaller scale to the groups identified above. Competitors in this group include NZFM, which manage the Crown leases at Lake Taupo and Rotoaira for the MAF, Ernslaw One, Evergreen Forests, and Nuhaka Forestry Fund.
49. The next group consists of fragmented, smaller scale forestry ownership. Owners include farmers with woodlots on parts of their farms and other private individuals with small blocks of plantation forests. They also include more substantial forests owned by bodies such as local governments or the Corrections Department.

### **Sawn Timber**

50. Timber produced from log processing can be categorised into the following grades:
- Appearance grades;
  - Structural grades; and
  - Industrial grades.
51. Appearance grades are also known as board grades and are used for finishing and in the manufacture of furniture. They include clear lumber, which is free of knots and other blemishes, and which is used for high quality joinery, furniture and mouldings. They also include 'cuttings grades', which are reprocessed to produce shorter clear lengths of

timber, which are often finger jointed and edge glued to produce mouldings and furniture.

52. Structural grades or framing grades are used primarily for construction. The main factor influencing these grades is the size and location of knots.
53. Industrial grades of timber are used in packaging for different products such as pallets, and concrete formwork
54. The production of sawn timber has increased by 69 percent since 1991. For the year ended 30 September 2002, production of sawn timber totalled 3.8 million m<sup>3</sup>. As at March 2001, 338 sawmills were operating throughout New Zealand. 60% (205) of them were situated within the North Island with the largest concentration of saw milling operations being within the Central North Island. Saw milling operations range in size from small portable saw milling operations to very large producers of sawn timber. Within the North Island, 136 mills (66%) produce less than 2000 m<sup>3</sup> of sawn timber, 29 mills produced less than 20,000 m<sup>3</sup>, whilst 31 mills (15%) produced over 20,000 m<sup>3</sup>. These larger mills were responsible for 90% of total output in the North Island.<sup>13</sup>

### Woodchips

55. Woodchips are produced as a residue from the saw milling and log processing process. They are also produced from the chipping of pulplogs. They are used in the manufacture of MDF, particleboard, pulp and paper.

### Commerce Commission Decision 426

56. On 30 March 2001, the Commerce Commission registered a notice seeking clearance for the acquisition by CHH of the shares in or the assets of the CNIFP. The Commission granted a clearance subject to undertakings by CHH to divest the right to harvest and own without limitation the wood produced from such harvest, pruned trees situated in the CNI compromising certain volumes of pruned sawlogs during the years ended 1 April 2002 to 2005.

### MARKET DEFINITION

57. The Act defines a **market** as:

*. . . a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.*

58. For the purpose of competition analysis, a relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, could impose at least a small yet significant and non-

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<sup>13</sup> Ministry of Agriculture and Forestry, *Statistical Release: Annual Production of Rough Sawn Timber, Year Ended 31 March 2000*.

transitory increase in price, assuming all other terms of sale remain constant (the ‘*ssnip* test’). For the purpose of determining relevant markets, the Commission will generally consider a *ssnip* to involve a five percent increase in price for a period of one year.

59. It is substitutability at competitive market prices that is relevant in defining markets. Where the Commission considers that prices in a given market are significantly different from competitive levels, it may be necessary for it to assess the effect of a *ssnip* imposed upon competitive price levels, rather than upon actual prices, in order to detect relevant substitutes.
60. The Commission will seek to define relevant markets in terms of four characteristics or dimensions:
  - the goods or services supplied and purchased (the product dimension);
  - the level in the production or distribution chain (the functional level);
  - the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic extent); and
  - the temporal dimension of the market, if relevant (the timeframe).
61. The Commission will seek to define relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration. A relevant market will ultimately be determined, in the words of the Act, as a matter of fact and commercial common sense.
62. Where markets are difficult to define precisely, the Commission will initially take a conservative approach. If the proposed acquisition can be cleared on the basis of a narrow market definition, it would also be cleared using a broader one. If the Commission is unable to clear the proposed acquisition on the basis of the narrower market, it will be necessary to review the arguments and evidence in relation to broader markets.
63. The Applicant submitted that the relevant markets in which the acquisition will result in horizontal aggregation of business activities are the markets for:
  - the production and supply of unpruned sawlogs in the CNI, Auckland and Hawke’s Bay;
  - the production and supply of pruned sawlogs in the CNI, Auckland, Hawkes’ Bay and East Coast of the North Island;
  - the production and supply of pulplogs in the CNI, Auckland, Hawke’s Bay and East Coast of the North Island;
  - the production and supply of woodchips in the CNI, Auckland, Hawke’s Bay and East Coast of the North Island; and
  - the production and supply of sawn timber in the North Island.

### **Product Dimension**

64. The delineation of relevant markets as a basis for assessing the competitive effects of a business acquisition begins with an examination of the goods or services offered by each of the parties to the acquisition. Both demand-side and supply-side factors are

generally considered in defining market boundaries. Broadly speaking, a market includes products that are close substitutes in buyers' eyes on the demand-side, and suppliers who produce, or are able easily to substitute to produce, those products on the supply-side.

65. The Commission takes the view that the appropriate time period for assessing substitution possibilities is the longer term, but within the foreseeable future.<sup>14</sup> The Commission considers this to be a period of one year, which is the period customarily used internationally in applying the 'ssnip' test (see below) to determine market boundaries. The Commission will take into account recent, and likely future, changes in products, relative prices and production technology in the process of market definition.

#### *Demand-side substitution*

66. Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so by a small change in their relative prices.
67. Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. Unequivocal substitutes are combined. For each initial market so defined, the Commission will examine whether the imposition of a snip would be likely to be profitable for the hypothetical monopolist. If it were, then all of the relevant substitutes must be incorporated in the market. If not, then the next most likely substitute good or service will be added to the initial market definition and the test repeated. This process continues until a combination of products is found which defines the product dimension of a relevant market, namely, the smallest combination of goods or services for which a snip would be profitable.
68. On the demand-side, the technical viability of one good or service as a substitute for another must be assessed. However, even where another product may technically be suitable as an alternative for the product in question, its price may be so much higher that it may be a poor substitute in an economic sense, at least for the great majority of buyers. In judging economic substitutability between products, the Commission will have regard to relative prices, quality and performance when assessing whether they are, in fact, close substitutes in the eyes of buyers.

#### *Supply-side substitution*

69. Close substitute products on the supply-side are those between which suppliers can easily shift production, using largely unchanged production facilities and little or no additional investment in sunk costs, when they are given a profit incentive to do so by a small change in their relative prices.

#### *Product Definition Analysis*

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<sup>14</sup> In *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [ ] 2 NZLR 351 Smellie J and the Court of Appeal on appeal approvingly quoted an earlier decision of the Commerce Commission in *Edmonds Food Ind Ltd v W F Tucker & Co Ltd* (Decision 21, June 1984) where the Commission had ruled: "A market has been defined as a field of actual or potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive".



70. Production forests in New Zealand are dominated by radiata pine, which accounts for 89% of total planted resource. In Decision 426, the Commission took into account that the ownership spread of species other than radiata pine is not markedly different from that of radiata pine and therefore considered that it was not necessary to focus specifically on the other species when assessing the competitive impact of the proposed acquisition.
71. The Applicant advised that the proposed acquisition would not have a more significant impact on any other species than on radiata pine.
72. The Commission therefore will continue to take the approach set out in Decision 426.
73. In Decision 426 the Commission decided that the appropriate product markets were:
- Pruned sawlogs
  - Unpruned sawlogs
  - Pulplogs
  - Woodchips
  - Sawn timber.
74. The Applicant adopted the same product markets in its application. The Commission is of the opinion that the above product markets are appropriate for assessing the competition implications of the proposed acquisition.

#### *Undifferentiated/Differentiated Products*

75. In some instances, market definitional problems arise because of the differentiated nature of the goods or services involved in a business acquisition, caused by differing technical specifications, branding, packaging, warranties, distribution channels and other factors.
76. Where a significant group of buyers within a relevant market is likely to be subject to price discrimination, the Commission will consider defining additional relevant markets based on particular uses for a good or service, particular groups of buyers, or buyers in particular geographic areas. In other cases, the primary focus may switch to the extent to which a business acquisition eliminates competition between the products brought together by the acquisition.
77. The Applicant submitted that the products are generally undifferentiated commodity products. It stated that there is some differentiation in pruned sawlogs in terms of quality which enables premiums to be obtained but that significant volumes are not involved. The Applicant also advised that although price is a key factor in purchasing decisions, reliability of delivery/supply is also important. This is because wood is perishable, requires a relatively large land area for storage, and sawmills face significant costs if they are unable to maintain throughput. Reliable delivery/supply may enable a premium to be obtained.
78. Information obtained from industry participants indicated that there is some differentiation in terms of quality for all the products. The amount of available clearwood affects the price payable for pruned and unpruned sawlogs and density is an

important factor for pulplogs used for some purposes and woodchips. Sawn timber is differentiated according to the purpose for which it is intended e.g. framing, furniture or packaging.

