



Project Atom – Competitive Effects

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Public version – confidential NZS information is redacted (identified by square brackets shaded in green), and confidential PSG information is redacted (identified by square brackets shaded in yellow).

1. Introduction and conclusions

BlueScope Steel (NZ) Limited, an interconnected body of New Zealand Steel Limited (“NZS”), is investigating the acquisition of some of the assets of Pacific Steel Group (“PSG”) from Fletcher Steel Limited. We have been asked by Chapman Tripp to analyse the competitive effects of such an acquisition.

Unless otherwise specified, we refer to all interconnected bodies of NZS as NZS.

We conclude that:

- NZS and PSG do not impose any material competitive pressure on each other – their products are generally not substitutes, and neither could be considered a “near entrant” into the other’s market;
- Rather, the constraint on their prices comes from imports.¹ The import constraint would not be affected by the merger;
- The merger is not likely to result in any “portfolio effects”, essentially because the fixed (and particularly sunk) costs of importing steel products are low; and
- Therefore the merger is unlikely to result in a substantial lessening of competition in any market.

2. Existing constraints

2.1. Demand-side substitutability

NZS produces “flat” steel products, and PSG produces “long” steel products. We understand that flat and long steel products are in general not substitutable by customers of NZS and PSG. Rather, the products generally have different functions, even if they can be used in the same structures.

There are two exceptions that we are aware of, which we discuss in the next subsections.

2.1.1. Multi-story buildings

We understand that multi-story buildings can be erected using either structural steel beams or steel reinforced concrete.² The steel input to the latter is a long product, manufactured by PSG or imported. Structural steel beams are typically produced from hot rolling steel blooms

¹ And in the case of COLORSTEEL®, a domestic competitor (Pacific Coil Coaters), an imported product and substitutable materials. We understand that Pacific Coil Coaters sources most of the underlying substrate for its product from NZS, with the balance being imported.

² And that timber holds a small market share, being approximately █%. We understand from NZS that █.

(blooms are large rectangular long products, similar to billets). Neither NZS nor PSG are currently capable of producing blooms, nor has the mill configuration to roll them. New Zealand consumed beams are either fabricated from plate manufactured by NZS (or possibly imported) or imported. Imported hot rolled “I” and “H” beams are straight, while Steltech’s (NZS’s) welded beams are straight or tapered, depending on design to optimise the structure and steel used. Nevertheless, we understand these products compete.

We understand that the imported rolled steel “I” and “H” beams are readily available from foreign steel mills, and some sizes are available from stock of the local steel distributors. We are advised that most buildings erected using structural steel in New Zealand use the imported hot rolled “I” and “H” beams.

One of the conclusions of our broader analysis of the proposed merger, which we describe in more detail later in this section 2 of our report, is the constraint placed by imports on the price and quality of NZS and PSG products. This constraint applies at various levels of the steel supply chain. It is for this reason that we do not consider the potential overlap between structural steel beams and steel reinforced concrete to raise any competition concerns in the event of a merger between NZS and PSG.

To explain further, suppose that the merged entity attempted to raise the price of the steel used in concrete for multi-story building purposes. As we discuss later in this section, the price of that steel input is already set to reflect “import pricing parity” (“IPP”). Therefore any attempt to raise price higher would result in substitution to imports.

Even if such an attempted price increase did lead to customers switching to beams, only a fraction of the diversion would be to the merged entity’s flat products. NZS estimates that, of the total domestic consumption of beams over the period 2008-2012, between 11% were manufactured using its plate, with the rest being imported “I” and “H” beams.

Now consider the implications of an attempted price increase by the merged entity of plate for structural beams, or structural beams themselves (NZS operates at both functional levels – as already noted, beams can be made by welding together plate). Once again, both plate and beams can be and are imported (although see footnote 3), and this import constraint determines the prices of NZS’s products (and would similarly determine the price of the merged entity’s products).

These import constraints are examples of a broader picture that we explain in this report – the true constraints on steel prices come from imports, and this constraint would be unchanged by the merger of NZS and PSG.

This logic would not apply if in fact competition between domestically-produced flat and long products for multi-story buildings had lowered the relevant prices below the effective IPP. In that case, the merger could still result in price rising, up to the effective IPP. However, if that was the case, we would expect there to be low levels of imports for plate and steel reinforcing product today, reflecting the lower domestic price. But this does not appear to be the case:

- We have already noted above that most buildings erected using structural steel in New Zealand use the imported hot rolled “I” and “H” beams; and

- The data in Table 4 of this report show that [redacted].

