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COMMERCE COMMISSION

Decision No. 378

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

Fletcher Challenge Steel Products Limited

and

Steel and Tube Holdings Limited

The Commission:	M J Belgrave (Chair) M N Berry P R Rebstock
Summary of Proposed Acquisition:	The acquisition by Fletcher Challenge Steel Products Limited of up to 100% of the shares in Steel and Tube Holdings Limited.
Determination:	Pursuant to section 66(3)(a) of the Commerce Act 1986, the majority of the Division of the Commission determines to give clearance for the proposed acquisition.
Date of Determination:	10 December 1999

CONFIDENTIAL MATERIAL IN THIS REPORT IS CONTAINED IN SQUARE BRACKETS [ ]

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THE PROPOSAL

1 In a notice to the Commission dated 23 November 1999, pursuant to section 66(1) of the Commerce Act 1986 (the Act), Fletcher Challenge Steel Products Limited (Fletcher Steel) sought clearance to acquire up to 100% of the shares in Steel and Tube Holdings Limited (Steel & Tube).

2 The proposed acquisition is the same as that for which clearance was declined by the Commission in Decision No 376 of 4 November 1999. In that Decision, the majority of the Commission concluded that they were not satisfied that the proposal would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in two of the six relevant markets.

3 Much of the factual information recorded in Decision No 376 is applicable to the present application also, but a good deal of further information has been obtained. The applicant has provided additional information on market shares, and commissioned a market research report on the awareness of steel purchasers of other steel distributors, and the purchasers' attitudes to these distributors. The applicant also obtained two further reports on the proposal from the New Zealand Institute of Economic Research. In addition, the Commission also conducted its own further extensive inquiries.

THE PROCEDURES

4 The application was received and registered on 24 November 1999. 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 the notice agree to a longer period. An extension of two working days was sought by the Commission and agreed to by Fletcher Steel. Accordingly, a decision was required by 10 December 1999.

5 In the application Fletcher Steel sought confidentiality for sensitive commercial information contained in the application, and a confidentiality order was made in respect of that information for a period of 20 working days from the Commission's determination of the notice. When that order expires, the provisions of the Official Information Act will apply.

6 The Commission's determination is based on an investigation conducted by its staff. In the course of this investigation, Commission staff discussed the application with a large number of parties, including over fifty steel users, several steel distributors and several overseas-based steel traders.

7 A substantial written submission dated 2 December 1999 was received from Steel & Tube on 3 December, and was discussed in detail at a meeting of company representatives and Commission staff. This meeting gave the company full opportunity to present its views. The company sought confidentiality for the contents of its submission.

THE PARTIES

Fletcher Challenge Steel Products Limited

8 Fletcher Steel is ultimately owned by Fletcher Challenge Limited. Further information on the company is contained in Decision 376.

Steel and Tube Holdings Limited

9 Steel & Tube is a listed company in which a controlling interest is held ultimately by Broken Hill Proprietary Limited. Additional information is given in Decision 376.

OTHER RELEVANT PARTIES

10 Steel distributors which compete with Fletcher Steel and Steel & Tube include Kiwi Steel Limited (Kiwi Steel), H J Asmuss and Co Limited and subsidiaries (Asmuss Steel), Vulcan Steel Limited (Vulcan Steel) and United Industries Limited. Information on these firms is included in Decision 376.

11 The two New Zealand steel manufacturers are BHP New Zealand Steel Limited and Pacific Steel Limited. Information on these two companies is given in Decision 376.

BACKGROUND

12 Background information on steel, and on the international and New Zealand steel industries, is given in Decision 376, and will not be repeated here.

THE RELEVANT MARKETS

13 Section 3(1A) of the Commerce 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.

14 Market definition is a conventional first step in competition analysis. The purpose of defining markets in relation to business acquisitions is to assess the degree of market power which the merged company might gain. As the judgment in the *Queensland Wire Industries* case noted, defining a market and evaluating the power in that market are part of the same process and the two steps are separated "for simplicity of analysis".[1]

15 Markets are defined in relation to product type, geographical extent and functional level. The boundaries of the product and geographical markets are identified by considering the extent to which buyers (or sellers, where supply-side substitution possibilities are being considered) are able to substitute other products, or the same

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[1] *Queensland Wire Industries Pty Limited* v *Broken Hill Pty Co Limited* (1989) 167 CLR 177.

product from other geographical regions, in response to a change in the relative price of the products concerned.

16 A properly defined market will include products which are regarded by buyers or sellers as being not too different ('product' dimension) and not too far away ('geographical' dimension). In such a market, a hypothetical profit-maximising sole supplier could impose at least a *s*mall yet *s*ignificant and *n*on-transitory *i*ncrease in *p*rice (the *'ssnip'* test) assuming other terms of sale remained unchanged.

17 Market definition principles are further outlined by the High Court in the *AMPS A* case.[2] The Court provided three explanations relating to the method and purpose of market definition. The first was the need to identify relevant areas of close competition. The purpose of this exercise is to identify competitive constraints. The second related to the ways that buyers and sellers would be likely to react to a small percentage increase in the prices of relevant products. The Court emphasised the need to ascertain the cross-elasticities of both supply and demand. The third noted the multi-dimensional nature of markets, namely the dimensions of product, space, functional level and time.

18 The precise boundaries of markets are seldom clear. Often a pragmatic assessment of markets will need to be made. It is important to recognise this when undertaking competition analysis.

19 In Decision 376 the relevant markets were defined as the national markets for: the distribution of merchant steel products; the distribution and fabrication of reinforcing steel; the distribution and processing of steel plate; the distribution and processing of steel coil; the manufacture and distribution of residential roofing products; and the manufacture and distribution of industrial roofing products.

20 In the present application, Fletcher Steel argues that pipes and pipe fittings used for reticulation comprise a separate market. In the previous application, these were regarded as being part of the merchant steel market. The Commission did not find any industry support for pipe to be defined in this way. Industry participants all viewed "pipe" as including "round hollows" and "tube", and it appears that these names are widely used interchangeably to describe "pipe". From a distribution perspective, it appears that specialised pipe (for reticulation) is distributed alongside all other steel products. Accordingly, the Commission did not find justification for placing pipe in a separate market, when the focus is on the distribution functional level of the market.

21 In this decision the Commission adopts the same markets as were identified in Decision 376. The relevant markets are therefore:

- the national market for the distribution of merchant steel products;
- the national market for the distribution and fabrication of reinforcing steel;

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2 *Telecom Corporation of NZ Limited* v *Commerce Commission* (1991) 4 TCLR 473, 502: 3 NZBLC 102,340, 102,362.

- the national market for the distribution and processing of steel plate products;
- the national market for the distribution and processing of steel coil products;
- the national market for the manufacture and distribution of domestic roofing products; and
- the national market for the manufacture and distribution of industrial roofing products.

Some further comment will be made in this decision on the precise boundaries of the merchant steel and steel coil markets.

COMPETITION ANALYSIS

22 Competition analysis assesses competition in the relevant markets, in order to determine whether a proposed acquisition would result, or would be likely to result, in the acquisition or strengthening of dominance. Section 47 of the Commerce Act proscribes a person acquiring of assets of a business or shares where as a result:

> (a) That person or another person would be, or would be likely to be, in a dominant position in a market: or
>
> (b) That person's or another person's dominant position in a market would be, or would be likely to be, strengthened.

23 The role of the Commission in respect of an application for clearance of a business acquisition is prescribed by the Commerce Act. Read in conjunction, sections 66(3) and 47(1) require that, where the Commission is satisfied that a proposed acquisition would not result, or would not be likely to result, in an acquisition or strengthening of a dominant position in a market, the Commission must give a clearance. Where the Commission is not so satisfied, clearance must be declined.