79. As in Decision 426, the Commission considers that although products are differentiated to some extent, the products are not so differentiated as to affect the market definition.

*Conclusion on product dimension*

80. The Commission concludes that for the purpose of assessing the competition implications of the proposed acquisition, the appropriate product markets are:

- Unpruned sawlogs
- Pruned sawlogs
- Pulplogs
- Woodchips
- Sawn timber.

**Geographic Extent**

81. The Commission seeks to define the geographical extent of a market to include all of the relevant, spatially dispersed, sources of supply to which buyers can turn should the prices of local sources of supply be raised. For each good or service combination, the overlapping geographic areas in which the parties operate are identified. These form initial markets to which a ssnip is applied. Additional geographic regions are added until the smallest area is determined within which the hypothetical monopolist could profitably impose a ssnip.

82. Where transport costs are high relative to the final value of a product, a narrower geographic market is more likely to be appropriate. Where product perishability and other similar practical considerations limit the distance that a product may be transported, this may limit the geographic extent of the market. The timeliness of delivery from alternative geographic sources is similarly relevant.

83. Although buyers and sellers of a particular good or service may interact in markets that are apparently local or regional in extent, those markets may themselves overlap and interrelate so as to form a market covering a larger geographical area. In these situations, the larger market is likely to be the appropriate one for analysing the competitive effects of a business acquisition.

84. In Decision 426, the Commission decided that the appropriate geographic markets were:

- Pruned sawlogs – CNI, Auckland and Hawke’s Bay
- Unpruned sawlogs – CNI
- Pulplogs – CNI
- Woodchips – CNI
- Sawn timber – North Island.

85. The Applicant submitted that the competitive dynamics of demand and supply as evidenced by actual and material movements justify enlarged geographic markets for each of the products.

#### *Pruned Sawlogs*

86. The Applicant submitted that significant volumes of pruned sawlogs flow into the CNI sawmills from the East Coast and that therefore the geographic market should be extended to include the East Coast.
87. Information obtained by the Commission indicates that there is some flow from the East Coast to the CNI, amounting to approximately [ ] of the total CNI, Auckland and Hawke's Bay supply of pruned sawlogs. The distance between the East Coast and the CNI mean that logs sent from the East Coast would incur significant transport costs. It is possible that it would only be viable to transport the higher-valued logs this distance. The Commission does not yet have sufficient information to conclude that East Coast pruned logs provide an effective competitive constraint on CNI log producers. In the absence of this information the Commission has taken a conservative position and excluded the East Coast from the geographic market under consideration. This is consistent with the approach the Commission adopted in Decision 426.
88. The Commission has, however, recognised that some imports from the East Coast are possible when considering the extent of FCF's market power in the defined market post-acquisition.

#### *Unpruned Sawlogs*

89. The Applicant submitted that a material volume of supply of unpruned sawlogs from Auckland and Hawke's Bay into the CNI indicates that the geographic market should be extended to include Auckland and Hawke's Bay.
90. Information obtained by the Commission indicates that there is some flow of unpruned sawlogs from Auckland and Hawke's Bay into the CNI, amounting to approximately [ ] of the total supply. Some logs also flow from the SNI [ ]. However, the Commission does not have sufficient information at this stage to be confident that these supplies to the CNI would increase sufficiently in response to a price increase to prevent a *snip*. In the absence of this information the Commission has taken a conservative position and excluded Auckland and Hawke's Bay from the geographic market under consideration. This is consistent with the approach the Commission adopted in Decision 426.
91. The Commission is therefore of the opinion that the appropriate geographic market for unpruned logs is the CNI. It has, however, recognised that some imports from outside the CNI are possible when considering the extent of FCF's market power in the defined market post-acquisition.

#### *Pulplogs*

92. The Applicant submitted that a material volume of supply of pulplogs from Auckland, East Coast and Hawke's Bay into the CNI indicates that the geographic market should be extended to include Auckland, East Coast and Hawke's Bay.
93. Information obtained by the Commission shows some flow of pulplogs from Auckland, East Coast and Hawke's Bay into the CNI, representing [ ] of CNI's total supply. Pulplogs are also obtained from SNI [ ] and Northland [ ]. The Commission has previously considered that the relative low value of pulplogs and high transport costs would restrict the ability of log producers to transport pulplogs outside their region in response to a *ssnip*. While noting the flows coming into the CNI from other areas, the Commission considers it does not have sufficient information at this time to justify an increase in the geographic scope of the pulplog market beyond that for the CNI. It notes that for the purpose of analysing the current application, this is a conservative position.
94. The Commission has recognised that there are some imports from outside the CNI when considering the extent of FCF's market power in the defined market post-acquisition.

#### *Woodchips*

95. The Applicant estimated that [ ] of total CNI demand is satisfied from sources outside the CNI. These inflows are comprised of [ ] and [ ] from the Northland and Auckland wood supply regions respectively. Having regard to these inflows, the Applicant submitted that the relevant geographic market includes at a minimum the CNI, Auckland, East Coast and Hawke's Bay wood supply regions.
96. The Commission has been informed that woodchips do flow from all over the North Island into the CNI but is of the opinion that the appropriate approach in order to assess the competition implication of the current application is to adopt a geographic market of the CNI and to take supply from other regions into account when assessing the constraints upon the merged entity.

#### *Sawn Timber*

97. The Applicant stated that the relevant geographic market in respect of sawn timber is national in extent but that given that significant constraint will be imposed on FCF post-acquisition such that competition will not be substantially lessened as a result of the acquisition, it accepted a North Island market for the supply and production of sawn timber for the purposes of this application, but reserved its position to argue the broader national geographic market.
98. Information gathered by the Commission from industry participants indicates that the flow of sawn timber between the North Island and the South Island is minimal in terms of the total supply. The Commission is therefore of the opinion that the appropriate geographic market for sawn timber is the North Island.

### *Conclusion on Geographic Markets*

99. The Commission concludes that for the purpose of assessing the competition implications of the proposed acquisition, the appropriate product markets are:

- Pruned sawlogs – CNI, Auckland and Hawke’s Bay
- Unpruned sawlogs – CNI
- Pulplogs – CNI
- Woodchips – CNI
- Sawn timber – North Island.

### **Functional Level**

100. The production, distribution and sale of a product typically occur through a series of functional levels – for example, the manufacturing/import level, the wholesale/distribution level and the retail level. It is often useful to identify the relevant functional level in describing a market, as a proposed business acquisition may affect one horizontal level, but not others.<sup>15</sup> Alternatively, some acquisitions, such as those involving businesses at different vertical levels, may raise issues related to vertical integration. Generally, the Commission will seek to identify separate relevant markets at each functional level affected by an acquisition and assess the impact of the acquisition on each.

101. The Applicant submits and the Commission agrees that the appropriate functional level for each product is the production and supply of each product.

### **The Timeframe**

102. Generally the Commission will view markets as functioning continuously over time. However where there are supply or demand characteristics which are likely to alter at different times, the Commission may seek to define a separate time dimension as part of its market definition process.

103. With forestry, production depends substantially on the level of plantings that took place many years before the felling of the tree. Radiata pine, for instance, usually take 25-30 years to reach maturity. Each firm’s potential production will vary with the age of its forest. Thus a firm’s market share (and market power) can vary over time.

104. The Commission considers, therefore, that it is appropriate in this case to have a time component in the market definitions. It considers that possible changes in market

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<sup>15</sup> *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473, 502 The High Court (Greig J, Shaw WJ, Prof M Brunt) noted: “If we ask what functional divisions are appropriate in any market definition exercise, the answer, ..., must be whatever will best expose the play of market forces, actual and potential, upon buyers and sellers. Wherever successive stages of production and distribution can be co-ordinated by market transactions, there is no difficulty: there will be a series of markets linking actual and potential buyers and sellers at each stage. And again, where pronounced efficiencies of vertical integration dictate that successive stages of production and distribution must be co-ordinated by internal managerial processes, there can be no market.”

power over time can be measured by assessing separately the periods 2003-2005, 2006-2010 and 2011-2015.

### **Conclusion on Market Definition**

105. The Commission concludes that the relevant markets are:

- the production and supply of unpruned sawlogs in the CNI, for the periods 2003-2005, 2006-2010 and 2011-2015 (the unpruned sawlog market);
- the production and supply of pruned sawlogs in the CNI, Auckland and Hawke's Bay for the periods 2003-2005, 2006-2010 and 2011-2015; (the pruned sawlog market);
- the production and supply of pulplogs in the CNI, for the periods 2003-2005, 2006-2010 and 2011-2015 (the pulplog market);
- the production and supply of woodchips in the CNI ( the woodchip market); and
- the production and supply of sawn timber in the North Island (the sawn timber market).

