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21 December 2017

Russell McVeagh
Lawyers
PO Box 8
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Attention: Troy Pilkington/Samuel Holmes 11.04/32769

Dear Troy and Samuel

Letter of issues - Daiken / Dongwha

1. We refer to the application from Daiken New Zealand Limited (Daiken) seeking clearance to acquire, either directly or indirectly, 100% of the shares of Dongwha New Zealand Limited (Dongwha) (the proposed merger).

2. The proposed merger would reduce the number of manufacturers of raw MDF in New Zealand from three to two. Nelson Pine Industries Limited (Nelson Pine) is New Zealand's only manufacturing supplier of raw medium density fibreboard (MDF) other than Daiken and Dongwha.

3. At this stage, we are not satisfied that the proposed merger would not give rise to competition issues in the manufacture and supply of raw MDF in New Zealand as a result of coordinated effects. We have no specific unilateral effects issues that need to be addressed at this time.

4. In reaching the preliminary views set out in this letter, we have considered information provided by Daiken and Dongwha as well as information gathered from other industry participants. We have not yet made any final decisions on the issues outlined below (or any other issues) and our views may change, and new competition issues may arise, as the investigation continues.

5. We will advise you if we identify any further issues during our analysis of the proposed merger and that are not discussed in this letter.

6. We are available to meet with Daiken to discuss this letter.

Process and timeline

7. We invite Daiken to submit on the issues raised below. We request that Daiken provides its submission, together with a public version of the submission, by close of business on **2 February 2018**. As already signalled, we will also be separately

requesting further information from Daiken to assist us with our investigation and assessment of the issues canvassed in this letter.

8. If Daiken considers it cannot adequately respond by the above date, please contact us to discuss timing.

9. We will be requesting that other parties intending to make a submission on the issues in this letter provide their submission by close of business on **2 February 2018**, and that they provide a public version of their submission.

10. All submissions received will be published on our website with appropriate redactions.

Market definition

11. In its clearance application, Daiken submitted that the relevant markets for assessing the proposed merger are:

    11.1 separate regional markets for the supply/acquisition of wood fibre; and

    11.2 the New Zealand wide market for the manufacture and supply of raw MDF.

12. We consider that the proposed merger raises no concerns in the supply/acquisition of wood fibre, as there is no horizontal aggregation from the proposed merger. This letter therefore focusses on the impact of the proposed merger on the manufacture and supply of raw MDF.

13. At this stage, we consider that the relevant market for assessing the proposed merger is likely to be the market for the manufacture and supply of raw MDF in New Zealand. In terms of this market, we note that:

    13.1 the geographic scope of this market is likely to be national, given that all three raw MDF manufacturers supply all of New Zealand from plants located in the South Island;

    13.2 the manufacture and supply of downgrade MDF is unlikely to be included in this market, as the relatively low price of downgrade MDF, and the close packaging substitutes that customers have for downgrade MDF (as distinct from non-downgrade MDF), means that the supply of downgrade MDF is likely to be part of a separate, broader packaging materials market;

    13.3 particle board and raw MDF are likely to be in separate markets, although particle board likely imposes some competitive constraint on raw MDF from outside the market, due to its substitutability in some applications; and

    13.4 the market likely only includes the direct supply of raw MDF in New Zealand by manufacturing suppliers. Our preliminary view is that the re-sale of raw MDF by customers of the manufacturers (for example, Laminex Group (N.Z.) Limited (Laminex) and building supplies merchants) falls within a separate downstream functional market.

The counterfactual

14. To assess whether a substantial lessening of competition is likely requires us to compare the likely state of competition if the merger proceeds (the scenario with the merger, often referred to as the factual) with the likely state of competition if it does not (the scenario without the merger, often referred to as the counterfactual) and to determine whether competition is likely to be substantially lessened comparing those scenarios.

15. In its clearance application, Daiken submitted that, absent the merger, [

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16. Our preliminary view is that the likely counterfactual is the status quo, where Dongwha (either under current or new ownership) would remain as an independent competitor and continue to compete in the manufacture and supply of raw MDF in New Zealand.

Competition assessment (coordinated effects)

17. A merger can substantially lessen competition if it increases the potential for the merged entity and all or some of its remaining competitors to coordinate their behaviour and collectively exercise market power such that output reduces and/or prices increase in the relevant market. Unlike a substantial lessening of competition which can arise from the merged entity acting on its own, coordinated effects require some or all of the firms in the market to be acting in a coordinated way. This could take the form of coordination on pricing or other non-price attributes, or of customer allocation across suppliers.

18. In carrying out our assessment, we have considered whether:

    18.1 the market for the manufacture and supply of raw MDF in New Zealand has characteristics which make it vulnerable to coordination; and

    18.2 the proposed merger is likely to change conditions in the market for the manufacture and supply of raw MDF in New Zealand so that coordination is more likely, more complete, or more sustainable.