24 Judicial pronouncements set a high threshold for dominance. In his judgment in *Commerce Commission* v *Port Nelson Limited*[3], McGechan J included the following statements[4]:

> 'Dominance' includes a qualitative assessment of market power, It involves more than 'high' market power; more than mere ability to behave 'largely' independently of competitors; and more than power to effect 'appreciable' changed in terms of trading. It involves a high degree of market *control*.
>
> How high? Clearly, not absolute control. There need not be monopoly. There need not be an ability to act totally without regard to competitors, suppliers, or customers….(However), (t)he firm must be able to set terms of trading independently of significant market constraints. It must be able to set prices or conditions without significant constraint by competitor or consumer reaction. (Emphasis in original.)

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[3] (1995) 6 TCLR 406.

[4] Ibid, 441-42. This test was affirmed by the Court of Appeal in *Port Nelson Limited* v *Commerce Commission* (1996) 3 NZLR 554, 573.

25 The Commission's *Business Acquisition Guidelines* also recognise that dominance involves a high degree of market power. The Guidelines reflect that for a firm to be dominant it must have the power to behave in a manner different from that which a competitive market would allow. The *Guidelines* (paragraph 7) state that:

> A person in a dominant position in a market will be able to set prices or conditions without significant constraint from competitor reaction.
>
> A person in a dominant position will be able to initiate and maintain an appreciable increase in price, or reduction in supply, quality or degree of innovation, without suffering an adverse impact on profitability in the short or long run.

26 As the *Port Nelson* judgment highlighted[5], the analysis of dominance must centre upon the provisions of section 3(8) of the Commerce Act. In relation to section 47, the relevant provisions are contained in section 3(9). The section requires that regard be had to three groups of factors:

> (a) The share of the market, the technical knowledge, the access to materials or capital of that person or that person together with any interconnected body corporate:
>
> (b) The extent to which that person is constrained by the conduct of competitors or potential competitors in that market:
>
> (c) The extent to which that person is constrained by the conduct of suppliers or acquirers of goods or services in that market.

27 The weight that will attach to each of these considerations will vary from case to case. As Richardson P noted in *AMPS A*:[6]

> (Section 3(9)) does not allow any theoretical or intuitive ranking applicable in all cases. It proceeds on the premise that the weighting must vary according to the particular facts. It calls for a pragmatic assessment in the particular circumstances of one's ability to exercise a dominant influence in one or more aspects of the relevant market.

28 In relation to the present application, attention will be concentrated principally on the two markets in which the Commission majority identified dominance concerns in the previous application. These are the national markets for the distribution and processing of steel plate products and the distribution of merchant steel products. Consideration has also been given by the Commission to the other markets identified in Decision 376. The only market in this category which was the subject of further detailed submissions was that for steel coil, and that matter will also be addressed in this decision.

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5 Ibid, 442-43.

6 *Telecom Corporation of NZ Limited* v *Commerce Commission* [ ] 3 NZLR 429, 444.

MARKET FOR THE DISTRIBUTION OF MERCHANT STEEL PRODUCTS

Market Concentration

29 The degree of concentration of market share which would result from a business acquisition is a useful first indication of the likely degree of market power which might follow, and this is recognised in the "safe harbours" that are defined in the Commission's *Business Acquisition Guidelines*. These safe harbours recognise the importance of both the absolute levels of market share, and the distribution of these shares.

30 The *Guidelines* state (paragraph 4.3):

> In the Commission's view, a dominant position in a market is generally unlikely to be created or strengthened where, after the proposed acquisition, either of the following situations exist:
>
> > the merged entity (including any interconnected or associated persons) has less than in the order of a 40% share of the relevant market;
> >
> > the merged entity (including any interconnected or associated persons) has less than in the order of a 60% share of the relevant market and faces competition from at least one other market participant having no less than in the order of a 15% market share.

31 Other things being equal, the higher the market share resulting from a business acquisition, the higher is the likelihood that dominance would be acquired or strengthened. However, conclusions cannot be drawn on market shares alone. As outlined above, the effect of section 3(9) of the Commerce Act is that market share is but one of a number of factors to be taken into account in reaching a view on dominance. The relative weight of these factors must be assessed in each market which is being examined, but the significance of market share could be outweighed by the other elements, especially the nature of entry conditions.

32 The market for "merchant steel" includes a broad and diverse range of products. The Commission obtained turnover figures from the parties to the proposal, as well as several competitors offering merchant products. In its application, Fletcher Steel estimated that the merged entity would have a market share of [ ] % , with two other operators having in the range of [ ]%.

33 The figures obtained by the Commission, which included very late information from Steel & Tube, and also from Kiwi Steel, are shown in the Table below. These figures increased the upper limit for the merged company's market share. The result is that the market share may fall within the range of [ ]% to [ ]% at the extreme. In the course of deliberations, the Commission agreed to base its decision on the following market shares: [ ]% for the merged entity and [ ]% for the second largest player. In doing so the Commission noted that the [ ]% market share assumed for the merged entity was the worst case scenario.

Table 1: Estimated Market Shares in the Merchant Steel Market

Company	**Tonnes**	**Estimated Market Share (%)**
Fletcher Steel	[ ]	[ ]
Steel & Tube	[ ]	[ ]
Combined Entity	[ ]	[ ]
Asmuss Steel	[ ]	[ ]
Vulcan Steel	[ ]	[ ]
Kiwi Steel		
Steel Plus	[ ]	[ ]
Total	[ ]	100.00

34 In the course of final deliberations, before making this decision, the Commission became aware that Kiwi Steel had in fact achieved an estimated turnover of [ ] tonnes, or about [ ] market share. On the basis of this information, the merged entity's market share reduces to [ ]%.

35 Based upon the above figures, the combined entity's market share is outside the Commission's "safe harbours". In addition, the distribution of shares of the remaining players is also outside the "safe harbours". However, as outlined above, the fact that a proposed acquisition may lead to a market share outside these safe harbours does not necessarily mean that it will be likely to result in the acquisition or strengthening of a dominant position in a market. Other factors must be examined also.

36 With respect to market shares, the Commission notes that a number of previous business acquisitions resulting in high market shares have been cleared by the Commission. A study of proposed acquisitions affecting 277 markets which were considered by the Commission between 1991 and 1996 was published in February 1998.[7] The survey found that, while dominance was found in many markets with high market shares, clearance was given to a number of such proposals. Clearance was given in four cases where the combined market share was 100%, to seven in the 90-99.9% range, to 19 in the 80-89.9% range and to 11 in the 70-79.9% range. On the other hand, clearance was declined in 26 cases where market share was high, though dominance was not found in any cases below 70%.

37 In the case of clearances of proposals which resulted in high market shares, market share alone was not considered to be determinative of market power or dominance. The existence of factors such as low barriers to entry, availability of imports, and the constraint effected by existing competitors and buyers were concluded to be sufficient to prevent the merged entity from acquiring or strengthening a dominant position.

38 In the cases where clearance was declined which resulted in high market shares there was a substantial proportion involving services rather than goods. In the markets in

[7] *A Study of the Commerce Commission's Evaluation of Applications for Business Acquisition Clearances and Authorisations, 1991-1996,* Occasional Paper No. 8, February 1998, Commerce Commission, Wellington.

question, none were contested by imports, except the fertiliser market in Ravensdown, where the two parties to the acquisition were already importers.

39 A notable feature in the markets where dominance would be acquired was the lack of other competitors[8]. In nearly all cases, there was either one player, or none at all. Two exceptions were Tip Top/New American and Hoyts/Pacer Kerridge. In the latter, the other players were small, geographically-based independent exhibitors unable to compete with the nationwide chains.

40 A characteristic of all markets where dominance would be acquired or strengthened was the presence of entry barriers which were high or insurmountable. In three of the applications, strict regulatory barriers would have prevented further entry; four of the applications involved natural monopoly conditions; four further applications involved a combination of entry conditions that in aggregate would create high entry barriers; and the remaining cases found situations of such strong incumbent advantage that it was considered entry would be most unlikely.