2.1.2. Fencing

Painted steel (flat) and wire (long) can both be used for fencing. However, fences made out of these products have quite different functions, with a key distinction being that one is see-through, and the other is not.

We are advised by NZS that painted steel fences are predominately used in urban applications, e.g., boundary fences between residential buildings where privacy is required. Wire fencing is typically used for security fencing and rural fencing.

Furthermore, as we discuss below, painted steel can also be purchased from Pacific Coil Coaters or imported, and wire can be imported.

Finally, there are other materials that can be used for fences, e.g., timber, brick, block and precast concrete.

2.2. Supply-side substitutability

For the reasons discussed in section 2.1, the products of NZS and PSG are not generally substitutable. Nevertheless, we have sought to test the proposition that NZS and PSG constrain each other by virtue of being “near entrants” into each other’s product space. For example, it is possible that NZS is currently constrained by the threat that its key customers (of which there are not many) could underwrite the investment required by PSG to enter into the production of flat products (and vice versa).

It is useful context that NZS once operated a billet caster (i.e., the equipment required to cast billet, which is then converted into long products) and sold the billets both domestically and in the export market, but shut the caster down in 1993 due it being “uneconomic”.³

A difficulty when considering entry by NZS into long, or PSG into flat, is determining at what functional level entry would occur. There are effectively two broad options (and many others in between):

- Limited entry at a downstream level where an upstream input must be purchased from the other company or imported (“limited downstream entry”); or
- Upstream entry with partial/full downstream replication (“comprehensive entry”).

Limited downstream entry would involve, for example, NZS/PSG entering into a specific downstream segment (e.g., NZS investing in a bar rolling mill or PSG investing in a metal coating line). A key feature of this scenario is that the entrant would need to purchase an upstream input (e.g. slab/billet, HRC or cold rolled coil) from the incumbent or an importer, before further processing it.

³ Source: NZS.

While neither PSG nor NZS consider this a realistic scenario, on further probing, PSG has estimated the cost of limited downstream entry by PSG and NZS into each other's downstream markets,⁴ although PSG considers such an outcome "highly improbable":

- Even if PSG installed a small-scale metal coating line (which is the point in the value chain where NZS first started) to initially focus on Fletcher Building's in-house domestic flat consumption, the capital cost would be about [redacted]; and
- If NZS was to move into long products, it is unlikely that it would start with billet, according to PSG. NZS would more likely undertake a more limited investment in rolling equipment to produce long product. These businesses buy billet and convert it into reinforcing bar. PSG estimates the capex needed for a 70-90,000 tonne p.a. facility as being [redacted] million plus working capital.

Therefore, even limited downstream entry would involve material investment. Also, in both of these examples, because different plant is required to make different downstream products, the constraint would only operate in the specific downstream segment in which entry occurs (e.g. re-bar in the NZS example above).

Comprehensive entry would involve either NZS investing in a billet caster or PSG investing in a slab caster, and then the relevant downstream plant.

Both NZS and Fletcher Building executives have (independently) stated to us that:

- For comprehensive entry, the required investment in either direction would be in the realm of a hundred or even hundreds of millions of dollars,⁵ and NZS executives have noted that a move into long would take [redacted] or more, including consent time;⁶ and
- Demand from the New Zealand market would not be anywhere near sufficient to justify such an investment. In fact, we understand that:
 - The existing NZS plant already has almost [redacted] the steelmaking capacity required to service the New Zealand flat products markets;⁷ and
 - The existing PSG plant already has [redacted] capacity than is required to service the New Zealand demand for the products it produces.⁸

These responses have been consistent and are, in our view, credible.

⁴ I.e., entry into the further processing of billets or slabs, not the manufacture of billets or slabs themselves.

⁵ We understand that it would be relatively more expensive for PSG to enter the flat product markets than it would for NZS to enter the long product markets.

⁶ Indeed, NZS expects to invest [redacted] post-acquisition of PSG in just a new billet caster, and for it to be at least [redacted] months from the start of pre-engineering to full commissioning.

⁷ NZS has steelmaking capacity of 635 to 670kt (depending how it is measured) compared to domestic consumption of ~[redacted]kt.

⁸ PSG's steelmaking capacity is [redacted]kt. Domestic long consumption has ranged between [redacted]kt over the past 10 years.

While the ability to supplement domestic sales by exporting (since steel products are tradable) may make entry more attractive in concept, we also note that steel exports from New Zealand are risky (due to international price and foreign exchange volatility) and have historically earned lower margins than domestic sales. For example, Figure 1 below shows the “Steel Value Chain” for PSG’s total business with the incremental margin “domestic” sales earn over “total” (domestic and exports) sales shown as an added premium in orange.