## **COMPETITION ANALYSIS**

### **Substantially Lessening of Competition**

106. Section 47 of the Act prohibits particular business acquisitions. It provides that:

*A person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.*

107. Section 2(1A) provides that substantial means "real or of substance". Substantial is taken as meaning something more than insubstantial or nominal. It is a question of degree.<sup>16</sup> What is required is a real lessening of competition that is not minimal. The lessening needs to be of such size, character and importance to make it worthy of consideration.<sup>17</sup>

108. Section 3(2) provides that references to the lessening of competition include references to the hindering or preventing of competition.<sup>18</sup>

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<sup>16</sup> *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406, 434; *Mobil Oil Corporation v The Queen in Right of NZ* 4/5/89, International Centre for Settlement of Investment Disputes, Washington DC, International Arbitral Tribunal ARB/87/2 (paras 8.2, 19, 20).

<sup>17</sup> *Dandy Power Equipment Ltd v Mercury Marina Pty Ltd* (1982) ATPR 40-315, 43-888; *South Yorkshire Transport Ltd v Monopolies & Mergers Commission* [ 1983 ] 1 All ER 289.

<sup>18</sup> For a discussion of the definition see *Commerce Commission v Port Nelson Ltd*, supra n 6, 434.

109. While the Act defines the words “substantial” and “lessening” individually it is desirable to consider the phrase as a whole. For each relevant market, the Commission will assess:

- the probable nature and extent of competition that would exist in a significant section of the market, but for the acquisition (the counterfactual);
- the nature and extent of the contemplated lessening; and
- whether the contemplated lessening is substantial.<sup>19</sup>

110. In interpreting the phrase “substantially lessening competition”, the Commission takes into account the explanatory memorandum to the Commerce Amendment Bill (No 2). The memorandum notes that:

*Two of the 3 key prohibitions are strengthened to bring New Zealand into line with Australian competition law, which will facilitate a more economic approach to defining anti-competitive behaviour.*

and, in relation to s47:

*This proposed new threshold is the same as the threshold for these types of acquisitions in section 50 of the Trade Practices Act 1974 (Australia).*

111. For the purposes of the analysis, the Commission takes the view that a lessening of competition and a strengthening of market power may be taken as being equivalent, since they are the two sides of the same coin. Hence, it uses the two terms interchangeably. Thus, in considering whether the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market, the Commission will take account of the scope for the exercise of market power, either unilaterally or through co-ordination between firms.
112. When the impact of enhanced market power is expected predominantly to be upon price, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and able to be sustained for a period of at least two years, for the lessening, or likely lessening, of competition to be regarded as substantial. Similarly, when the impact of increased market power is felt in terms of the non-price dimensions of competition, these also have to be both material and able to be sustainable for at least two years for there to be a substantial lessening, or likely substantial lessening, of competition.

### **The Counterfactual**

113. The Commission uses a forward-looking, counterfactual, type of analysis in its assessment of business acquisitions, in which two future scenarios are postulated: that with the acquisition in question, and that in the absence of the acquisition (the counterfactual). The impact of the acquisition on competition can then be viewed as

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<sup>19</sup> See *Dandy*, supra n 5, pp 43–887 to 43–888 and adopted in New Zealand: *ARA v Mutual Rental Cars* [ ] 2 NZLR 647; *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [ ] 2 NZLR 352; *Fisher & Paykel Ltd v Commerce Commission* [ ] 2 NZLR 731; *Commerce Commission v Carter Holt Harvey*, unreported, High Court, Auckland, CL 27/95, 18/4/00.

the difference between those two scenarios. It should be noted that the status quo cannot necessarily be assumed to continue in the absence of the acquisition, although that may often be the case. For example, in some instances a clearly developing trend may be evident in the market, in which case the appropriate counterfactual may be based on an extrapolation of that trend.

114. The Applicant submitted that the relevant counterfactual is the acquisition of the CNIFP assets by an independent third party with no existing CNI forestry assets.
115. It claimed, however, that as FCF is the current manager and there are significant synergies to be gained for a forest owner in having FCF manage the CNIFP estate in conjunction with FCF's own forest, it is more likely than not that FCF will continue to be appointed as manager of the CNIFP estate even if it is sold to a third party. It stated that this situation is confirmed by the fact that there are no interested alternative buyers that have the facilities to manage the CNIFP assets. The Applicant states that if such an alternative buyer were to appoint a manager it will more likely than not appoint a manager which is experienced, skilled in the region of the forests and which can provide strong value synergies from its own forests and forestry operations and draws the conclusion that the manager is therefore more likely than not to be FCF.
- The Receiver advised that [

]

- FCF advised that [

]

116. Two very different views of the counterfactual [ ] have been expressed. The Commission is not in a position at this stage to ascertain which is the more likely to occur. For the purposes of analysis of the competition implications of the proposed acquisition, the Commission has taken the conservative approach of adopting the scenario which is most likely to result in the greatest amount of competition in the relevant markets.
117. The Commission considers that the most appropriate counterfactual to adopt in order to thoroughly test the competition implications of the proposed acquisition by FCF is



that of an acquisition of the CNIFP assets by a third party (as specified in paragraph 116) and the management of those assets by a party other than FCF.

### **Conclusion – Competition Analysis Principles**

118. The Act prohibits business acquisitions that would be likely to have the effect of substantially lessening competition in a market. The Commission makes this assessment against a counterfactual of what it considers would be likely to happen in the absence of the acquisition. In the present case the counterfactual is considered to be the acquisition of the CNIFP assets by a third party (as specified in paragraph 116) and the management of those assets by a party other than FCF. A substantial lessening of competition is taken to be equivalent to a substantial increase in market power. A business acquisition can lead to an increase in market power by providing scope either for the combined entity to exercise such power unilaterally, or for the firms remaining in the market to co-ordinate their behaviour so as to exercise such power.
119. In broad terms, a substantial lessening of competition cannot arise from a business acquisition where there are sufficient competitive constraints upon the combined entity. The balance of this Decision considers and evaluates the constraints that might apply in the relevant markets under the following headings:
- existing competition;
  - potential competition from entry; and
  - other competition factors.

## **THE UNPRUNED SAWLOG MARKET**

### **Analysis of Existing Competition**

#### *Scope for Unilateral Market Power*

##### Introduction

120. An examination of concentration in a market post-acquisition can provide a useful guide to the constraints that market participants may place upon each other, including the combined entity. Both structural and behavioural factors have to be considered. However, concentration is only one of a number of factors to be considered in the assessment of competition in a market. Those other factors are considered in later sections, as noted above.
121. Market shares can be measured in terms of revenues, volumes of goods sold, production capacities or inputs (such as labour or capital) used. All measures may yield similar results in some cases. Where they do not, the Commission may, for the purposes of its assessment, adopt the measure which yields the highest level of market share for the combined entity. The Commission considers that this will lead to an appropriately conservative assessment of concentration, and that the factors which

lead to the other different market share results are more appropriately considered elsewhere during the assessment of the acquisition.<sup>20</sup>

122. In determining market shares, the Commission will take into account the existing participants (including ‘near entrants’), inter-firm relationships, and the level of imports. This is followed by a specification of the Commission’s ‘safe harbours’, an estimation of market shares, and an evaluation of existing competition in the market. Each of these aspects is now considered in turn.

### Existing Participants

123. The existing competitors are set out in paragraphs 13 to 16 of this report. The largest existing competitor is CHH, which is currently the largest forest owner in New Zealand.

### Imports

124. In markets where imports are present, the Commission will consider whether actual competition from imported products is the equivalent to that from domestic supply. In undertaking this evaluation, the Commission will take into account the existence of any limits on quantities of imported product (the price elasticity of supply), and the effects on trade of various factors. Imports channelled through the parties to an acquisition, or persons associated with them, will be added to their domestic production in assessing market share, rather than being treated as independent sources of supply.
125. Potential imports may also provide a constraint on domestic suppliers. This is considered as part of the assessment of the constraint from market entry below.
126. There are currently no imports of any of the products relevant to this investigation because of the substantial costs involved in transport. Industry participants advised the Commission that this situation is likely to continue.

### Safe Harbours

127. Once the relevant market has been defined, the participants have been identified, and their market shares estimated, the Commission’s ‘safe harbours’ can be applied. Under these safe harbours, a business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:
- where 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

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<sup>20</sup> For example, where market share measured in terms of capacity produces a significantly lower share of the market in the hands of participants than a measure in terms of sales volumes, the constraint on a combined entity from that unemployed capacity might be taken into account when identifying near entrants or the constraint from new market entry. In some cases, the model of market power being used may influence the choice as to which market share measure is used.