41 A further consideration in deciding what weight should be given to market share in this case is to reconsider the nature of the product market. The precise boundary of the merchant steel market is not altogether clear. For example, Kiwi Steel, which specialises in the distribution of steel plate, and which is a substantial supplier of this product, has only recently expanded its operations and entered the merchant steel market. The company has substantial overseas backing. The Commission understands that this involved little by way of new investment, but rather was simply an expansion in product range. Hence, this appears to be, not an example of 'new entry', but merely 'near entry' by a competitor on the margin of the market. This supply-side substitution suggests that the market may be wider than merchant steel. Other steel distributors not currently involved in merchant steel products are similarly able to enter merchant steel distribution. Thus, some recognition needs to be given to the possibility that the merchant steel distribution market has been defined too narrowly, and that the market shares are potentially overstated in consequence.

42 Notwithstanding this observation, this decision proceeds on the assumption that the market is that for merchant steel, and that the market share of the merged entity might be at the extreme end of the range mentioned above, that is [ ].

Constraint from Existing Competition

43 The Commission examined the results of independent market research commissioned by Fletcher Steel to assess the awareness amongst steel fabricators and other steel purchasers of the presence of merchant and plate steel suppliers. The research showed significant awareness of distributors other than Fletcher Steel and Steel & Tube. [

]

8 Ibid.

44 In light of the results of the [ ] survey, Commission staff also undertook an extensive assessment of the extent to which other steel suppliers, particularly Asmuss Steel, Kiwi Steel and Vulcan Steel, would be likely to provide an effective constraint. Such evidence of the existing state of competition is of relevance under section 3(9)(b). Discussions were held with over 50 steel users chosen at random on the factors which they took into account in decisions on steel purchases. Following the completion of this further investigation it was interesting to compare the responses of some firms with their written opposition to the first application. A substantial number of letters had been received from steel users in relation to the previous application, with the similarity in their content suggesting that their origins had been coordinated. These letters had led the Commission to believe that the firms concerned had sourced their steel requirements only from Fletcher Steel and Steel & Tube. However, the discussions referred to above revealed that this was not necessarily the case.

45 Not surprisingly, price was found to be an important factor in purchase decisions. Medium-sized and larger steel users often seek quotes from several suppliers, and purchase from the cheapest source. Some small users prefer to have immediate supply, by personal visits to warehouses; however, for such firms, convenience is also a factor. Not all small buyers had this approach, and many consider that overnight or later delivery is adequate. Some purchasers have established good personal relationships with suppliers, and, when prices are comparable, they will purchase from the established supplier.

46 A common comment of North Island users who purchased some or all of their steel requirements from Fletcher Steel was that supplies were often shipped from Auckland, even where there is a Fletcher Steel branch in their city. A similar comment was made by South Island users who referred to an apparent trend by both Steel & Tube and Fletcher Steel to supply steel by overnight delivery from Christchurch.

47 Kiwi Steel, Asmuss Steel and Vulcan Steel provided details of their sales in provincial cities. This information showed a significant geographic spread of customers. All three companies indicated that their policy is to tender for any contract, regardless of size or location.

48 Commission staff found a high level of awareness on the part of steel users of the capabilities of the smaller steel distributors. The smaller distributors are widely regarded as credible and effective competitors to Fletcher Steel and Steel & Tube.

49 Another issue that was examined was the question of the breadth of range of merchant steel products stocked by the smaller distributors, in comparison with the ranges of Fletcher Steel and Steel & Tube. It was found that the range stocked by the smaller distributors is surprisingly wide. In particular, Vulcan Steel stocks 676 individual merchant steel lines, a figure substantially higher than the 481 stocked by Fletcher Steel. While at times, particular lines listed by Vulcan could be out of stock, this can occur with large distributors as well as small. The Commission therefore did not find that the size of the stock range of the smaller distributors is likely to diminish their effectiveness as competitors.

50 There was, therefore, significant new information before the Commission in the current application pertaining to the awareness, and the competitive capability, of suppliers other than Fletcher Steel and Steel & Tube.

51 Accordingly, the Commission concludes that the main independent distributors - Asmuss Steel, Kiwi Steel and Vulcan Steel - are seen as credible alternatives to Fletcher Steel and Steel & Tube by most steel users at present, and are also likely to continue to be credible alternatives if the proposed acquisition were to go ahead. Accordingly, Asmuss Steel, Kiwi Steel and Vulcan Steel pose an existing competitive constraint.

Constraint from Expansion of Existing Competition

52 The extent to which these companies will provide more of a competitive constraint will depend in part on their ability to expand.

53 These competitors have established national distribution networks. They have chosen a relatively centralised branch structure from which they distribute nationally by road and rail. These companies could expand further if, in time, there were a perceived need to adopt a more decentralised branch structure. In addition, each company could readily expand its existing facilities. For example, Vulcan Steel is currently expanding its presence by constructing a warehouse in Dunedin. [ ]

54 A further important consideration is the availability of merchant steel product to Asmuss Steel, Kiwi Steel and Vulcan Steel. In this context it is also important to consider the likely buying power advantages that the merged entity may enjoy.

55 Asmuss Steel, Kiwi Steel and Vulcan Steel are largely dependent on imported products. Asmuss Steel indicated that it relies on imports for more than [ ]% of its merchant steel needs (and [ ]% of its plate). Vulcan Steel imports about [ ]% of its supplies of both merchant steel and plate. Kiwi stated that it imports "the majority" of both types. Fletcher Steel and Steel & Tube are similarly reliant on high levels of imports, as noted below in paragraph 58.

56 Discussions about supply terms were held with Australia-based and New Zealand-based representatives of five international trading houses namely [ ]. The first two of these said that the price advantage to a larger purchaser such as the merged entity would be small. The third said in a telephone conversation that the price advantage could be up to 10% (combining price and freight advantage), but, in a subsequent written communication to the Commission, did not confirm that the advantage would be as high as that. The trader said that "we do not believe that it is possible to establish an average advantage". The fourth trading company representative said that the price advantage was possibly in the range of 2 to 3%. The fifth said that there would be no real difference in prices. The impression gained by the Commission from this evidence is that the level of potential discounts is likely to be small.

57 The merged company is likely to enjoy advantages in freight costs. The overseas traders consulted by Commission staff did not state figures for the likely extent of this saving, which they indicated was negotiable and difficult to quantify. The extreme difference would be equivalent to 5% of the price, but typical differences would be substantially less.

58 There may be problems in relying upon imports where there are lead times of about three months in making direct purchases from mills. This problem is not limited to Asmuss Steel, Kiwi Steel and Vulcan Steel however, as the two parties to the proposal currently also rely heavily upon imports. Fletcher Steel imports [ ]% of its merchant steel and [ ]% of its plate. Steel & Tube is estimated to import [ ]% of its merchant steel and [ ]% of its plate supplies. These problems, which will arise from time to time, do not mean that the competition from Asmuss Steel, Kiwi Steel and Vulcan Steel will be limited. Forward planning, ordering and expansion will be likely to go hand-in-hand.

59 While domestically produced steel is of relatively less importance to the smaller distributors, the potential buying power of the merged entity was also considered in relation to those sources of supply.

60 BHP New Zealand Steel negotiates rebates with major customers. Rebates are of two types. The first is based on the tonnage ordered, and has the scale shown in Table 2.

Table 2: Volume Discounts on Steel Purchases by Distributors

Tonnes per annum	Rebate %
[	[
]	]

61 The second type is a value added rebate, which is negotiated on a confidential basis and which is based on product promotion and a number of other factors. The maximum level of this rebate is [ ].

62 [

]

63 Pacific Steel [

].

64 While a large purchaser of domestically produced steel will have a price advantage compared with a smaller purchaser, price levels in New Zealand are strongly influenced by the price of imported steel. It is not clear that the proposal would increase the existing price advantage of large purchasers to any significant extent. The question of rebates on purchases of domestic steel also appears unlikely to constitute a significant limitation on the operations of the smaller distributors. That is, while prices of domestically produced steel are relevant, import prices are significant. This point is demonstrated, for example, by reference to the possibility that users may bypass the distributors and import direct.