Figure 1
[PSG: Domestic premium over total average sales]

Source: PSG and NERA analysis]

Similarly, a direct comparison of the PSG margin earned on domestic and export sales for the steel and wire businesses shows that [].

Table 1
[PSG: Margin on net sales for steel products]

		2008	2009	2010	2011	2012	2013	Average
Steel								
	Domestic	[]%	[]%	[]%	[]%	[]%	[]%	[]%
	Export	[]%	[]%	[]%	[]%	[]%	[]%	[]%
Wire								
	Domestic	[]%	[]%	[]%	[]%	[]%	[]%	[]%
	Export	[]%	[]%	[]%	[]%	[]%	[]%	[]%

Source: PSG and NERA analysis]

Equivalent data for NZS is set out in Table 2.

Table 2
[NZS margin on net sales for steel products]

	2008	2009	2010	2011	2012	2013	Average
Domestic	[]%	[]%	[]%	[]%	[]%	[]%	[]%
Export	[]%	[]%	[]%	[]%	[]%	[]%	[]%

Source: NZS.]

On this evidence, we do not think the Commerce Commission’s supply-side substitutability test is satisfied, i.e., if prices increased, whether “firms would easily, profitably and quickly (generally within one year) switch production to the products or locations in question without significant cost”.⁹ As the Commission’s *Mergers and Acquisitions Guidelines* state at footnote 63: “To be a near competitor, a firm must be able to enter a market with little or no investment, and, in particular, without incurring significant sunk costs.”

Accordingly we think it is reasonable to conclude that NZS and PSG do not impose any material competitive pressure on each other.

2.3. Imports

The evidence demonstrates that the prices of NZS and PSG are generally constrained by import prices. We set out this evidence in the following sections.

2.3.1. Constraint from imports

We understand that both NZS and PSG specifically benchmark their (domestic) prices against their estimates of an import parity price (IPP).¹⁰ IPP is estimated by taking the US dollar FOB export price from the foreign country,¹¹ and then adding international freight,¹² New Zealand duty, and domestic freight costs, converting to New Zealand dollars where necessary.

□ The domestic price for the next period is then set by negotiation with customers, with the intention of gaining a premium above IPP. □¹³

We also understand that customers often provide quotes from importers during negotiations. The premium above IPP also varies across product categories, as discussed below (see section 2.3.3).

⁹ Paragraph 3.16 of the Commission’s *Mergers and Acquisitions Guidelines* July 2013.

¹⁰ Other than in the case of COLORSTEEL®.

¹¹ This FOB price is often published.

¹² □

¹³ □

As a demonstration of the relationship between prices and IPP, Figure 2 below plots PSG's price for "Rod – All lengths" to its customer United Industries and the calculated IPP over 7 pricing periods.

Figure 2

[PSG: IPP and Price for "Rod - All lengths"]

Source: PSG]

Similarly, Figure 3 below plots domestic, East Asian (“EA”) and IPP prices for reinforcing bar (also known as “Rebar”).

Figure 3

[Rebar: EA, Domestic and IPP prices]

Source: NZS]

Due to PSG facing export parity prices on its scrap metal inputs, the cost of its key raw material also tracks world prices.

Figure 4

[Scrap Pricing: PSG cost vs East Asia CFR]

Source: PSG]

Regarding flat products, Figure 5 depicts NZS’s galvanized domestic and export prices, as well as the relevant Statistics New Zealand import price series.

Figure 5

[Galvanised Import Prices versus NZS Net Selling Price]

Source: NZS]

Figure 6 depicts NZS’s domestic and export Zinalume prices, as well as the import prices. (See section 2.3.3 of this report for further discussion of Zinalume pricing.)

Figure 6
[NZS Zinalume and import prices]

Source: Statistics NZ Trade Data & NZS.]

2.3.2. Import market shares

Neither NZS nor PSG manufactures all of the flat and long products (respectively) that are demanded by New Zealand customers. For example, in 2012:

- NZS was able to contest approximately [] of the estimated flat product demand in New Zealand; and
- PSG was able to contest [] of the estimated long product demand in New Zealand.

The market share figures that we set out in this section are for that part of the domestic demand that is contested by NZS and PSG respectively.¹⁴

We are advised that both NZS and PSG manufacture “mild” steel products (i.e. steel grades with a carbon content of less than 0.25%). Alloy steel and stainless steel products are only available from foreign mills (and are both manufactured as flat and long products). They have not been considered as part of the domestic market.