- where 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%.
128. As noted below, market shares by themselves are insufficient to establish whether competition in a market has been lessened. Other relevant issues are discussed in later sections.

#### Market Shares

129. Market share information has been provided by the Applicant and industry participants. Further information was obtained from the NEFD National and Regional Wood Forecasts 2001. The market shares are estimates only as production is variable due to factors such as the weather. Also the interaction of supply and demand, and the impact on price, mean that companies are continually re-evaluating when they harvest. Annual production flows are therefore uncertain. Estimated market shares are shown in Table 6.

**Table 6: Future Wood Flows for Unpruned Sawlogs in the CNI (m<sup>3</sup>)**

Supplier	2003-2005		2006-2010		2011-2015	
	Ann Avg	% Mkt Share	Ann Avg	% Mkt Share	Ann Avg	% Mkt Share
CNIFP	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
FCF	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Merged entity</b>	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
CHH	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Crown	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Winstone	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Tahorakuri	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
UBS	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Evergreen	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Other Owners	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Total CNI</b>	[ ]		[ ]		[ ]	
Imports Akl	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Imports EC	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Imports HB	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Imports SNI	[ ]	[ ]	[ ]	[2]	[ ]	[ ]
<b>Total</b>	[ ]	<b>100</b>	[ ]	<b>100</b>	[ ]	<b>100</b>

Source: Industry participants and NEFD National and Regional Wood Forecasts 2001

130. The three firm concentration is [ ] in the first period, [ ] in the second period and [ ] in the third period. With market shares of [ ], [ ] and [ ], the merged entity would be outside the safe harbours.
131. As already noted, market shares are insufficient in themselves to establish whether competition in a market has been lessened. It is the interplay between a number of competition factors, of which seller concentration is only one, that has to be assessed in determining the impact of a business acquisition on competition. Other competition factors include entry conditions; the presence of an aggressive, innovative or maverick firm; countervailing power of buyers or suppliers; rapid innovation in the market; and others. These are considered for the relevant market in subsequent sections.
132. As in decision 426, the Commission notes that the major forestry owners are vertically integrated and so consume some of their own production. Consequently the Commission has also considered the extent to which woodflows are committed to particular uses and therefore the extent by which the merged entity would be able to control or influence the flow of wood to parties such as the independent saw millers.
133. Table 7 analyses the supply of unpruned sawlogs, independent from the merged entity's supply, to determine whether that supply could satisfy the demand of the independent sawmillers. For the purpose of this analysis, it is assumed that the current proportion of exports (32%) is maintained.

**Table 7: Estimated Supply and Demand (excl. FCF/CNIFP) in CNI : Unpruned Sawlogs**

<b>Supply</b>	<b>2003-2005 Ann Avge (m3)</b>	<b>2006-2010 Ann Avge (m3)</b>	<b>2011-2015 Ann Avge (M3)</b>
CHH	[ ]	[ ]	[ ]
Other CNI	[ ]	[ ]	1,593,250]
Imports	[ ]	[ ]	[ ]
<b>Total Supply</b>	[ ]	[ ]	[ ]
Exports @ 32% of CNI production	[ ]	[ ]	[ ]
<b>Total Available to Domestic Market</b>	[ ]	[ ]	[ ]
<b>Demand</b>			
CHH	[ ]	[ ]	[ ]
Indep. Sawmills	[ ]	[ ]	[ ]
<b>Total</b>	[ ]	[ ]	[ ]
<b>Surplus</b>	[ ]	[ ]	[ ]

Source: Industry participants and NEFD National and Regional Wood Forecasts 2001

134. The analysis in Table 7 shows that for all three periods, supply available from forest owners other than the merged entity will exceed demand. Accordingly, independent purchasers of unpruned sawlogs will not be dependent on the merged entity for supply.

#### State of Existing Competition

135. Tables 6 and 7 shows that if the merged entity increased prices by a snip, purchasers are likely to be able to obtain logs from other suppliers. CHH in particular is a large supplier with a considerable surplus in each of the relevant periods. CHH is reported by industry participants as being a vigorous competitor in all the markets in which it is involved.
136. Supply contracts between forest owners and sawmills are generally either year long agreements with three monthly reviews of price and supply, or three month contracts. Accordingly, a purchaser can readily switch supplier.
137. Imports of unpruned sawlogs from other regions have increased significantly over the last year and this pattern is likely to continue. The availability of logs from Hawke's Bay and the East Coast in particular will be increasing considerably as the forests in those regions mature.
138. The supply of logs from smaller owners such as farmers is predicted to increase considerably and would be available to independent purchasers.

139. The Applicant pointed out that the Commission has previously accepted there is a general price relationship between the delivered price of domestic grades and the FOB prices of export grades of logs and that the Commission formed the view that export sales by competitors have potential to provide an ongoing competitive constraint. The Applicant stated that domestic and export unpruned sawlog pricing levels do converge over the long term. It submitted that on this basis, any attempts by the merged entity to raise domestic prices would be constrained by the ability of other suppliers to divert export logs to the domestic market at attractive prices.
140. The Commission has found evidence of a general price relationship between the delivered price of domestic grades and the *FOB* prices of export grades of logs.<sup>21</sup> Forest owners have acknowledged that export logs could be diverted back to the domestic market if market conditions were attractive. CHH said that it would be feasible, for the right prices, to divert enough from export for the supply of independent sawmillers.
141. With respect to this last point, independent small sawmillers were asked whether they were concerned by the proposed transaction. They were unanimous in considering there was no specific problem arising from the transaction. The potential difficulty they foresaw was a lack of availability of logs because of diversion of supply to the export market. However, they noted this would be an issue irrespective of who owned the CNIFP, as it was really a matter of domestic market conditions being affected by world market conditions.
142. It is the Commission's view that the ability to divert export sales by competitors has the potential to provide an ongoing competitive constraint.
143. The Applicant submitted that domestic customers are important to FCF and other suppliers because they take a variety of log products, which FCF needs to be able to produce and sell to optimise the forest cut. Furthermore, as unpruned sawlogs are part of a commodity market, demand, and price rise and fall drastically - dictated by international pricing in respect of which New Zealand forests are price takers not price leaders. Accordingly, forest owners (particularly large forest owners which require continual cash flow) require a hedge or alternative market. The domestic sawmills provide this alternative as their lumber markets (mainly New Zealand and Australia) either lag or follow different trends to the international log prices.
144. Other forest owners agreed with these points. They all said that the domestic market is crucial to the success of a supplier as it is stable, in comparison to the volatility of the export market, and provides guaranteed sales.

#### Conclusions – Unilateral Market Power

145. The Commission is of opinion that the above factors, in particular the availability of sufficient supply independent of the merged entity, the increasing availability of imports from other regions and the ability of suppliers to divert export sales to the domestic market will provide constraints on the merged entity.

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<sup>21</sup> The export log grade specifications are different to domestic log grade specifications. The differences relate to small end diameter, knot size and sweep class.

146. Accordingly, the Commission concludes that the merged entity will be constrained by existing competition in any attempt to exercise unilateral market power in the unpruned sawlog market.

### *Scope for the Exercise of Coordinated Market Power*

#### Introduction

147. A business acquisition may lead to a change in market circumstances such that coordination between the remaining firms either is made more likely, or the effectiveness of pre-acquisition coordination is enhanced. Firms that would otherwise compete may attempt to coordinate their behaviour in order to exercise market power by restricting their joint output and raising price. In extreme cases, where all firms in the market are involved and coordination is particularly effective, they may be able to behave like a collective monopolist. Where not all firms are involved, and market share in the hands of the collaborators is reduced, coordinated market power becomes more difficult to exercise because of competition from the independent firms in the market.
148. In broad terms, successful coordination can be thought of as requiring two ingredients: ‘collusion’ and ‘discipline’. ‘Collusion’ involves the firms individually coming to a mutually profitable expectation or agreement over coordination; ‘discipline’ requires that firms that would deviate from the understanding are detected and punished (thereby eliminating the short-term profit to be gained by the firm from deviating).
149. When assessing the scope for coordination in the market during the consideration of a business acquisition, the Commission will evaluate the likely post-acquisition structural and behavioural characteristics of the relevant market or markets to test whether the potential for coordination would be materially enhanced by the acquisition. The intention is to assess the likelihood of certain types of behaviour occurring, and whether these would be likely to lead to a substantial lessening of competition.

#### Collusion

150. “Collusion” involves firms in a market individually coming to a mutually profitable expectation or agreement over coordination. Both explicit and tacit forms of such behaviour between firms are included.
151. The structural and behavioural factors that are usually considered to be conducive to collusion are set out in the left-hand column in Table 8. The significance of these is explained more fully in the Commission’s *Practice Note 4*. The right-hand column of the Table then assesses the extent to which those factors are present, or are likely to be enhanced post-merger, in the LMI market. A high proportion of ‘yes’ responses would suggest that the market was particularly favourable to ‘collusion’; a high proportion of ‘no’ responses the reverse.