65 Although the Commission recognises that smaller steel users are unlikely to import their own steel requirements, it also received evidence that a number of users do bypass the established suppliers, and import directly. One such example is that of a medium sized user [ ]. This firm, after receiving competing quotes to supply steel plate from both of Fletcher Steel and Steel & Tube, imported [ ] tonnes directly from a Singaporean mill. The price advantage was advised as being [ ] cheaper than the local quotes, even after costs to land the products were added.

66 The Commission therefore considers that the competitive response of the smaller distributors is likely to be significant, and is likely to constrain the ability of the merged entity to impose a *ssnip*. This is a constraint to which significant weight should be attached.

Constraint from Market Entry

67 A business acquisition is unlikely to result in the acquisition or strengthening of dominance if there is a credible threat of market entry. Potential competition can act as a constraint on market power, and so an examination of the nature and extent of this constraint is part of the Commission's assessment of competition.

68 Entry conditions, including the nature and height of any entry barriers, must be considered before the threat of new entry, which might constrain the conduct of a merged entity, can be evaluated.

Distribution Network

69 It is possible that a lack of access to distribution networks could constitute a barrier to entry, as the Commission's *Business Acquisition Guidelines* acknowledge. Fletcher Steel and Steel & Tube each have branches in a number of locations in New Zealand. Some industry sources consider that a new entrant would need to duplicate such networks in order to become substantial competitors on a par with those companies. Both Fletcher Steel and the existing small competitors do not agree with this view.

70 The existence of networks of warehouses allows for immediate delivery in some cases. Some small users apply a 'just-in-time' approach to their procurement of raw materials. That is, they either request delivery on the same day they place their order, or they collect the materials from a distributor's warehouse with their own vehicle as required. However, in centres where there is no warehouse, such as Queenstown,

comparable small users appear able to manage adequately with next-day or later delivery from another centre.

71 The Commission found that Asmuss Steel, Kiwi Steel and Vulcan Steel compete for business throughout New Zealand, and are successful in obtaining orders in centres where they have no physical presence. Given these outcomes, there is no obvious reason why new entrants also could not distribute over a considerable geographic area from one or a small number of branches. In any event, as indicated above, the cost of establishing a distribution network such as is operated by these companies does not appear to be prohibitive, and the sunk cost content of such a development is not great.

Access to Merchant Steel Products

72 A prospective entrant's ability to enter this market depends also on the availability of steel on competitive terms. The same considerations as those discussed above for the expansion of existing competitors apply here also. Several industry participants pointed out that the world surplus of steel is of particular relevance to the feasibility of obtaining competitively priced stocks.

Costs of Establishing Brand Loyalty and Reputation

73 Fletcher Steel and Steel & Tube, and their operating subsidiaries, are long-established businesses with large branch networks, and are known to virtually all steel users. However, the research undertaken on behalf of Fletcher Steel by a market research firm, which is summarised in paragraph 43 above, and the Commission's own study conducted in the course of investigating this application, have shown that Vulcan Steel, which was established as recently as 1996, has become quite widely known as a credible supplier of an extensive range of merchant steel lines.

Conclusion: Barriers to Entry

74 The Commission concludes that there are no factors in this market which constitute major barriers to entry. Given that sunk costs appear only moderate, and that supplies are available on competitive terms, it is unlikely that an incumbent would act in a predatory fashion. The background to this assessment is contained in paragraph 26 of the minority's dissenting opinion for Decision 376.

Assessment of the Constraint by Potential Competition

75 Potential competition can constrain the exercise of market power. The question in the present case is whether the acquisition will reduce the likelihood of entry.

76 The Commission uses the "*lets*" test to assess the degree of constraint likely from the threat of market entry. The test has four elements: entry must be *l*ikely, sufficient in *e*xtent, *t*imely and *s*ustainable for it to impose a credible constraint on firms which might otherwise possess market power. Lack of entry is not necessarily 'bad'. Rather, this test is based upon likely market responses should the merged entity attempt to impose a *ssnip*.

Likelihood and Sustainability of Entry

77 An effective constraint requires that entry be likely in commercial terms. The Commission notes that, in the distribution of merchant steel products, as with any other market, no new entrant can be guaranteed of success. A combination of product knowledge, marketing and financial ability and business acumen are essential minimum conditions. Former staff members of Fletcher Steel and Steel & Tube have featured prominently as founders of the existing competitors, and others with experience in the large companies could be well-placed to be future entrants.

78 A recent small-scale entrant is T J Steel, which is based in Hamilton. There does not appear to be any reason why the successful entry of the smaller distributors could not be achieved by others. The Commission notes that the number of prospective entrants need not be large for their existence to constrain existing suppliers.

79 Given the large number of steel traders which operate internationally, it appears improbable that the merged company could make exclusive deals which would prevent new entrants gaining access to imported supplies.

80 While there has been relatively little entry in this market in the past several years, this might not be surprising given the overall pattern of demand for steel in New Zealand. According to the *Steel Statistical Yearbook 1998*, published by the International Institute of Steel and Iron, apparent consumption of finished steel in New Zealand was 580,000 tonnes in 1997, compared with 630,000 tonnes in 1994. Notwithstanding these trends, there has been successful entry.

Extent of Entry

81 If entry is to constrain an otherwise dominant firm, such entry must potentially be at a scale sufficient to impact significantly on its behaviour.

82 Given that the experience of the existing smaller competitors has shown that distribution over a relatively wide area is feasible from a small number of distribution points, a network on the scale of Fletcher Steel and Steel & Tube does not appear to be essential. The experience of Vulcan, for example, shows that a wide product line offering was achieved within a relatively short time-frame.

83 The Commission concludes that new entry, using relatively centralised distribution, could be achieved on a scale which would be sufficient to constrain the merged entity.

Timeliness of Entry

84 Entry must be likely to occur before users are detrimentally affected to a significant extent, if it is to be sufficient to alleviate dominance concerns.

85 The view within the industry is that the arrangements necessary to allow entry could be undertaken within twelve months. One case which was mentioned to Commission staff was that of [ ] which was able to effect entry on a small scale in a substantially shorter time. The timeliness criterion therefore appears to be satisfied.

Conclusion on Constraints from Potential Competitors

86 After reviewing the above factors, and the achievements of Asmuss Steel, Kiwi Steel and Vulcan Steel, the Commission concludes that entry on a small to medium scale will be feasible and sufficient to constrain the merged entity. Viewed from another perspective, the use of the *ssnip* test leads to the conclusion that the merged company could not profitably increase its prices or reduce the quality of its service without inducing new entry (or further expansion by existing competitors).

Countervailing Power of Buyers

87 A firm may be constrained by any countervailing power possessed by its customers. Large purchasers clearly have this power because they have the possibility of importing their requirements, or of buying directly from the domestic mills. Fisher and Paykel is an example of a large user which does this, while the example of [ ] quoted above is an example of a medium sized firm which found this feasible.

Conclusion on the National Market for the Distribution of Merchant Steel Products

88 Merchant steel is a product group for which it is difficult to set precise boundaries. Partly because of this, it is difficult to get exact market shares. Nonetheless, this matter does not assume major significance because, even assuming a worst case of a [ ]% market share, this factor alone is not determinative of dominance. Rather, on the overall facts of this application, the Commission attaches greater weight under section 3(9) to factors other than market share.

89 The other factors to which substantial weight has been given include the expansion possibilities for the smaller competitors, Asmuss Steel, Kiwi Steel and Vulcan Steel, the low entry barriers (which are typically found in distribution markets), and the constraints which steel buyers are able to exercise.

90 The Commission's examination of these factors has led it to conclude that the merged entity would not be likely to acquire dominance in the national market for the distribution of merchant steel products. The merged entity would not be likely to achieve the level of market power identified under the *Port Nelson* test of dominance.