19. For the reasons set out below, at this stage we consider that the proposed merger may raise competition concerns in the manufacture and supply of raw MDF in New Zealand due to coordinated effects.

Is the market for manufacture and supply of raw MDF vulnerable to coordination?

20. We note that a range of market features are commonly accepted as making a market more vulnerable to coordination. That is, there are market features that make it more likely that firms would be able to successfully coordinate their behaviour to increase their profits. Not all need be present for a market to be vulnerable to

coordination. Nor does the existence of some or all of these features inevitably mean that firms would engage in coordinated behaviour.

21. We have assessed the market features that normally facilitate coordinated conduct in order to reach a view on whether the features of the market for the manufacture and supply of raw MDF in New Zealand mean that competitors could more effectively reach or sustain a coordinated outcome.

22. Our preliminary view is that, as previously identified by the Commission in its 2008 *Sumitomo/CHH* decision, a number of features of the market for the manufacture and supply of raw MDF in New Zealand make it vulnerable to coordination. In particular:

    22.1 supplier's products are homogeneous;

    22.2 manufacturers have information on each other's prices and volumes;

    22.3 the market is currently concentrated, with few suppliers;

    22.4 there are repeated sales/interactions;

    22.5 there appears to be little innovation, stable demand and lack of supply shocks/volatility; and

    22.6 there is some symmetry in size and cost structures.

23. These factors increase the scope for suppliers in the market for the manufacture and supply of raw MDF in New Zealand to achieve and sustain some level of coordination. We discuss these factors below.

<u>Homogeneous product</u>

24. Coordinated conduct can be facilitated where the products supplied are homogeneous. Homogeneous products are products that have substantially the same characteristics as one another in the eyes of customers. Where products are homogeneous, it can be easier to reach agreement on pricing levels and more difficult to deviate from coordinated outcomes through product differentiation.

25. We received feedback that there are no material differences between the raw MDF produced by each of Daiken, Dongwha and Nelson Pine. The raw MDF produced by all three manufacturing suppliers is similar, largely undifferentiated and homogeneous. In most cases, quality in the New Zealand market is similar, with all three manufacturers producing raw MDF from radiata pine fibre inputs.

<u>Manufacturers have information on each other's prices and volumes</u>

26. The extent to which suppliers in the market for the manufacture and supply of raw MDF in New Zealand can observe each other's prices and volumes is relevant to our assessment, as transparency makes coordination on prices/volumes more achievable.

27. The evidence currently before us suggests that all three raw MDF manufacturers may be able to obtain information about each other's prices. For example, competitors' prices (or the relativity between prices) may be communicated to them by their customers.

28. Suppliers send out price change notifications directly to customers, but do not publish these on their websites. Any discounts and rebates offered by suppliers (off list prices), or other forms of customised pricing, likely make actual prices paid by individual customers less transparent. However, some customers buy from multiple suppliers and we received information suggesting that some customers share pricing information between suppliers (eg, the fact that one supplier had notified a price increase). This dynamic is similar to that observed by the Commission in *Sumitomo/CHH*.

29. We also note that there is evidence suggesting price discrimination between customers in the market. [

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30. Daiken indicated an understanding of [

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31. We are also considering whether the market for the manufacture and supply of raw MDF in New Zealand is vulnerable to coordination regarding the allocation of customers between suppliers. This need not necessarily be for all customers, nor would an individual customer's entire demand need to be allocated to one supplier. Such coordination would not necessarily require transparency in terms of prices and volumes.

32. We note that if a supplier was to deviate from coordination, this would likely be detected by another supplier when it lost a customer or part of a customer's volume. Having detected deviation, a supplier would likely seek to find the rival's price from the customer who switched and may respond by competitively pricing offers to that supplier's other customers, effectively punishing that supplier.

<u>Relatively concentrated market</u>

33. The fewer competitors there are in a market, the easier it is for them to coordinate. This is because it is easier to reach agreement between a small number of suppliers and easier to detect and punish cheating.

34. The market is currently relatively concentrated, with only three competitors in the market for the manufacture and supply of raw MDF in New Zealand.

Repeated sales/interactions

35. As Daiken submitted, customers want frequent supply of raw MDF on an ongoing basis to reduce their stock-holding requirements. Customers place orders for varying quantities as and when needed. This means that manufacturing suppliers of MDF engage in frequent, repeated sales and interactions with customers and have many opportunities to observe their competitors' behaviour in the market. Frequent sales can reduce the gains from deviating from coordinated outcomes, depending on the size of transactions. It also means that deviating can be more swiftly punished, reducing the incentive to deviate in the first place.