**Table 8: Testing the Potential for ‘Collusion’ in the Unpruned Sawlog Market**

<b>Factors conducive to collusion</b>	<b>Presence of factors in the market</b>
High seller concentration	No
Undifferentiated product	No
New entry slow	Yes
Lack of fringe competitors	No
Price inelastic demand curve	Relatively inelastic
Industry’s poor competition record	No
Presence of excess capacity	Yes
Presence of industry associations/fora	Yes

152. The factors set out in Table 8 are inconclusive and it is therefore necessary to consider the factors relevant to co-ordinated market power in the unpruned sawlogs market in light of the information gathered during this investigation.
153. As FCF is already the manager of the CNIFP assets, the acquisition will not alter the relationship between FCF and CHH or their ability to collude. Industry participants advised the Commission that there has been no evidence of price co-ordination between FCF and CHH or between any other competitors. They stated that CHH and FCF have always been very competitive. They pointed to CHH’s attempt in 2001 to price lead that failed because FCF and other forest owners did not follow and the independent sawmillers were able to resist the price increases.
154. Tachikawa Forest Products (NZ) Ltd which is the largest independent sawmiller and purchases logs from both FCF and CHH advised that they would be able to detect any attempt at price coordination. They stated that FCF and CHH compete vigorously for their business.
155. The existence of several other competitors in the unpruned sawlogs market would also limit the ability of the larger participants to collude.
156. The Commission therefore concludes that collusion would not be likely to be increased by the proposed acquisition.

#### Conclusions – Co-ordinated Market Power

157. The Commission considers that the scope for the exercise of co-ordinated market power in the unpruned sawlog market would not be enhanced by the acquisition.

#### *Conclusions – Existing Competition*



158. The Commission concludes that the merged entity will be constrained by existing competition in any attempt to exercise unilateral market power in the unpruned sawlog market.
159. Furthermore, the Commission concludes that the scope for co-ordinated market power in the unpruned sawlog market would not be enhanced by the acquisition.

## **Constraints from Market Entry**

### *Introduction*

160. A business acquisition is unlikely to result in a substantial lessening of competition in a market if behaviour in that market continues to be subject to real constraints from the threat of market entry.
161. Where barriers to entry are clearly low, it will not be necessary for the Commission to identify specific firms that might enter the market. In other cases, the Commission will seek to identify likely new entrants into the market.
162. The Commission will consider the history of past market entry as an indicator of the likelihood of future entry. The Commission is also mindful that entry often occurs on a relatively small scale, at least initially, and as such may not pose much of a competitive constraint on incumbents within the relevant time frame.

### *Barriers to Entry*

163. The likely effectiveness of the threat of new entry in constraining the conduct of market participants, following a business acquisition that might otherwise lead to a substantial lessening of competition in a market, is determined by the nature and height of barriers to entry into that market.
164. The Commission considers that, for the purpose of considering this issue, a barrier to entry is best defined as an additional or significantly increased cost or other disadvantage that a new entrant must bear as a condition of entry. In evaluating the barriers to entry into a market, the Commission will generally consider the broader 'entry conditions' that apply, and then go on to evaluate which of those constitute entry barriers.
165. It is the overall obstacle to entry posed by the aggregation of the various barriers that is relevant in determining whether entry is relatively easy or not, and therefore whether or not potential entry would prevent a substantial lessening of competition.
166. For entry to act as an antidote to a substantial lessening of competition stemming from a business acquisition, it must constrain the behaviour of the combined entity and others in the market.
167. A potential entrant could enter by purchasing a mature or near mature plantation forest within this market. There have been recent acquisitions of existing forests by companies such as UBS and Huaguang with the result that there has been an increase in the number of industry participants. Although this is likely to continue in the

future, it is not possible to ascertain to what degree such new entrants would be able to constrain the merged entity.

168. As stated in Decision 426, any newly planted forest does not begin to become productive for approximately 27 years and therefore would not provide any constraint in the relevant periods.
169. The Commission therefore concludes that potential competition is not likely to provide additional constraint on the exercise of market power by the merged entity in the unpruned sawlog market if the proposed acquisition were to proceed.

### **Other Competition Factors**

#### *Elimination of a Vigorous and Effective Competitor*

170. Sometimes an industry contains a firm that is in some way non-typical, or has different characteristics, or is an innovator, or is regarded as a maverick. The independent or less predictable behaviour of such a firm may be an important source of competition in the market, and may undermine efforts by other firms to engage in coordination. Such a firm need not be large to have an impact on competition out of proportion to its relative market size. Should it become the target of a business acquisition, the resulting elimination of a vigorous and effective competitor could have the effect of substantially lessening competition in the market (especially if there are barriers preventing the entry of new, effective competitors).
171. In accordance with the counterfactual, the Commission considers that if the proposed transaction does not proceed, the CNIFP assets will be purchased by a third party (as specified in paragraph 116) and will be managed by a party other than FCF. The Commission also anticipates that this owner and manager (which could be either one party or two) would provide vigorous competition in the relevant markets. However, it has no grounds for considering that it/they would be a maverick or innovator such that it/they would have an impact on competition other than that already considered in the competition analysis section of this report.

#### *Constraint from Buyers or Suppliers*

172. The potential for a firm to wield market power may be constrained by countervailing power in the hands of its customers, or alternatively, when considering buyer (oligopsony or monopsony) market power, its suppliers. In some circumstances, it is possible that this constraint may be sufficient to eliminate concerns that a business acquisition may lead to a substantial lessening of competition.
173. Where a combined entity would face a purchaser or supplier with a substantial degree of market power in a market affected by the acquisition, the Commission will consider whether that situation is such as to constrain market participants to such an extent that competition is not substantially lessened.
174. The purchasers of unpruned sawlogs are generally fragmented and do not possess a large degree of countervailing power. The larger purchasers such as Tachikawa

would possess a certain degree of countervailing power but it is unlikely that this would be sufficient to provide an effective constraint on the merged entity.

### *Supply of Logs*

175. All industry participants spoken to said that the main issue that could arise for them from a sale of the CNIFP assets would be difficulties in obtaining sufficient supplies of logs, both pruned and unpruned, because of an increase in exports. They pointed out, however, that this could be an issue no matter what entity purchased the assets. They also said that it was a part of normal business in the industry rather than something that would arise as a result of the proposed acquisition or any other acquisition of the CNIFP assets. It should be noted that this is not a competition issue but one of export parity whereby a party wanting to purchase any of the products relevant to this application must pay the world parity price.

### **Conclusion on the Unpruned Sawlog Market**

176. The Commission has considered the probable nature and extent of competition of competition that would exist in the unpruned sawlog market but for the proposed acquisition.
177. The Commission has considered the nature and extent of the contemplated lessening of competition in terms of the competitive restraints that would exist following the acquisition from existing competition.
178. The Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the unpruned sawlog market.

## **THE PRUNED SAWLOG MARKET**

### **Analysis of Existing Competition**

#### *Scope for Unilateral Market Power*

#### Existing Participants

179. The existing competitors are set out in paragraphs 13 to 16 of this report. The largest existing competitor is CHH, which is currently the largest forest owner in New Zealand.

#### Imports

180. There are currently no imports into New Zealand of pruned sawlogs because of the substantial costs involved in transport. Industry participants advised the Commission that this situation is likely to continue.

### Market Shares

181. Market share information has been provided by the Applicant and industry participants. Further information was obtained from the NEFD National and Regional Wood Forecasts 2001. Estimated market shares are shown in Table 10.

**Table 9: Future Wood Flows for Pruned Sawlogs in the CNI, Akl & HB (m<sup>3</sup>)**

	2003-2005		2006-2010		2011-2015	
	Ann Avg	% Mkt Share	Ann Avg	% Mkt Share	Ann Avg	% Mkt Share
CNIFP	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
FCF	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Merged Entity</b>	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
CHH	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Crown	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Pan Pac	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Evergreen	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Tahorakuri	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
UBS	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Winstone	[ ]	[ ]	[ ]	-	[ ]	[ ]
Others	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Total</b>	[ ]		[ ]		[ ]	
Imports						
EC	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Total</b>	[ ]	<b>100</b>	[ ]	<b>100</b>	[ ]	<b>100</b>

Source: Industry participants and NEFD National and Regional Wood Forecasts 2001

182. The three firm concentration is [ ] in the first period, [ ] in the second period and [ ] in the third period. With market shares of [ ], [ ] and [ ], the merged entity would be inside the safe harbours.
183. As already noted, market shares are insufficient in themselves to establish whether competition in a market has been lessened.
184. Table 10 analyses the supply of pruned sawlogs, independent of the merged entity's supply, to determine whether that supply could satisfy the demand of the independent sawmillers.