The Market for the Distribution and Processing of Steel Plate Products

Market Share

91 A little over half of the steel plate used in New Zealand is imported, with the balance being produced domestically.

92 On the figures available for Decision 376 it was found that the merged entity would be outside the Commission's safe harbours because the combined market share would be [ ]% and the three next largest competitors would all have only [ ]% each. The

majority of the Division of the Commission concluded that the smaller distributors were not of a size or scale to effectively constrain the merged entity.

93 New figures obtained from the distributors, and shown Table 3 below, have placed the market which would result from the proposal comfortably within the Commission's second safe harbour. While the revision is substantial in the case of one supplier, [ ], the Commission is satisfied that the figures now available accurately reflect the market structure.

Table 3: Market Shares in Plate

Company	**Tonnes (1999)**	**%**
Fletcher Steel	[	[
Steel & Tube		
Sub-total		
Asmuss		
Kiwi		
Vulcan		
Steel Plus		
Others (incl. direct imports)		]
Total	]	100.0

Competition

94 In this market [ ] is a significant supplier, and there appear to be no reasons why it would be other than a strong competitor to the merged company.

95 Apart from market share, the remaining analysis for this market is the same as for merchant steel. Thus, expansion possibilities, low entry barriers and the constraint afforded by the medium and larger users are significant.

Conclusion on Steel Plate

96 The Commission concludes that the merged entity would not be likely to acquire dominance in the national market for the distribution and processing of steel plate.

Other Steel Markets

97 The four remaining markets relevant to this application are;

- the national market for the distribution and processing of steel reinforcing;
- the national market for the distribution and processing of steel coil;
- the national market for the manufacture and distribution of domestic roofing products;

- the national market for the manufacture and distribution of industrial roofing products.

98 A submission was received [ ] in relation to the present application which presented arguments for separating the market for the distribution and processing of steel coil into two: one for coil which is to be used to produce roofing, and one for coil which is to be used in general manufacturing. It was argued that much of the coil which is used for roofing is roll-formed into roofing profiles by the roofing manufacturers. In contrast, general manufacturers require processing, which generally means that the coil is either cut to length or slit. The Commission's inquiries established that while most roofing manufacturers obtain coil without having it processed by another firm (that is, they purchase it in the width required), it is not unknown for processors to slit coil to the widths which a roofing manufacturer requires. This can be done on the same machinery as is used to process coil for use in general manufacturing. That being so, the Commission did not find sufficient basis to divide the steel coil market into two.

99 No other information has been received on any of the other four markets that has caused the Commission to change the view it reached in Decision 376. Accordingly, the Commission concludes that the acquisition would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in any of these four markets.

OVERALL CONCLUSION

100 The Commission has considered the likely impact of the proposal in the following markets:

- the national market for the distribution of merchant steel products;
- the national market for the distribution and processing of steel reinforcing;
- the national market for the distribution and processing of steel plate;
- the national market for the distribution and processing of steel coil;
- the national market for the manufacture and distribution of domestic roofing products; and
- the national market for the manufacture and distribution of industrial roofing products.

101 Having regard to the various elements of section 3(9) of the Act, and all the other relevant factors, the majority of the Division of the Commission is satisfied that the proposal would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in any of the markets identified above.

DETERMINATION ON NOTICE OF CLEARANCE

102 Accordingly, pursuant to section 66(3)(a) of the Act, the majority of the Division of the Commission determines to give clearance for the proposed acquisition by Fletcher Challenge Steel Products Limited of up to 100% of the shares in Steel and Tube Holdings Limited.

103 Ms Paula Rebstock has dissented from the majority decision and her opinion follows.

Dated this 10th day of December 1999

M J Belgrave
Chair

DISSENTING OPINION OF P R REBSTOCK

INTRODUCTION

1 Commissioner Rebstock agrees with the market definition adopted by the majority.

2 Commissioner Rebstock also agrees with the conclusions reached by the majority that the Commission can be satisfied that dominance would not result, or be likely to result, from the proposed acquisition in the following markets:

- the national market for the distribution and fabrication of reinforcing steel;
- the national market for the distribution and processing of steel plate products;
- the national market for the distribution and processing of steel coil products;
- the national market for the manufacture and distribution of domestic roofing products; and
- the national market for the manufacture and distribution of industrial roofing products.

3 Having regard to the various elements of section 3(9) of the Commerce Act, and all the other relevant factual evidence and competition issues in the national market for the distribution of merchant steel products, Commissioner Rebstock, however, is not satisfied that the acquisition would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in that market.

4 Therefore, the dissenting opinion of Commissioner Rebstock focuses on the competition analysis associated with the national market for the distribution of merchant steel products.

COMPETITION ANALYSIS: MARKET FOR THE DISTRIBUTION OF MERCHANT STEEL PRODUCTS

Market Concentration

5 The degree of concentration of market share that would result from a business acquisition is a useful first indication of the likely degree of market power which might follow. This is recognised in the “safe harbours” that are defined in the Commission’s *Business Acquisition Guidelines*. The *Guidelines* state (paragraph 4.3):

> “In the Commission’s view, a dominant position in a market is generally unlikely to be created or strengthened where, after the proposed acquisition, either of the following situations exist:
>
> > the merged entity (including any interconnected or associated persons) has less than in the order of a 40% share of the relevant market;

> the merged entity (including any interconnected or associated persons) has less than in the order of a 60% share of the relevant market and faces competition from at least one other market participant having no less than in the order of a 15% market share."

6 These safe harbours recognise that both the absolute levels of market share, and the distribution of these shares between the merged firm and its rivals is relevant in considering the extent to which the rivals are able to provide a constraint over the merged firm. The Commission went on to state:

> "Except in unusual circumstances, the Commission will not seek to intervene in business acquisitions which, given appropriate delineation of the relevant market and measurement of shares, fall within these safe harbours."

7 Although, in general, the higher the market share held by the merged firm, the greater the probability that dominance will be acquired or strengthened (as proscribed by s 47 of the Act), market share alone is not sufficient to establish a dominant position in a market. Other factors intrinsic to the market structure, such as extent of rivalry within the market and constraints provided through market entry, also typically need to be considered and assessed.

8 In its application, Fletcher Steel estimated that the merged entity would have a market share of [ ] %, with two other operators having in the range of [ ]%.

9 The Commission obtained turnover figures from the parties to the proposal, as well as several competitors offering merchant products. The figures obtained by the Commission are shown in the Table 1 below. These figures increased the upper limit for the merged company's market share and lowered the market share of the largest non-acquisition company. The Commission based its decision on the following market shares that were derived from turnover data: [ ] for the merged entity and [ ] for the second largest player. In doing so, the Commission noted that the [ ] market share assumed for the merged entity was likely to be the worst case scenario.

10 Subsequently, Kiwi Steel has provided the Commission with turnover data [ ] that puts their market share at [ ] and reduces the combined entities share slightly to [ ].

Table 1: Estimated Market Shares in the Merchant Steel Market

Company	**Tonnes**	**Estimated Market Share (%)**
Fletcher Steel	[ ]	[ ]
Steel & Tube	[ ]	[ ]
Combined Entity	[ ]	[ ]
Asmuss Steel	[ ]	[ ]
Vulcan Steel	[ ]	[ ]
Kiwi Steel (see para 10)	[ ]	[ ]
Steel Plus	[ ]	[ ]
Total	[ ]	100.00

11 Based upon the above figures, the combined entity's market share is outside the Commission's "safe harbours". In addition, the distribution of shares of the firms outside the merger also falls outside the Commission's "safe harbours". However, the fact that a proposed acquisition may lead to a market share outside these safe harbours is not sufficient evidence to conclude that it will be likely to result in the acquisition or strengthening of a dominant position in a market. Other factors must be examined also.