36. Domestic contracts for supply of raw MDF are typically non-exclusive, and of a short duration (eg, one year or less). Even where customers have longer-term supply contracts, pricing is generally negotiated annually based on target volumes or subject to price review with notice, with actual volumes purchased being based on orders placed nearer the time of delivery (eg, forecasted orders a few months in advance).

Little innovation, stable demand and lack of supply shocks/volatility

37. Evidence suggests that there has been little innovation in the manufacture and supply of raw MDF in New Zealand, demand has been stable, and there has not been significant supply shocks/volatility. As such, coordinated outcomes are unlikely to be disturbed by shocks to the market.

38. Our preliminary view is that there is static production technology in the manufacture of raw MDF. There has been little innovation in the manufacture of raw MDF. All manufacturers use similar production technologies.

39. Daiken submitted that while New Zealand market demand for MDF has been stable for a number of years, there are increasing alternatives (such as increasingly fine particle board). However, the evidence suggests that market demand for raw MDF in New Zealand has been stable for a number of years, with no supply shocks/volatility.

40. Daiken submitted that customers are highly price sensitive – [ ]. However, the market demand for raw MDF in New Zealand appears to be relatively price inelastic (we have seen [ ], but the quantity demanded has remained relatively stable). This inelasticity may encourage coordination, as market-wide price increases are more likely to be profitable. To the extent that the ability of customers to readily switch to self-supply via imports or switch from raw MDF to particle board is limited, our preliminary view is that it is unlikely that customers have countervailing power.

Symmetry of size and cost structures

41. Similarity of cost structures, production capabilities, and ranges of products are important as these similarities make it easier to arrive at a tacit understanding, allow

the responses of competitors to be more predictable, and make coordination strategy more stable.

42. Each of the three existing suppliers in the market for the manufacture and supply of raw MDF in New Zealand have capacity that greatly exceeds domestic demand and a high proportion of output is exported. This may affect the ability and/or incentives of the manufacturers to coordinate, or to sustain coordination, because the ability to divert export volumes to the domestic market may be an effective threat of punishment for deviating from the coordinated outcome.

43. Our preliminary view is that there are likely to be cost similarities between manufacturers of raw MDF in terms of production costs given that they use similar production technologies and their product ranges are almost identical. All manufacturers are likely exposed to the same changes in major costs of producing MDF (ie, energy, wax/resins and wood fibre). We have not seen any evidence that the cost of raw MDF production materially varies with any differences in scale present across the current manufacturing suppliers of raw MDF.

<u>Conclusion</u>

44. We continue to consider whether the market for the manufacture and supply of raw MDF in New Zealand is vulnerable to coordination. However, at this stage, the evidence discussed above suggests that the market may be vulnerable to coordinated outcomes.

Would the merger make coordination more likely, complete, or sustainable?

45. We note that where a merger materially enhances the prospects for any form of coordination between businesses, the result is likely to be a substantial lessening of competition. This could happen if the proposed merger is likely to change conditions in the market for the manufacture and supply of raw MDF in New Zealand so that coordination is more likely, more complete, or more sustainable.

46. At this stage, we are concerned that the proposed merger is likely to make coordination more likely, more complete and/or more sustainable. This is because:

    46.1 the merger would eliminate the only competitor to Daiken and Nelson Pine in the manufacture and supply of raw MDF in New Zealand, resulting in a market with only two competitors in which coordination would be easier;

    46.2 Dongwha may be the last remaining competitor with the ability and incentive to disrupt or de-stabilise coordination; and

    46.3 the merger would increase the degree of symmetry between Daiken and Nelson Pine.

47. In this respect, we note that the Court of Appeal has previously stated weight can be given to the theoretical concerns raised by three-to-two mergers in markets with high barriers to entry.[1]

Coordination would be easier with only two suppliers

48. Coordination would be easier post-merger with only two suppliers. The loss of an independent Dongwha would mean there is one less participant who can disrupt coordination. Given the high barriers to entry or expansion and our preliminary view is that new entry or expansion in raw MDF manufacturing in New Zealand is not likely, and would not occur in a timely manner.

49. A reduction in the number of suppliers from three to two would likely make any understanding over coordinated prices or sales easier (ie, it would be easier to reach an understanding and/or establish a focal point for coordinated pricing or customer allocations more obvious) and make it easier to detect and punish deviation from coordinated outcomes. Sales gained by one supplier would be lost by the other and there likely would be no other third party against which punishment would need to be either targeted or avoided.

The impact of the removal of Dongwha

50. Daiken submitted that the merger involves the acquisition of a mere "fringe" competitor (Dongwha), which does not exert significant pricing pressure on Nelson Pine and Daiken.

51. We consider that an important issue that is likely to influence our ultimate conclusion on whether or not the merger is likely to substantially lessen competition due to coordinated effects, is the role that Dongwha plays in constraining prices in the market and/or would play in constraining or destabilising any coordination.