**Table 10: Estimated Supply and Demand (excl. FCF/CNIFP) in CNI/Akl/HB : Pruned Sawlogs**

<b>SUPPLY</b>	<b>2003 – 2005 Pruned Ann Avg (m<sup>3</sup>)</b>	<b>2006 – 2010 Pruned Ann Avg (m<sup>3</sup>)</b>	<b>2011 – 2015 Pruned Ann Avg (m<sup>3</sup>)</b>
CHH	[ ]	[ ]	[ ]
Other Suppliers	[ ]	[ ]	[ ]
Imports (EC – does not account for imports from Nthland)	[ ]	[ ]	[ ]
<b>TOTAL</b>	[ ]	[ ]	[ ]
<b>DEMAND<sup>22</sup></b>			
CHH	[ ]	[ ]	[ ]
Indep. Sawmills	[ ]	[ ]	[ ]
<b>TOTAL</b>	[ ]	[ ]	[ ]
<b>Surplus</b>	[ ]	[ ]	[ ]

Source: Industry participants and NEFD National and Regional Wood Forecasts 2001

185. The analysis shows that for all three periods supply available from forest owners other than the merged entity will exceed demand. Accordingly, independent purchasers of pruned sawlogs will not be dependent on the merged entity for supply.

#### State of Existing Competition

186. Tables 9 and 10 show that if the merged entity increased prices by a snip, purchasers would be able to obtain logs from other suppliers. CHH in particular is a large supplier with a considerable surplus in each of the relevant periods. CHH is reported by industry participants as being a vigorous competitor in all the markets in which it is involved.
187. As with unpruned sawlogs, supply contracts between forest owners and sawmills are generally either year long agreements with three monthly reviews of price and supply, or three month contracts. Accordingly, a purchaser can readily switch supplier.
188. Imports of pruned sawlogs from other regions have increased over the last year and this pattern is likely to continue. The availability of logs from the East Coast and Northland in particular will be increasing considerably as the forests in those regions mature. Furthermore, in the long term, there is considerable capacity in those regions for planting of new forests.
189. The supply of logs from smaller owners such as farmers is predicted to increase considerably and would be available to independent purchasers.

<sup>22</sup> As noted in Decision 426, relatively few pruned logs are exported, so the Commission has not allowed for a residual flow of exported pruned logs to meet export commitments.

190. The Applicant submits that, as with unpruned sawlogs, domestic customers are important to FCF and other suppliers because they take a variety of log products which FCF needs to be able to produce and sell to optimise the forest cut. Furthermore, forest owners (particularly large forest owners which require continual cash flow) require a hedge or alternative market. The domestic sawmills provide this alternative as their lumber markets (mainly New Zealand and Australia) either lag or follow different trends to the international log prices.
191. Other forest owners agreed with these points. They all said that the domestic market is crucial to the success of a supplier as it is stable, in comparison to the volatility of the export market, and provides guaranteed sales.

#### Conclusions – Unilateral Market Power

192. The Commission is of opinion that the above factors, in particular the availability of sufficient supply independent of the merged entity and the increasing availability of imports from other regions will provide constraints on the merged entity.
193. Accordingly, the Commission concludes that the merged entity will be constrained by existing competition in any attempt to exercise unilateral market power in the pruned sawlog market.

#### *Scope for the Exercise of Coordinated Market Power*

194. For the same reasons set out in paragraphs 149 to 159, the Commission considers that the scope for the exercise of co-ordinated market power in the pruned sawlog market would not be enhanced by the acquisition.

#### *Conclusions – Existing Competition*

195. The Commission concludes that the merged entity will be constrained by existing competition in any attempt to exercise unilateral market power in the pruned sawlog market.
196. Furthermore, the Commission concludes that the scope for co-ordinated market power in the pruned sawlog market would not be enhanced by the acquisition.

#### **Constraints from Market Entry**

197. A potential entrant to this market who wishes to establish a new plantation forest, is not able to supply pruned sawlogs until the forest matures at an age between 25 and 30 years.<sup>23</sup> Furthermore, for an entrant to produce pruned sawlogs, the trees must be pruned between years 5 and 10, to ensure that ‘clear wood’ is developed around the core of the tree. The decision to produce pruned logs is made 20 years before the tree

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<sup>23</sup> The harvesting age is determined by factors such as site location.

is harvested. This further limits the ability of an entrant to enter the market within the relevant time periods.

198. The Commission concludes that potential competition is not likely to provide additional constraint on the exercise of market power in the pruned sawlog market by the merged entity if the proposed acquisition were to proceed.

### **Constraints from Suppliers**

199. The purchasers of unpruned sawlogs are generally fragmented and do not possess a large degree of countervailing power. The larger purchasers such as Tachikawa would possess a certain degree of countervailing power but it is unlikely that this would be sufficient to provide an effective constraint on the merged entity.

### **Conclusion on the Pruned Sawlog Market**

200. The Commission has considered the probable nature and extent of competition of competition that would exist in the pruned sawlog market but for the proposed acquisition.
201. The Commission has considered the nature and extent of the contemplated lessening of competition in terms of the competitive restraints that would exist following the acquisition from existing competition.
202. The Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the pruned sawlog market.

## **THE PULPLOG MARKET**

### **Analysis of Existing Competition**

#### *Scope for Unilateral Market Power*

#### Existing Participants

203. The existing competitors are set out in paragraphs 13 to 16 of this report. The largest existing competitor is CHH, which is currently the largest forest owner in New Zealand.

#### Imports

204. There are currently no imports of pulplogs because of the substantial costs involved in transport. Industry participants advised the Commission that this situation is likely to continue.

### Market Shares

205. Market share information has been provided by the Applicant and industry participants. Further information was obtained from the NEFD National and Regional Wood Forecasts 2001. Estimated market shares are shown in Table 11.

**Table 11: Future Wood Flows for Pulplogs in the CNI (m<sup>3</sup>)**

	2003-2005		2006-2010		2011-2015	
	Ann Avg (m <sup>3</sup> )	% Mkt Share	Ann Avg (m <sup>3</sup> )	% Mkt Share	Ann Avg (m <sup>3</sup> )	% Mkt Share
CNIFP	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
FCF	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Combined entity</b>	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
CHH	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Crown	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Winstone	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Tahorakuri	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
UBS	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Other Owners	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Total CNI</b>	[ ]		[ ]		[ ]	
Imports Nthld	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Imports Akl	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Imports EC	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Imports HB	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Imports SNI	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Total</b>	[ ]	<b>100</b>	[ ]	<b>100</b>	[ ]	<b>100</b>

Source: Industry participants and NEFD National and Regional Wood Forecasts 2001

206. The three firm concentration is [ ] in the first period, [ ] in the second period and [ ] in the third period. With market shares of [ ], [ ] and [ ], the merged entity would be outside the safe harbours for the first three years and inside the safe harbours for the other two periods.
207. As already noted, market shares are insufficient in themselves to establish whether competition in a market has been lessened.
208. For pulplogs, the Commission does not consider the analysis in Tables 7 and 10 relevant because of the very different structure of the market – in particular that FCF is not a user (purchaser) of pulp logs itself and also because there are just a few large purchasers with significant market power. For instance, FCF is contractually obliged to supply up to approximately [ ] of its current production sold domestically to FibreCo (CHH/Norske Skog buying group) and to Fletcher Building and also supplies approximately [ ] to CHH's Kinleith Mill and [ ] to CHH's Whakatane mill. This situation is discussed further with relation to constraint provided by purchasers.

### State of Existing Competition



209. The large consumers of pulp logs are pulp and paper mills situated at Kinleith (CHH), Kawerau (Norske Skog and CHH) and Ohakune (WPI). If the merged entity attempted to increase its pulp log prices by a *ssnip*, it would face some constraint by suppliers like CHH and NZFM and other small and medium sized suppliers situated within the area.
210. Imports of pulplogs from other regions have increased over the last year and this pattern is likely to continue. The availability of logs from the East Coast and Northland in particular will be increasing considerably as the forests in those regions mature.
211. It is the Commission's view that, as with pruned sawlogs, export sales by competitors have the potential to provide some competitive constraint.

#### Conclusions – Unilateral Market Power

212. The Commission is of opinion that the above factors, together with the merged entity's contractual obligations will provide constraints on the merged entity.
213. Accordingly, the Commission concludes that the merged entity will be constrained by existing competition in any attempt to exercise unilateral market power in the pulplog market.

#### Scope for the Exercise of Coordinated Market Power

214. For the same reasons set out in paragraphs 155 to 158, the Commission considers that the scope for the exercise of co-ordinated market power in the pulplog market would not be enhanced by the acquisition. Another factor relevant to the pulplog market that supports this conclusion is that sales are large and infrequent with very long-term commitments.