Both NZS and PSG have large but fluctuating market shares in their respective markets, with the balance held by imports.¹⁵ This is depicted at an aggregate level for NZS in the following figures.

Figure 7
[NZS domestic market share and volumes]

Source: Statistics NZ Trade Data & NZS.]

Figure 8
[COLORSTEEL® market share]

Source: NZS]

¹⁴ To be specific (at least in the case of NZS), “contestable” steel imports refer to products within New Zealand Customs code categories which NZS considers are inside its product range or have dimensions that are close to, and can be easily substituted for, NZS’s products. In some cases the category covers a wider range of products (e.g., different dimensions) than NZS is capable of producing.

¹⁵ And Pacific Coil Coaters in the case of COLORSTEEL®.

Table 3 below shows NZS's share for its broad product categories over time.

Table 3
[NZS: Market shares]

(%)	2008	2009	2010	2011	2012	2013 ¹⁶
HRC	[]	[]	[]	[]	[]	[]
Plate	[]	[]	[]	[]	[]	[]
Cold Rolled	[]	[]	[]	[]	[]	[]
Beams ¹⁷			[]			
COLORSTEEL®	[]	[]	[]	[]	[]	[]
Zincalume	[]	[]	[]	[]	[]	[]
Galvanised ¹⁸	[]	[]	[]	[]	[]	[]
Hollow Sections	[]	[]	[]	[]	[]	[]

Source: NZS.]

We have also been provided with market share statistics for PSG. Table 4 below shows PSG's market share over time on an annual basis, split into wire and non-wire products.

Table 4
[PSG: Market Shares]

Product	2009	2010	2011	2012
Wire				
<i>Bright Wire</i>	[]%	[]%	[]%	[]%
<i>Galv Wire</i>	[]%	[]%	[]%	[]%
Steel				
<i>bar</i>	[]%	[]%	[]%	[]%
<i>coil</i>	[]%	[]%	[]%	[]%
<i>rod</i>	[]%	[]%	[]%	[]%

Source: PSG]

¹⁶ For 12 months to October 2013.

¹⁷ Steltech's share.

¹⁸ NZS brands some of its galvanised product as "AXXIS" (see, e.g., www.axxis.co.nz), which is used by downstream customers to create steel framing for residential housing. This steel framing competes against timber framing, and NZS estimates that its steel has about []% of this framing market.

Figure 9 and Figure 10 below which plot imports versus domestic production and the market share of imports over the period July 08 to October 13 for the Steel division and June 06 to October 13 for the Wire division.

Figure 9

[PSG: Imports vs domestic sales (Steel)]

Source: PSG]

Figure 10

[PSG: Imports vs domestic sales (Wire)]

Source: PSG]

A depiction for reinforcing steel specifically is in Figure 11 below.

Figure 11

[PSG: Domestic Reinforcing Market Share and Imports]

Source: PSG]

2.3.3. Variation in the premium over IPP

While the IPP represents the price that a New Zealand customer could buy a steel product at, there are also likely to be more qualitative costs not incorporated into the IPP estimates, e.g., longer lead times for ordering, minimum order sizes, storage and working capital costs, lower levels of service and technical support. This is likely to explain the evidence that NZS and PSG add a premium to their estimates of IPP when negotiating the domestic price.

Figure 12 shows a time series of the premium over IPP for each of NZS's product categories.¹⁹

Figure 12

[NZS premium over IPP by product category]

Source: Statistics NZ Trade Data & NZS.]

We understand from NZS that the varying premia over IPP over time reflect factors such as varying levels of spare capacity at overseas plants, foreign exchange volatility, fixed prices and shipping scheduling. The fact that the premium varies by product implies that NZS carefully considers the elasticity of each product, and prices up to the point of indifference for each product.

¹⁹ Other than COLORSTEEL® (which faces domestic competition from Color Cote®, KiwiColour® and substitutable materials used in similar applications), hollows (for the reasons discussed in the footnote 21) and beams (for the reasons discussed in the main text).

Note the following:

- [REDACTED]²⁰

Figure 13

[REDACTED]

Source: NZS]

Figure 14

[REDACTED]

Source: NZS]

- [REDACTED];
- The premiums represented in Figure 12 relate to an IPP estimated from the value of imports captured by the New Zealand Customs Service;²¹ and
- The premiums represented in Figure 12 relate to prices net of rebates.

2.4. Conclusions on constraints

The evidence implies that NZS and PSG do not place any material competitive pressure on each other, whether from the demand- or supply-side. Rather each firm prices each of its respective products up to the point of indifference for customers in buying from NZS/PSG or an importer. That point of indifference is a function of:

- The IPP; and
- What we might loosely call the transaction costs of importing, and any quality differentials.