12 With respect to market shares, a number of previous business acquisitions resulting in high market shares have been cleared by the Commission. A study of proposed acquisitions affecting 277 markets which were considered by the Commission between 1991 and 1996 was published in February 1998.[9] The survey found that despite the fact that many acquisitions would result in high market shares, clearance was given to a number of such proposals. Clearance was given in four cases where the combined market share was 100%, to seven in the 90-99.9% range, to 19 in the 80-89.9% range and to 11 in the 70-79.9% range. On the other hand, clearance was declined in 26 cases where market share was high, though dominance was not found in any cases below 70%.

13 In the case of clearances of proposals which resulted in high market shares, market share alone was not considered to be determinative of market power or dominance. The existence of factors such as low barriers to entry, availability of imports, and the constraint affected by existing competitors were concluded to be sufficient to prevent the merged entity from acquiring or strengthening a dominant position given the particular circumstances in the market under consideration.

14 In the cases which would have resulted in high market share, but they were declined, there was a substantial proportion involving services rather than products. In the markets in question, none where contested by imports, except the fertiliser markets in the Ravensdown proposal, where the two parties to the acquisition were already importers. The Ravensdown decision relied heavily on the fact that there was considerable value-added to the sale of the fertilisers in the form of transportation services.

15 A notable feature in the markets where dominance would be acquired was the lack of other competitors. In nearly all cases, there was either one other player or none at all. Two exceptions were TipTop/ New American and Hoyts/Pacer Kerridge. In the latter, the other players were small, geographically based, independent exhibitors unable to compete with the nation-wide chains.

16 A characteristic of all markets where dominance would be acquired or strengthened was the presence of entry barriers which were high or insurmountable. In three of the applications, strict regulatory barriers would have prevented further entry; four of the applications involved natural monopoly conditions; four further applications involved a combination of entry conditions that in aggregate would create high entry barriers;

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[9] *A Study of the Commerce Commission's Evaluation of Applications for Business Acquisition Clearances and Authorisations, 1991-1996,* Occasional Paper No. 8, February 1998, Commerce Commission, Wellington

and the remaining cases found situations of such strong incumbent advantage that it was considered entry would be most unlikely.

Constraint from Existing Competition

17 The key issues to be addressed when considering the likely constraint from existing competition should the proposed acquisition proceed are the dynamics of the current market environment and the ability of the non-acquisition participants to compete post merger. These factors are considered below.

Brand Loyalty and Reputation

18 The Commission examined the results of independent market research commissioned by Fletcher Steel to assess the awareness amongst steel fabricators and other steel purchasers of the presence of merchant and plate steel suppliers. The research showed significant awareness of distributors other than Fletcher Steel and Steel & Tube. [

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19 In light of the results of the [ ] survey, Commission staff also undertook an informal Steel Buyers Questionnaire. 50 steel buyers across New Zealand were identified through the Yellow Pages and contacted by telephone. The Questionnaire set out 16 questions to be asked of each company. The questions all pertained to the current market situation: products purchased, suppliers utilised, rationale for selecting suppliers, awareness of other suppliers, use of direct importing, bidding behaviour and bidding outcomes, etc. Consistent with the purpose of the Questionnaire, no questions about the expected dynamics should the merger proceed were asked. In a minority of the responses some comment about the impact of the proposed merger was made and recorded. The Questionnaire did not relate only to the merchant steel market, but covered other steel markets in New Zealand as well.

20 While the survey undertaken on behalf of the applicant and the Questionnaire undertaken by Commission staff may be biased due to the timing of the surveys (both followed the extensive investigations by the Commission in response to the first application, as well as extensive press coverage associated with that decision), steel purchasers appear to be widely aware of the fringe players in the steel markets under consideration.

21 Nevertheless, despite apparent widespread familiarity with these fringe players who have been in these markets over many years, the revealed preferences of purchasers (ie. their actual purchases) clearly suggests that while these players have been able to enter the merchant steel distribution market, they remain niche players unable to move into the core of this market. Indeed the market share of the largest merchant steel distributor [ ] other than the acquisition parties is well outside the Commission's "safe harbours".

Dynamics of the Current Merchant Steel Distribution Market

22 The questionnaire undertaken by Commission staff also provides useful insights into the nature of the dynamics of the current market structure and the critical issues which impact on the demand patterns across the some steel markets in New Zealand. The Questionnaire provides a means to discern the factors that are important to steel users when making their purchasing decisions. These factors provide some preliminary guidance on the possible sources of barriers to expansion/entry, which need to be considered in each steel market under consideration. Some of the key factors which arose from the survey include:

- cost advantages;
- the scope and scale of the distribution networks of the various players;
- the ability to carry sufficient quantities of the range of stock carried;
- the ability to carry a sufficient range of stock;
- the ability to provide same day /just in time/ overnight delivery to the extent provided by competitors;
- the ability to provide consistent and reliable service; and
- the ability to provide financing terms that are competitive with that offered by other competitors.

23 These factors are consistent with the issues raised in over 100 submissions received by the Commission from purchasers of steel products who have expressed concern about the impact of the proposed merger. In saying this, Commissioner Rebstock notes the coordinated nature of many of these letters. In addition, two other steel distributors that have expressed concern to the Commission about the impact of the proposed merger have also highlighted a number of these issues which feature in the current market and would be likely to be accentuated post acquisition.

24 Some purchasers and some small competitors have indicated that these factors are not of concern to them. Other industry players have indicated that in some circumstances the small players can meet the requirements of merchant steel users. This, however, is not necessarily evidence that the small players are also able to constrain the merged entity to the extent required across the whole market, particularly in the absence of a second large player.

25 While the fringe players are widely known in the industry, and purchasers ‘cherry pick’ under particular circumstances, the fringe players are not widely seen as providing a credible competitive constraint on the two large players across the all steel markets, consistently across the whole product range for the quantities demanded at any particular point in time. The fringe players are generally seen to be competitive in particular circumstances that pertain from time to time for some of the purchasers in some markets. Unlike for the two large players, only a small fraction of the purchasers have indicated that their full steel requirements are met by a small distributor.

26 The key services provided in the distribution market for merchant steel have a high value-added content, such as transportation services, financing services, and inventory services. The nature of the merchant steel products, in which there are several thousand different products, places a premium of these value-added services as

compared with the other steel markets. This provides one possible explanation for why a relatively high degree of concentration has been perpetuated in this particular market. Given the need to stock large quantities of a vast array of individual products in order to compete successfully, it is not surprising that this particular market has proven difficult to penetrate on a large scale across the whole country.

27 In addition, the Commission has been advised that there are lead times of 3 months to purchase imports direct from mills. Steel & Tube is estimated to import [ ]% of its merchant steel, while Fletchers Steel is estimated to import [ ] of its merchant steel. Furthermore, the actual amounts that will be ultimately supplied can only be guaranteed within a range of +/– 10%. These constraints impose far greater barriers on participants with low market share than those with large market shares. These factors coupled with the diverse range of products in this markets, suggests that the merged entity is likely to have substantial advantages in terms of its ability to economically provide inventory services in the merchant steel market.

28 From the evidence before the Commission, there appears to be considerable competitive pressure within the current market structure. The two large distributors provide considerable constraint on one another throughout the country, across each of the steel markets under consideration and across product ranges within each market. The fringe distributors provide pockets of additional constraint in particular segments of some markets and widespread constraint in some steel markets. While these fringe distributors have been able to enter particular markets on a small scale and compete successfully in some of the markets, they have not been able to extend their share of the market and become a significant part of the core market for the distribution of merchant steel products.

Ongoing Constraint through Existing Non-Merger Participants

29 Further issues to consider when examining the likely constraint of existing participants on the post acquisition entity centre on the ongoing ability of the smaller players to compete and/or on any barriers to expansion the fringe players may face. These are considered below.

30 [ ], currently with a small market position in the merchant steel distribution market in New Zealand, made the following points in its submission dated 22nd October 1999 to the Commission on the proposed acquisition.

[

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31 These factors warrant further consideration. First, further exploration of the potential purchasing power of the combined entity is of particular relevance. Evidence on prices in this market, however, is very difficult to obtain. There are no published price lists and there appears to be widespread use of volume discounts and loyalty

rebates that vary across the product range. Nevertheless, the evidence provided to the Commission does allow estimates to be made.