#### *Conclusions – Existing Competition*

215. The Commission concludes that the merged entity would be constrained by existing competition in any attempt to exercise unilateral market power in the pulplog market.
216. Furthermore, the Commission concludes that the scope for co-ordinated market power in the pulplog market would not be enhanced by the acquisition.

#### **Constraint from Potential Competition**

217. As with pruned and unpruned sawlogs, the time dimension of the market limits the ability of new entrants to provide a constraint.

218. The Commission therefore concludes that potential competition is not likely to provide additional constraint on the exercise of market power in the pulplog market by the merged entity if the proposed acquisition were to proceed.

### **Constraint from Purchasers**

219. The only purchasers of pulplogs in New Zealand are all significant firms with a large degree of countervailing power. Domestically, FCF supplies FibreCo and Fletcher Building, [ ]  
 ]. Each represents a significant volume to FCF.
220. FibreCo has two long term contracts with FCF:
- [ ]
221. FibreCo also purchases [ ] pulplogs from third party sawmillers through FCF which manages the logistics and invoicing.
222. Currently, FCF supplies [ ] of its pulplogs to CHH, FibreCo and Fletcher Building's MDF plant in Taupo. Even in the absence of long-term contractual commitments constraining the ability of FCF to price in a discretionary manner, each of these purchasers would wield significant countervailing power.
223. Additional constraint is imposed on the pricing decisions of FCF by CHH is CHH's ability to satisfy its pulp fibre requirements by utilising pulplogs or woodchips. Woodchips are readily available.
224. The Commission concludes that the merged entity would be constrained by the countervailing power of purchasers in any attempt to exercise market power in the pulplog market.

### **Conclusion on the Pulplog Market**

225. The Commission has considered the probable nature and extent of competition that would exist in the pulplog market but for the proposed acquisition.
226. The Commission has considered the nature and extent of the contemplated lessening of competition in terms of the competitive restraints that would exist following the acquisition from:
- existing competition; and
  - purchasers.

227. The Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the pulplog market.

## THE WOODCHIP MARKET

### Analysis of Existing Competition

#### *Scope for Unilateral Market Power*

#### Existing Participants

228. The existing competitors are all sawmillers from Whangarei to Taupo.

#### Imports

229. There are currently no imports of woodchips because of the substantial costs involved in transport compared with the value of woodchips. Industry participants advised the Commission that this situation is likely to continue.

#### Market Shares

230. Market share information has been provided by the Applicant and industry participants. Estimated market shares are shown in Table 12.

**Table 12: Woodchips - CNI**

Supplier	Total Supply <sup>24</sup>	% Market Share
FCF	[ ]	
CNIFP	[ ]	
<b>Merged entity</b>	[ ]	[ ]
CHH	[ ]	[ ]
Tachikawa	[ ]	[ ]
Others	[ ]	[ ]
Imports from other regions	[ ]	[ ]
<b>Total</b>	[ ]	[ ]

Source: Industry participants

231. The three firm concentration is [ ]. With a market share of [ ] the merged entity would be outside the safe harbours.

<sup>24</sup> Includes sawmill chip and whole log chip.

232. As already noted, market shares are insufficient in themselves to establish whether competition in a market has been lessened.

#### State of Existing Competition

233. Woodchips are produced as a residue from the saw milling and log producing processes, and are also produced by conversion of logs, generally pulp logs, into chips. Woodchips are used as an input into the pulp making process and also in the production of fibreboard. Woodchips are a commodity and price is an important competitive factor.
234. The structure of this market is characterised by several large suppliers of woodchips and a large number of smaller suppliers. The scale of supply is a function of the scale of log production and sawmilling. The merged entity would be the largest supplier. However, as the Commission concluded in Decision 426 with respect to CHH, FCF would face effective competition from the next largest competitor, CHH, and from the fragmented, but collectively significant independent sawmills.
235. The large consumers of woodchips are pulp and paper mills situated at Kinleith (CHH), Kawerau (Norske Skog and CHH) and Ohakune (WPI). If the merged entity attempted to increase its pulp log prices by a *ssnip*, it would face some constraint by suppliers like CHH and NZFM and other small and medium sized suppliers situated within the area.
236. If the merged entity attempted to exercise market power by raising its price for woodchips by a *ssnip*, it is the Commission's view that it would be constrained by independent suppliers diverting export supply to the domestic market, or by increasing the production of woodchips by increasing the processing of logs not suitable for sawmilling.

#### Conclusions – Unilateral Market Power

237. The Commission concludes that the merged entity will be constrained by existing competition in any attempt to exercise unilateral market power in the woodchips market.

#### *Scope for the Exercise of Coordinated Market Power*

238. The market structure and behavioural factors conducive to collusive behaviour are assessed in Table 13.

**Table 13: Testing the Potential for ‘Collusion’ in the Woodchip Market**

<b>Factors conducive to collusion</b>	<b>Presence of factors in the market</b>
High seller concentration	Yes
Undifferentiated product	Yes
New entry slow	No – entry using a mobile wood chipping machine could occur within a month.
Lack of fringe competitors	No
Price inelastic demand curve	Relatively inelastic
Industry’s poor competition record	No
Presence of excess capacity	Variable
Presence of industry associations/fora	No

239. The factors set out in Table 13 are inconclusive and it is therefore necessary to consider the factors relevant to co-ordinated market power in the unpruned sawlogs market in light of the information gathered during this investigation.
240. Successful collusion would require the participation of CHH. However, CHH is unlikely to collude with FCF due to CHH’s involvement as a purchaser of woodchips to satisfy its various mill requirements.
241. FCF has no pricing discretion in respect of a significant proportion of its woodchip sales as sales to CHH and FibreCo are governed by contractual pricing formulae.
242. Furthermore, as pointed out by the Applicant, there is an active competitive fringe of a significant number of competitors in the woodchips market. Any attempt to collude to increase price could be defeated by these independent suppliers increasing the production of woodchips by increasing the processing of logs not suitable for sawmilling.

#### Conclusions – Co-ordinated Market Power

243. The Commission considers that the scope for the exercise of co-ordinated market power in the woodchips market would not be enhanced by the acquisition.

#### *Conclusions – Existing Competition*

244. The Commission concludes that the merged entity will be constrained by existing competition in any attempt to exercise unilateral market power in the woodchips market.
245. Furthermore, the Commission concludes that the scope for co-ordinated market power in the woodchips market would not be enhanced by the acquisition.

### **Constraint from Potential Competition**

246. All of the domestic suppliers of woodchips in this market produce them either as a by-product of the sawmilling process, or as a by-product of the log production process. Likely entry into this market is by entry or expansion in either of these markets. Expansion could be effected by each of the independent sawmills operating in the CNI. Such expansion is likely, would be of sufficient extent, sustainable, and could occur in a timely fashion in response to the necessary price incentive. Suitable logs are readily available. There are no specific legislative or regulatory approvals required to enter or expand. An entrant could utilise a mobile chipping machine to enter within a month. The Commission is of the opinion that there are no significant barriers to entering this market.
247. The Applicant pointed out that the absence of entry/expansion barriers is also illustrated by reference to Marubeni, a Japanese trading company. Marubeni is an independent woodchipper, operating out of Gisborne and Whangarei. It purchases pulplogs, chips them and then exports that woodchip to Japan. While Marubeni is not active in the CNI market, its presence indicates the ability of non-integrated operators to successfully enter the woodchip market.
248. The Commission therefore concludes that potential competition is likely to provide additional constraint on the exercise of market power in the woodchip market by the merged entity if the proposed acquisition were to proceed.

### **Constraint from Purchasers**

249. The only purchasers of woodchips in New Zealand are all significant firms with a large degree of countervailing power. FibreCo and CHH (in the latter's individual capacity) are the largest purchasers of woodchips in the market and account for [ ] and [ ] of FCF's total sales respectively. Each of these purchasers would wield significant countervailing power.
250. [ ]  
 ]. Accordingly, all third party sales of woodchip are to customers who, even in the absence of FCF's contractual obligations could exercise significant countervailing power.
251. While CHH is likely to be reliant on FCF/CNIFP in the foreseeable future for its "pulp fibre" requirements, FCF/CNIFP is likewise reliant on CHH to acquire its pulplogs and woodchips, which constrains FCF/CNIFP's ability to increase price (and in the reverse, CHH to lower its acquisition price). Any attempt by FCF to substitute to the export market in response to aggressive bargaining by Norske Skog or CHH is constrained by the fact FCF is a price taker on the international market, and, certain domestic purchasers play an important role in 'smoothing out' fluctuations in international price.

252. The Commission concludes that the merged entity would be constrained by the countervailing power of purchasers in any attempt to exercise market power in the woodchip market.