This import constraint would be unaffected by the merger.

3. Portfolio Effects

3.1. Introduction

There are some steel customers (particularly distributors) that purchase both flat and long products. Keeping in mind that flat and long products do not appear to be substitutes (in general), we have been asked to consider whether the merger would nevertheless result in any anticompetitive effects because of the common customers of the merging firms. Such effects

²⁰ We understand that sales to [REDACTED] make up about [REDACTED] of NZS's Zinalume production.

²¹ This is why we do not present a line on the graph for hollows – the value data for the relevant category captured by Customs is for a much wider suite of products than is produced by NZS.

are sometimes termed “portfolio effects” (or “conglomerate effects”), i.e., effects resulting from a merger of products that do not have a pre-existing competitive relationship.²²

Portfolio effects generally arise from the bundling or tying of two (or more) products of the merged firm. Bundling can occur when two goods are sold together at a discount to the total price that would otherwise be paid if the goods were purchased individually.²³ In contrast, with tying the firm requires that a customer purchasing one of the goods must also purchase the second good from the firm.²⁴

As already discussed, the evidence suggests that all flat and long products can be imported. However, we are advised by executives of both NZS and PSG that as a generalisation PSG’s long products are more commoditised than flat products (currently produced by NZS). Reasons given include a simpler process to manufacture the relevant long products, and it is easier to import the relevant long products. As we have already noted in section 2, [] of New Zealand long product demand is met by imports.

Accordingly, we might posit a theory that the merged entity could somehow anticompetitively bundle or tie *relatively* non-contestable (i.e., flat) products with *relatively* contestable (i.e., long) products in order to retard competition by importers. We test this theory in the following sections.

3.2. Evidence of market power

The economic analysis of bundling and tying is equivalent,²⁵ and therefore the remainder of our analysis applies to both phenomena. The economics literature is clear that bundling and tying generally have a pro-competitive efficiency rationale and raise consumer welfare, e.g., by lowering prices or improving quality by overcoming information failures.²⁶ However, the literature also develops theories about ways in which bundling and tying can be used strategically to lessen competition.²⁷ Unfortunately this literature is not yet settled, and is dependent on specific assumptions.

²² Barry Nalebuff (2003), “Bundling, Tying and Portfolio Effects: Part 1 – Conceptual Issues”, DTI Economics Paper No. 1, p.84.

²³ This is known as “mixed bundling”. Another form of bundling is “pure bundling”, where the two goods are bundled together in fixed proportions and are not sold individually.

²⁴ This is often referred to as “requirements tying”. Another form of tying is “package tying”, which is essentially the same as pure bundling – for a discussion see section 7.3.2 of Massimo Motta (2004), *Competition Policy: Theory and Practice*, Cambridge University Press.

²⁵ For example, Carlton and Waldman (2008, p.1231) state that: “Analysis of tying relies on the same economics as that used to analyze bundling, though the law seems to make a distinction between the two” (Dennis W. Carlton and Michael Waldman (2008), “Safe Harbors for Quantity Discounts and Bundling”, *George Mason Law Review*, 15(5), 1231-1239). Nalebuff (2005, p.322) notes that he “include[s] bundling and tying together” (Barry Nalebuff (2005), “Exclusionary Bundling”, *Antitrust Bulletin*, 50(3), 321-370).

²⁶ For a summary of this literature see section 7.3.2.1 of Massimo Motta (2004), *Competition Policy: Theory and Practice*, Cambridge University Press; and pp.598-599 of Dennis W. Carlton, Patrick Greenlee and Michael Waldman (2008), “Assessing the anticompetitive effects of multiproduct pricing”, *Antitrust Bulletin*, 53(3), 587-622.

²⁷ For a summary of this literature see section 7.3.2.3 of Motta (2004), *op cit.*, and pp.601-605 of Carlton, Greenlee and Waldman (2008), *op cit.*

A central requirement for anticompetitive bundling and tying is for the firm to have market power in the market for one of the goods in the bundle or tie. Market power is typically defined as the ability to profitably and sustainably raise prices above marginal cost.²⁸ In the real world, pricing at marginal cost rarely occurs, and firms are generally expected to have at least some (technical) market power. However, market power only becomes a competition concern when it is deemed to be “substantial” or “significant”.

In the present case, some of the evidence is indicative of the merged firm having market power in the production of flat steel products, particularly that NZS has a high market share (e.g., █% for Zinalume and █% for HRC – see Table 3).