32 First, the pricing behaviour of New Zealand based manufacturers indicates that each of the current large players already obtain a volume discount of up to [ ] over the smaller players for domestically produced product. In addition, up to a further [ ] advantage is available due to 'value-added' rebates. It is likely that these discounts are dictated by those available to purchasers through imported product. While one domestic producer has indicated that they would resist further discounts, it seems reasonable to assume that the outcome of negotiations should the acquisition proceed will be largely determined by what discounts and rebates are available to the merged entity through imports.

33 Second, the Commission has been provided with a wide range of estimates about the potential import purchasing power of the merged entity, which accounts for the vast majority of the merchant steel trade. Estimates of volume discounts and loyalty rebates that the merged entity could obtain ranged up to [ ]. In addition, the merged entity is likely to benefit from freight costs advantages of up to [ ]. Taken together there appears to be the potential for an absolute cost advantage of [ ]%.

34 The merged entity will take the most advantageous combination. The trader that indicated that the merged entity could have an advantage of up to [ ] currently operates in this market and knows the relative size and nature of the trade. The trader confirmed this advantage in his subsequent communication to the Commission. In his communication of 7 December 1999, he stated:

> [
>
>]

35 If a combined entity did indeed gain an absolute cost advantage of up to [ ] once all of these factors are taken into account, then it is also likely that the merged entity could engage in strategic pricing behaviour that would further restrict existing competitors (and deter entry). Once this is accomplished, the combined entity could profitably impose a sustainable price increase well in excess of the 5% rule customarily used as a benchmark for dominance. Indeed it is also apparent that even if the combined entity were not able to achieve further cost advantages than currently available to each of the large players, it would nevertheless have the capacity to profitably impose a sustainable price increase, given the absence of another player with similar cost advantages. The ability to sustain such a price increase would be supported by the other barriers to entry, which are discussed below.

Conclusion on Constraint from Existing Competition

36 In conclusion, Commissioner Rebstock considers that the competitive response of the existing small distributors to the combined entity is unlikely to be effective in constraining the ability of the combined entity to impose a significant and sustainable price increase. The evidence strongly suggests that the existing small competitors, without the constraining influence of a second sizeable player in the market, would be unable to impose a constraint of sufficient extent to constrain the market power of the merged entity.

Constraint from Market Entry

37 A business acquisition is unlikely to result in the acquisition or strengthening of dominance in a market if behaviour in that market continues to be subject to significant constraints from the threat of market entry.

38 The Commission accepts that potential competition can act as a constraint on business activity. An assessment of the nature and extent of that constraint is an integral part of the Commission's assessment of competition and market dominance.

Barriers to Entry

39 Entry conditions, including the nature and height of any entry barriers, must be considered before the threat of new entry, which might constrain the conduct of a merged entity, can be evaluated.

Distribution Network

40 A lack of access to distribution networks can constitute a barrier to entry, as the Commission's *Business Acquisition Guidelines* acknowledge. Fletcher Steel and Steel & Tube each have branches throughout New Zealand, providing for immediate delivery in many areas. Some industry sources, including steel users and other distributors, consider that a new entrant would need to duplicate such networks in order to become substantial competitors on a par with those companies. [ ] and several of the existing small competitors do not agree with this view.

41 [ ] in their submission to the Commission provided evidence on the limited capacity of the smaller players in terms of the scale and scope of their existing distribution centres. Given the market share of these distributors, it seems likely that these facilities may not be comparable to those of the two large players. This evidence seems consistent with a wide range of concerns expressed to the Commission about the apparent inability of the small players to consistently supply the required quantities of a wide range of stock in a timely manner.

42 The efficiencies of establishing and maintaining an extensive distribution centre on a scale and scope required to constrain the combined entity are onerous if an entrant does not have the market share and thus the revenue base to support it. While fixed costs of setting up a distribution centre may not be high; inventory costs impose a high capital cost, particularly given the need to stock large quantities of several thousand products if the entrant is to meet consumer expectations of frequency,

timeliness and level of service. While some purchasers may not have such requirements, a significant proportion of the merchant steel consumers approached by the Commission do.

43 In conclusion, Commissioner Rebstock considers that difficulties with establishing a distribution network that are of similar scale and scope to those operated by the combined entity are likely to impose substantial entry barriers to potential entrants.

Incumbent Advantage

44 The ability to enter the merchant steel market will depend on a range of factors that have been discussed above in the section, *Constraint from Existing Competitors* and will not be repeated here. The Commission received considerable evidence that entry may be deterred due to the inability of potential entrants to access supplies on a competitive basis as compared with the combined entity. Such cost advantages could be argued to result in consumer benefits through the possibility of reduced prices. However, if these cost advantages, along with other barriers to entry/expansion, provide the merged entity with a dominant position in the market, there will not be sufficient competitive pressure for these consumer benefits to be realised.

45 Any firm contemplating entry in the market under the conditions that are likely to exist post-merger could expect to encounter an immediate and vigorous response from the combined entity.

Brand Loyalty and Reputation

46 Evidence of widespread brand recognition of the fringe players that is not associated with significant market share may be evidence of a failure to establish brand loyalty and reputation. This appears to be the case with respect to the fringe players currently operating in this market. They entered the market, achieved roughly their current market share within the initial years, and have been unable to extend their share and move from the periphery of the market to its core. Consumers 'cherry pick' on occasion, but on the whole, brand loyalty and reputation rests largely with the two parties to the proposed acquisition. The revealed preferences of buyers and the failure of the fringe players to make significant in-roads into this market over a ten-year period support this argument.

47 In Commissioner Rebstock's view there is a high degree of brand loyalty to the two large players. While the consumers know of the existence of the smaller players and give them, on average, a small proportion of their business, the niche players have been unable, except in infrequent cases, to significantly shift brand loyalty and reputation away from the two large players. In addition, there is significant brand proliferation amongst the existing participants, which further constrains both expansion and entry opportunities.

48 New entry may prove to be difficult and risky, given the current brand loyalty and reputation of the merged entity, particularly given the sunk costs required to create a new brand, establish market reputation and gain market share.

Conclusion: Barriers to Entry

49 Commissioner Rebstock concludes that there is a wide range of barriers to entry operating in the current market and these are likely to be accentuated should the acquisition proceed. The market entry barriers are not only extensive, but also high. Key barriers include: strong incumbent advantage (market share, purchasing power and established reputation and loyalty); the capital cost of large inventories; long lead-in time to acquire imports; the customer lock-in effects of loyalty rebates that appear to be a common feature of this market; and the nature of the product market itself (several thousand products to be stocked in large quantities).

Assessment of the Constraint by Potential Competition

50 The Commission recognises that potential competition can act as a constraint on the exercise of market power. Hence, the assessment of the nature and extent of that constraint represents an important element in the evaluation of whether, in a business acquisition, the combined entity will acquire or strengthen a dominant position.

51 In the present case the issue is whether Fletcher Steel will acquire or strengthen a dominant position in the national market for the distribution of merchant steel products through its acquisition of Steel and Tube.

52 The Commission assesses whether the threat of market entry is a sufficient constraint on the exercise of market power through the *"lets"* test. Under this test, potential entry must satisfy all four of the following criteria: it must be *l*ikely, sufficient in *e*xtent, *t*imely and *s*ustainable.

Likelihood and Sustainability of Entry

53 In order to be an effective constraint on incumbent market operators, entry must be likely in commercial terms, ie. under the condition of a lasting economic incentive.

54 The Commission considers the history of past market entry as an indicator of the likelihood of future entry. Commissioner Rebstock recognises that entry has been affected by small operators, with limited stock and on a limited geographic scale. However, it is noteworthy that large-scale entry over the past decade has been absent.