### **Conclusion on the Woodchip Market**

253. The Commission has considered the probable nature and extent of competition of competition that would exist in the woodchip market but for the proposed acquisition.
254. The Commission has considered the nature and extent of the contemplated lessening of competition in terms of the competitive restraints that would exist following the acquisition from:
- existing competition;
  - potential competition; and
  - purchasers.
255. The Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the woodchip market.

## **THE SAWN TIMBER MARKET**

### **Analysis of Existing Competition**

#### *Scope for Unilateral Market Power*

#### Existing Participants

256. FCF currently operates three sawmills in the CNI. The CNIFP has a sawmill at Waipa. CHH owns five sawmills throughout the North Island. There are approximately 338 saw milling operations in New Zealand, with 60% (205) of them being situated within the North Island. Within the North Island, the largest concentration of saw milling operations are within the Central North Island. Saw milling operations range in size from small portable saw milling operations to very large producers of sawn timber. Within the North Island, 136 mills (66%) produce less than 2000 m<sup>3</sup> of sawn timber, 29 mills produced less than 20,000 m<sup>3</sup>, whilst 31 mills (15%) produced over 20,000 m<sup>3</sup>. These larger mills were responsible for 90% of total output in the North Island.<sup>25</sup>

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<sup>25</sup> Ministry of Agriculture and Forestry, *Statistical Release: Annual Production of Rough Sawn Timber, Year Ended 31 March 2000*.

Imports

257. There are currently no imports of sawn timber because of the substantial costs involved in transport. Industry participants advised the Commission that this situation is likely to continue.

Market Shares

258. Market share information has been provided by the Applicant and industry participants. Estimated market shares are shown in Table 14.

**Table 14: Sawn Timber – North Island**

<b>Supplier</b>	<b>Estimated Production (000m<sup>3</sup>)</b>	<b>Market Share %</b>
FCF	[ ]	[ ]
CNIFP	[ ]	[ ]
<b>Merged Entity</b>	[ ]	[ ]
CHH	[ ]	[ ]
Pan Pac	[ ]	[ ]
Tachikawa	[ ]	[ ]
Others	[ ]	[ ]
<b>Total</b>	[ ]	<b>100</b>

Source: Industry participants

259. The three firm concentration is [ ]. With a market share of [ ], the merged entity would be inside the safe harbours.

State of Existing Competition

260. There are several large independent sawmilling operations that could offer effective competition to the merged entity in the production of the lower value structural, cuttings and packaging grades of sawn timber. These competitors include CHH, Pan Pac, WPI, Tachikawa, and Juken Nissho. Smaller sawmilling operations have different cost structures to the larger corporates. These smaller competitors will also offer effective competition to the merged entity in the production of higher value grades of timber such as appearance grades.
261. Approximately 40% of sawn timber production is exported. The main markets are Australia (structural grades), Asia ( industrial grades) and North America (appearance grades). Domestic suppliers to these markets would have the ability to divert supply back to domestic markets if market conditions encouraged such behaviour. If the merged entity attempted to increase prices in the domestic market, an export diversion strategy would provide further constraint on the competitive behaviour of the merged entity.



### Conclusions – Unilateral Market Power

262. The Commission concludes that the merged entity will be constrained by existing competition in any attempt to exercise unilateral market power in the sawn timber market.

### *Scope for the Exercise of Coordinated Market Power*

263. The market structure and behavioural factors conducive to collusive behaviour are assessed in Table 15.

**Table 15: Testing the Potential for ‘Collusion’ in the Sawn Timber Market**

<b>Factors conducive to collusion</b>	<b>Presence of factors in the market</b>
High seller concentration	No
Undifferentiated product	Yes
New entry slow	No.
Lack of fringe competitors	No
Price inelastic demand curve	Relatively inelastic
Industry’s poor competition record	No
Presence of excess capacity	Variable
Presence of industry associations/fora	Yes

264. The factors set out in Table 15 are inconclusive and it is therefore necessary to consider the factors relevant to co-ordinated market power in the sawn timber market in light of the information gathered during this investigation.
265. Approximately [ ] of the market is supplied by approximately 200 competing sawmills some of which, such as those owned by Pan Pac, WPI, Tachikawa and Juken Nissho, are large. The presence of such a significant number of competitors, coupled with an absence of many other factors required for effective collusion and discipline indicates that the proposed acquisition would not increase the risk of co-ordinated market power in the sawn timber market.
266. Industry participants spoken to stated that there had been no sign of price coordination in the sawn timber market.

### Conclusions – Co-ordinated Market Power

267. The Commission considers that the scope for the exercise of co-ordinated market power would not be enhanced by the acquisition.

### *Conclusions – Existing Competition*

268. The Commission concludes that the merged entity will be constrained by existing competition in any attempt to exercise unilateral market power in the sawn timber market.
269. Furthermore, the Commission concludes that the scope for co-ordinated market power in the sawn timber market would not be enhanced by the acquisition.

### **Constraint from Potential Competition**

270. An entrant into this market would require capital to invest in the necessary plant and equipment, access to logs, competencies in sawmilling through the hire of skilled labour and also in selling and marketing.
271. The capital cost of investing in a sawmilling operation is very much dependent upon the scale of the operation. Sawmilling operations range from small portable saw mills to large scale operations, which produce significant quantities of sawn timber. Portable sawmills range in price from US\$2,500 to US\$35,000, whilst small mills producing under 10,000m<sup>3</sup> would cost up to \$5 million. Medium sized mills producing under 50,000m<sup>3</sup> would cost up to \$20 million, whilst large-scale operations can cost up to \$50m. One industry participant advised that a mill would cost at least \$50 million if it was to be competitive against the larger industry competitors and not be limited in the range and amount of output. There is not a significant level of sunk cost in this investment. The plant and equipment generally has long economic lives, and there is an active market for used equipment.
272. The capital cost of entry into this market on a small or medium scale is not considered to be a barrier to entry. However, investment in a large scale sawmilling operation would require significant capital expenditure and could be regarded as a moderate barrier to entry.
273. An entrant to this market would require access to the needed input, sawlogs. Unless the saw milling operation was backwardly integrated into forest ownership, the entrant would have to access supply from the market for the supply of sawlogs. The Commission considers that there would be sufficient independent supply of sawlogs and that access would not be a barrier to entry.
274. The Commission therefore concludes that potential competition is likely to provide additional constraint on the exercise of market power in the sawn timber market by the merged entity if the proposed acquisition were to proceed.

### **Constraint from Purchasers**

275. The Applicant submits that the large building supplier merchant chains, in particular Placemakers, impose significant countervailing power on FCF. Placemakers currently accounts for [ ] of FCF's total domestic sales ([ ] of total sales) and is an important customer to FCF.
276. In Decision 426 the Commission concluded that the large independent distribution channels would be able to exert a degree of countervailing power.
277. The Commission concludes that the merged entity would be constrained by the countervailing power of purchasers in any attempt to exercise market power in the sawn timber market.

### **Conclusion on the Sawn Timber Market**

278. The Commission has considered the probable nature and extent of competition of competition that would exist in the sawn timber market but for the proposed acquisition.
279. The Commission has considered the nature and extent of the contemplated lessening of competition in terms of the competitive restraints that would exist following the acquisition from:
- existing competition;
  - potential competition; and
  - purchasers.
280. The Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the sawn timber market.

### **OVERALL CONCLUSION**

281. The Commission has considered the probable nature and extent of competition that would exist in the relevant markets but for the acquisition. The Commission considers that the appropriate benchmark for comparison is an acquisition of the CNIFP assets by a third party (as specified in paragraph 116) and the management of those assets by a party other than FCF.
282. The Commission has also considered the nature and extent of the contemplated lessening, in terms of the competitive constraints that would exist following the merger from:
- existing competition;
  - potential competition from entry; and
  - other competition factors.
283. The Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the following markets:
- the production and supply of unpruned sawlogs in the CNI, for the periods 2003-2005, 2006-2010 and 2011-2015 (the unpruned sawlog market);
  - the production and supply of pruned sawlogs in the CNI, Auckland and Hawke's Bay for the periods 2003-2005, 2006-2010 and 2011-2015; (the pruned sawlog market);
  - the production and supply of pulplogs in the CNI, for the periods 2003-2005, 2006-2010 and 2011-2015 (the pulplog market);

- the production and supply of woodchips in the CNI ( the woodchip market); and
- the production and supply of sawn timber in the North Island (the sawn timber market).

**DETERMINATION ON NOTICE OF CLEARANCE**

284. Accordingly, pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the acquisition by Fletcher Challenge Forests Limited through its wholly owned subsidiary Kaingaroa Timber Company Limited, from CITIC New Zealand Limited (BVI) (in receivership) and Forestry Corporation of New Zealand Limited (in receivership) (together the Vendors) of the operating assets of the partnership between the Vendors known as the Central North Island Forest Partnership.

Dated this 14th day of August 2002

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John Belgrave  
Chair