However, there is also some contrary evidence. Firstly, all flat and most long products face inter-material competition. For example, while NZS supplies █% of New Zealand’s HRC, there are end-use substitutes for HRC, so this █% share may not necessarily indicate market power. Table 5 and Table 6 below set out the end-use substitutes for flat and long products respectively. At this stage we have not tested whether the substitution of these products is strong enough such that they would be included in the same antitrust market, although we assume not for the purposes of this analysis.

Table 5
Inter-material substitutes for flat products

Flat Products	Typical End Use	Inter-material substitutes
Hot rolled coil	Pipe manufacturing - water, sewage, bridge, piling	PE; PVC; Concrete
Plate	Beams, General Manufacturing	Precast concrete; imported manufactured items
Cold rolled coil	Drums for food storage, Pipe manufacture (furniture etc)	Plastic drums; imported manufactured goods
Hollows - Pipe & RHS	Agricultural equipment, gates, fences, scaffolding	Imported manufactured Items; PVC for irrigation; aluminum scaffolding sections
Coated Steel – Galv and Zinalume®	Refrigeration, building components, general manufacturing, Roofing, RWG, Purlins Structural	Concrete tiles; timber purlins; Imported manufactured goods
Painted	Roofing, Cladding, rainwater goods, Coolroom, Garage Doors	Concrete tile; tilt slab; plastic RWG

Source: NZS

²⁸ See p.814 of George A. Hay (1991), “Market Power in Antitrust”, *Antitrust Law Journal*, 60, 807-827.

Table 6
Inter-material substitutes for long products

Long Products	Typical End Use	Inter-material substitutes
Beams	Beams for commercial building	Concrete, Timber (laminated veneer Lumber systems<4 levels)
Rod	Input for wire makers – draw wire out of rod; nails	Specialist adhesives
Rounds/bar	General manufacturing/machining Pile cages, components, fabrication	Fibreglass in specialist applications
Reinforcing coil/wire	Coil for manufacturers to make mesh & rod for concrete reinforcement, block work etc	Simple composite flooring systems
Bright Wire	Mild steel wire for general engineering and manufacturing purposes; steel rope	None
Galv Wire	Fencing; Agricultural and horticultural sector for crop supports; Security fencing	Plastic electric fence tape Limited competition for temporary systems

Source: NZS

Secondly, the definition of market power noted above refers to the ability of the firm to raise prices. To put this another way, the firm has discretion over its price. However, the pricing discretion of NZS and PSG is constrained by import prices, and any rents are likely to be volatile.

Finally, we understand that domestically manufactured flat and long steel products are not differentiated from imports, i.e., most of the products are homogenous.^{29, 30} The evidence discussed in section 2 of this report suggests that NZS and PSG price their products just at or below the point of indifference for customers between buying New Zealand-made versus foreign-made products. We think this is quite critical, because whether or not one would conclude that either firm has market power, any price increase from current levels is likely to lead to material levels of switching to imports. Furthermore, customers have (import) substitutes for all products, even those in respect of which the merged firm might have a very high market share. Neither NZS nor PSG (and therefore the merged entity) has any “must have” products.^{31, 32}

²⁹ We understand that COLORSTEEL® is an exception.

³⁰ Steel products are manufactured to certain standards, depending on the application. To sell the product, the manufacturer must meet the appropriate standard. Engineering designs will specify the product to be used and the appropriate standard. We are advised by NZS executives that foreign manufacturers are capable of manufacturing to New Zealand and Australian standards (which are generally the same).

³¹ There is a domestic competitor for COLORSTEEL®, being Pacific Coil Coaters.

³² We understand that HRC is the most globally traded steel product.

To put this another way, there is no true monopoly, even for products where the merging parties have very high market shares. In a 2005 report for the UK Office of Fair Trading, RBB Economics points out that (paragraph 4.39), “Economic theories of foreclosure are better developed for what might be deemed 'super dominant' firms. Foreclosure theories would appear to be less well developed (and hence less robust) in situations where dominant firms face some, albeit not fully effective, competition”.³³ In the present case, any bundle or tie offered by the merged entity could be replicated by an importer or importers.