55 Consideration of the barriers to entry, discussed above, and the history of entry into this market, suggests that potential entry at a scale that could provide an effective constraint on the combined entity is unlikely. The ability of the combined entity to provide a quick and vigorous response to significant entry (or expansion), in particular reduces the likelihood of entry being attempted.

56 Consideration needs to be given to whether a company with sufficient offshore backing could nevertheless establish itself should the merged entity attempt to impose a sustained price increase. Commissioner Rebstock notes that there is economic evidence that this type of entry is normally associated with high growth markets in the early stages of an industry's lifecycle. It is in this environment that the cost advantages of the incumbent may be softened. The Commission has been provided

with considerable evidence that the market for steel under consideration is a low growth market in its mature phase and may be characterised by considerable excess capacity. Commissioner Rebstock, therefore, concludes that the entry environment is hostile, even if a possible entrant has the backing of a large offshore parent. Such a parent would still have to weigh up the opportunity costs and risks of backing a venture of this nature in a mature, low growth market in which the incumbent may have significant excess capacity and substantial incumbent advantages.

57 As discussed above, the combined entity has the potential to impose a significant price increase that could be sustained due to its purchasing power and the other significant barriers to entry in this market. Therefore, Commissioner Rebstock concludes that entry on a sufficient scale is neither likely nor sustainable.

Extent of Entry

58 If entry is to constrain an otherwise dominant firm, such entry must be at least potentially at a scale sufficient to impact significantly on its behaviour.

59 Entry on a modest or localised basis has occurred in the last ten years. However, even with a market structure in which two large players appear to be played off against one another by purchasers, no new entrant into this market has achieved more than niche or fringe status.

60 Fringe players appear to be caught in a chicken and egg dilemma. On the one hand, they do not have the market share required to establish and efficiently operate an extensive distribution network supported by adequate quantities of a wide product range that would allow them to expand their market share. On the other hand, these players do not have an extensive distribution network supported by adequate quantities of a wide product range that allows them to compete effectively to extend their market share. The factors that appear to have supported restricted entry to date will be accentuated by the acquisition.

61 Having regard to these factors, Commissioner Rebstock concludes that it is unlikely that new entry could be achieved on a scale and scope sufficient to effectively constrain the combined entity.

Timeliness of Entry

62 Entry must be likely to occur before users are detrimentally affected to a significant extent if it is to be sufficient to alleviate dominance concerns.

63 The lack of significant new entry in this market in the past several years is not surprising given the overall pattern of demand for steel in New Zealand. According to the *Steel Statistical Yearbook 1998*, published by the International Institute of Steel and Iron, consumption of finished steel in New Zealand was 580,000 tonnes in 1997, compared with 630,000 tonnes in 1994.

64 To constrain effectively the exercise of market power to the extent necessary to alleviate concerns about market dominance, entry must be likely to occur before consumers or users in the relevant market are detrimentally affected to a significant

extent. The Commission has previously said that the relevant time period has to be considered on a case-by-case basis.

65 Commissioner Rebstock notes that only two independent operators of significant size in this context have entered the merchant steel market in the last ten years. While entry was achieved, the scope and scale of that entry has been effectively restricted to niche or fringe status. These players reached their current market share within the first years of operation and have not extended this share in the subsequent period. It is therefore difficult to accurately assess the timetable needed to effect entry on a scale sufficient to constrain the merged entity.

66 Industry sources advised that entry could be effected within 12 months. This period refers to the time necessary to physically organise depot facilities, distribution networks, and the purchase of stock. It does not include the likely timeframe within which an entrant is expected to attain a market share and associated strengths that could constrain the merged entity. Once entry has been effected, the entrant must start competing. Therefore, notwithstanding that entry to date has been of a restricted scale and scope, Commissioner Rebstock considers that if a firm were to enter the market, entry could be achieved within 12 months.

Conclusion on Constraints from Potential Competitors

67 Given the above factors, Commissioner Rebstock concludes that the threat of entry at a level similar to that affected by Asmuss Steel and Vulcan Steel is unlikely to constrain the merged entity. The only entry to the merchant steel distribution market which would be likely to act as a constraint on the merged entity would involve an extensive national network, providing a full range of products, stocked in sufficient quantities to meet 'just in time' requirements in a similar manner to that of the merged entity.

68 The Commission has not seen any evidence that entry or (expansion) to such a level is likely. Conversely, the evidence indicates that entry has only occurred, when it does, on a small scale. The high degree of market power of the merged entity is likely to make entry on a sufficient scale to be a constraint even less likely in the future.

69 Commissioner Rebstock concludes that while restricted entry into the merchant steel products market might be expected to be achieved in a timely manner, entry would not be likely, sufficient in extent or sustainable enough to constrain the potential market power of the merged entity.

Countervailing Power of Buyers

70 A firm may be constrained by any countervailing power possessed by its customers. The Commission recognises that a firm may be constrained by countervailing power in the hands of its consumers or when considering monopsony (single buyer) power, suppliers.

71 Industry sources advised that the purchasers of merchant steel products covered a wide variety of end users, including manufacturers, building merchants, and the

construction industry. In the case of large purchaser, it is generally accepted that those purchasers could in principle exert a degree of countervailing power on the merged entity, due to the purchasing power of these buyers, and their ability to source directly from the producer, either domestically or internationally.

72 The Commission has been advised that there are currently cost savings of up to [ ] available if end users purchase directly from the overseas mills. Nevertheless, there is surprisingly low levels of direct importing even by medium and large end users of merchant steel products. Despite very sizeable price differences that might normally result in widespread switching, there are many medium and large end users that nevertheless do not directly import. This evidence strongly reinforces the high value added nature of the services (finance, inventory and transportation) provided in this distribution market and the limited impact of direct imports of merchant steel even within the current market.

73 Furthermore, countervailing power does not exist for a significant number of small steel merchant users. The Commission received submissions from a wide variety of merchant steel buyers concerned at the potential ability of the merged entity to increase prices. It was not available to these consumers to source products from elsewhere, due to the relatively small volume of merchant steel products that they require.

74 Commissioner Rebstock therefore concludes that there is little or no countervailing power available to small to medium end users of merchant steel products, such that it may provide an effective constraint on the merged entity. While, in principle, large purchasers have countervailing power, the high value added nature of the services provided by the domestic distribution companies has resulted in very little switching to direct imports despite very considerable price incentives to do so.

Conclusion on the National Market for the Distribution of Merchant Steel Products

75 High market share is a necessary, but not a sufficient condition to establish market dominance. In addition, consideration must be given to other factors such as barriers to entry and the potential constraint from existing competitors.

76 Commissioner Rebstock has attributed significant weight to the fact that entrants over the past 10 years have been unable to establish significant market shares in this market, despite a relatively competitive environment created by the existence of two relatively large players. In addition, substantial weight has been attached to the barriers to entry in this market, including cost advantages, capital costs associated with large and extensive inventory, widespread use of loyalty rebates, three month lead-in times to acquire imports and lack of economic access to extensive distribution networks.

77 These factors lead to the conclusion that the combined entity would be able to engage in strategic pricing behaviour that could be damaging to existing small competitors and would also deter new entry. Ultimately, it is likely that the acquisition parties could significantly increase prices and the increase could be sustained over a long period of time. The cumulative impact of these factors is likely to result in a high

degree of market power and market control. The test of high market control that is required to establish the likelihood of dominance being achieved is readily met.

78 In conclusion, examination of these factors has led Commissioner Rebstock to not be satisfied that the merged entity would not or would not be likely to acquire a dominant position in the national market for the distribution of merchant steel products.

OVERALL CONCLUSIONS

79 Having regard to the various elements of section 3(9) of the Commerce Act, and all other relevant factors, Commissioner Rebstock is not satisfied that the proposed acquisition would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in a market.

80 Therefore, Commissioner Rebstock considers that the Commission should decline to give clearance for the proposed acquisition by Fletcher Challenge Steel Products Limited of up to 100% of the shares in Steel and Tube Holdings Limited.

P R Rebstock
Associate Commissioner