3.3. Other Elements of Anticompetitive Bundling/Tying

In addition to the ability of customers to substitute to imported steel products, for the following reasons we think that anticompetitive bundling/tying is not a likely outcome of the merger:

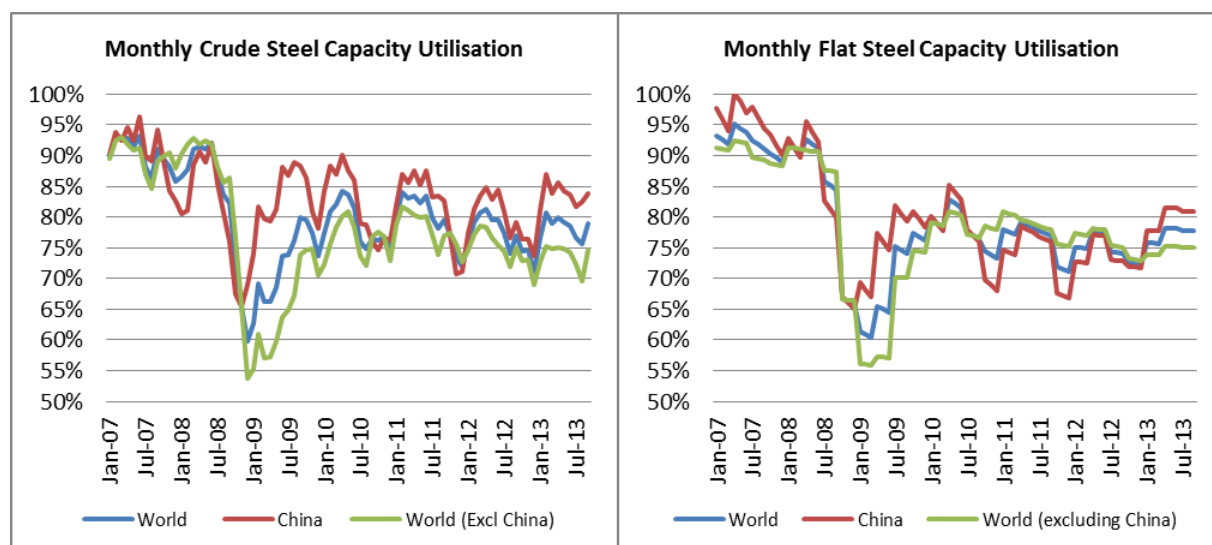
- Anticompetitive bundling/tying strategies rely on taking advantage of some sort of impediment to competition, such as economies of scale or network effects.³⁴ However, the fixed, and particularly sunk, costs of importing are relatively low, and the foreign manufacturers have sunk factories overseas (and therefore low forward-looking costs). Indeed, overseas manufacturers operate at a significantly greater scale than NZS and PSG. Furthermore, New Zealand demand for steel is miniscule compared to world steel production, and there is significant overcapacity worldwide. For example, in 2012 New Zealand consumption of steel was ~0.6m tonnes, compared to world steel production of 1,545m tonnes.³⁵
- Figure 15 below shows world crude and flat steel capacity utilization from 2007 to 2013.

³³ RBB Economics (2005) “Selective price cuts and fidelity rebates”, report for the Office of Fair Trading.

³⁴ See p.605 of Carlton, Greenlee and Waldman (2008), *op cit*. See also paragraph 20 of European Commission, *Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertaking*, 2009/C 45/02.

³⁵ See World Steel Association, *Steel Statistical Yearbook 2013*.

Figure 15
Global steel capacity utilisation %



Source: Bluescope

These graphs show that there is significant excess capacity globally. Combined with a lack of sunk costs to import, it is likely that “hit and run” tactics can easily be used by importers. Foreign steel manufacturers will be looking to sell extra tonnes at any price above the marginal costs of doing so;

- The Antitrust Modernization Commission (2007) recommended a three-part test to determine whether bundled discounts violate section 2 of the Sherman Act. The second part of the test was that “*the defendant is likely to recoup these short-term losses*”.³⁶ The AMC went on to explain that: “*Under the second part of the test, a plaintiff would need to prove that the defendant was likely to recoup its losses from its use of the challenged bundled discount or rebate. This would typically require a plaintiff to show that entry into the relevant market is not easy and therefore is unlikely to undermine the defendant’s ability to recoup its losses*”.^{37, 38} While we understand that there has been some criticism of the AMC’s recoupment recommendation,³⁹ there does not appear to be a definitive

³⁶ Antitrust Modernization Commission (2007), *Report and Recommendations*, April, p.30.

³⁷ *Ibid.*, p.100.

³⁸ Note that the AMC’s three-part test relates only to bundling, and specifically excludes tying (see footnote 157 of the AMC report, stating that “The Commission is not recommending application of this test outside the bundled pricing context, for example in tying or exclusive dealing cases. The Commission did not undertake to study tying and exclusive dealing issues more generally”). However, recoupment has been suggested as a requirement for anticompetitive tying – see Jean Tirole (2005), “The Analysis of Tying Cases: A Primer”, *Competition Policy International*, 1(1), 1-25.

³⁹ There are models in the literature finding that anticompetitive bundling strategies can be profitable in and of themselves, meaning that recoupment is not a necessary ingredient: see Barry Nalebuff (2005), “Exclusionary Bundling”, *Antitrust Bulletin*, 50(3), 321-370; and Patrick Greenlee, David Reitman, and David S. Sibley (2008), “An antitrust analysis of bundled loyalty discounts”, *International Journal of Industrial Organization*, 26, 1132-1152. However, these models rely on very specific assumptions, and so should be regarded as the exceptions rather than the rule. In this regard, Hovenkamp (2012, p.96) notes that “The literature includes many models showing that such [loyalty and bundling] discounting practices can be anticompetitive, but all depend on highly specific assumptions” (Herbert Hovenkamp (2012), “Antitrust and the Costs of Movement”, *Antitrust Law Journal*, 78(1), 67-104).

view on this in the literature,⁴⁰ and we consider that recoupment is still an important consideration in conjunction with the other factors we set out here. For the reasons already noted, entry into the relevant NZS markets by importing is likely to be relatively easy, with little in the way of sunk investment, making recoupment difficult;

- The customers are large⁴¹ and will have an incentive to keep importers in the market, to maximise the tension on the merged entity; and
- Anticompetitive bundling/tying strategies could be undermined by end users. Our understanding is that while distributors purchase both long and flat products, end users typically do not. Therefore if the merged entity attempted to anticompetitively bundle or tie in respect of transactions with distributors, end consumers could simply bypass the distributors, e.g., by purchasing directly from the merged entity,⁴² purchasing from a distributor that purchases only long or flat products, or importing.⁴³

Our conclusions are consistent with the Commission's analysis of the 2012 Vodafone/TelstraClear merger, where the Commission stated in the context of discussing portfolio (conglomerate) effects (paragraphs 420-423):⁴⁴

To have the effect of substantially lessening competition, a firm would need to have the ability to raise prices after competitors have been (partially) foreclosed from the market.

...

The Commission notes that for there to be a substantially lessening of competition as a result of anti-competitive foreclosure via bundling, the conditions of entry would need to be such that an exercise of market power by Vodafone post foreclosure would not attract price disciplining entry or expansion.

It is also relevant to note that we are not aware of any evidence of bundling or tying being a strategy under the status quo. However, both NZS and PSG currently operate loyalty discount schemes, which are closely related to the concept of bundling. Nevertheless, for the

⁴⁰ For example, Jacobson (2007) provides some justification for the AMC's recoupment requirement (Jonathan Jacobson (2007), "Exploring the Antitrust Modernization Commission's Proposed Test for Bundled Pricing", *Antitrust*, 21, 23-29). Carlton and Waldman (2008, p.1237) note that Nalebuff's (2005, *op cit.*) paper uses a static model, while the AMC's approach to recoupment has in mind a dynamic model (Dennis Carlton and Michael Waldman (2008), "Safe Harbors for Quantity Discounts and Bundling", *George Mason Law Review*, 15(5), 1231-1239). Hovenkamp and Hovenkamp (2008), while critical of the AMC's recoupment requirement as it stands, recast it slightly into an alternative form that "might be acceptable" (p.520). Nonetheless, because of the information demands of showing recoupment, they suggest abandoning it and focusing on showing that the market is capable of being monopolized via high barriers to entry and economies of scale (p.539) – Erik Hovenkamp and Herbert Hovenkamp (2008), "Exclusionary bundled discounts and the Antitrust Modernization Commission", *Antitrust Bulletin*, 53(3), 517-553.

⁴¹ For example, the two largest customers of NZS account for over █% of its domestic volumes.

⁴² This option may only be available to large end users.

⁴³ Areeda and Hovenkamp (2011, pp.17-65-17-66) make a similar point – Philip Areeda and Herbert Hovenkamp (2011), *Fundamentals of Antitrust Law*, Fourth Edition, Wolters Kluwer & Business. They state that "[f]oreclosure is also unlikely when end users are readily able to avoid the tie" and give the example of a manufacturer attempting to tie the sale of petrol and tyres to a petrol station, when the petrol station's customers are free to purchase either petrol or tyres, or both.

⁴⁴ Vodafone New Zealand Limited and TelstraClear Limited [2012] NZCC 33, 29 October 2012.

same reasons already discussed above in respect of anticompetitive bundling, we think that anticompetitive loyalty discounts are an unlikely outcome of the merger. In particular:

- There is no true monopoly – all products can be imported; and
- Barriers to importing are very low.

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