52. At this stage, we are considering whether Dongwha is the only supplier that could, in the counterfactual, expand and/or divert export volumes to the domestic market to successfully disrupt coordination between Daiken and Nelson Pine so as to prevent a substantial lessening of competition.

53. In *Sumitomo/CHH*, the Commission considered that Dongwha provided only limited competition and constraint on Nelson Pine and CHH (now Daiken). There is some evidence suggesting that Dongwha may not currently play a significant role in constraining the prices at which MDF is supplied in New Zealand. This is because:

    53.1 most of Dongwha's sales of raw MDF in New Zealand are vertically integrated sales to its minority shareholder, Laminex (who is a customer in the market for the manufacture and supply of raw MDF in New Zealand, but is not a supplier in that market);

    53.2 Dongwha supplies raw MDF to few customers other than Laminex;

[1] *Commerce Commission v Woolworths Ltd* [2008] NZCA 276, (2008) 12 TCLR 194 at [200].

53.3 Dongwha [ ]; and

53.4 we are not aware of any customers supplied by Daiken who do not have Nelson Pine as an alternative supplier to constrain supply from Daiken.

54. However, we are considering whether Dongwha may be preventing coordination from occurring currently and/or could play a role in constraining or destabilising any coordination absent the merger. This is because:

54.1 the fact that Dongwha accounts for a very small proportion of sales of raw MDF in New Zealand to customers other than Laminex does not mean that Dongwha does not provide a competitive constraint and is not having an impact on the prices at which raw MDF is supplied in New Zealand. In particular, [ ] (which may continue absent the merger) could prevent or disrupt coordination between Daiken and Nelson Pine;

54.2 the threat of Dongwha redirecting export volumes into the domestic market, or it actually doing so, could prevent or disrupt coordination. Redirecting volumes to the domestic market would likely be easy and quick, and may therefore be a significant threat to coordination; and

54.3 Dongwha's relatively small portfolio of domestic customers may mean that it has a greater incentive to increase sales to domestic customers than Daiken or Nelson Pine. This may mean it is more likely to disrupt any coordination.

55. As such, where there is a lack of other competitive constraints on Daiken and Nelson Pine, the loss of Dongwha could potentially make coordination between Daiken and Nelson Pine more likely, more complete and/or more sustainable.

<u>The merger may make Daiken and Nelson Pine more symmetrical</u>

56. Daiken submitted that Daiken and Nelson Pine have, and would continue to have, materially different cost structures.

57. However, we note that the three manufacturers of raw MDF use similar production technologies and there are likely to be cost similarities between manufacturers of raw MDF in terms of production costs.

58. The merger would likely increase the degree of symmetry between Daiken and Nelson Pine in terms of size and, potentially, cost structures. It would result in there being only two manufacturers of raw MDF in New Zealand with market shares and production capacity that would be more symmetric than is the case currently. [ ]

59. Symmetry generally makes it easier to reach agreement because the parties are more likely to have a common view about what the coordinated level of price or

quantity should be. While asymmetry can also help to discipline coordination, due to the threat of a price reduction from a supplier with a lower cost base, as discussed above, the threat of export diversion provides a significant discipline in the market for the manufacture and supply of raw MDF in New Zealand.

Are there constraints that might counteract any coordinated effects?

60. Below we consider whether there are likely to be other constraints which may counteract a substantial lessening of competition as a result of coordinated effects.

<u>Laminex unlikely to act as a constraint in the market</u>

61. Daiken submitted that the product supply agreement that Daiken and Laminex would enter into ancillary to the merger means that to the extent Dongwha currently acts as a constraint in the market, that constraint will continue into the future (albeit via Laminex).

62. However, at this stage, we consider it unlikely that Laminex would provide any material constraint.

63. As noted earlier, at this stage we consider that any re-sale of raw MDF by parties such as Laminex likely falls within a separate downstream functional market from the market in which Daiken, Dongwha and Nelson Pine manufacture and supply raw MDF in New Zealand. We note that, outside of sales to related entities within the Fletcher Building group, Laminex (like other resellers of raw MDF) supplies raw MDF to customers who are generally too small to buy direct from any of the MDF manufacturers and/or who want to buy raw MDF bundled with other products. There is no evidence that Laminex competes to supply the customers that buy direct from Daiken or other MDF manufacturers.

64. Further, we note that, even if Laminex was to provide a constraint on Daiken and Nelson Pine by on-selling raw MDF that it purchases, the scale of this is likely to be considerably smaller than the constraint that Dongwha may be able to impose by diverting export volumes to the domestic market. In addition, the price at which Laminex is able to re-sell raw MDF will depend on the price at which it is able to purchase raw MDF from the manufacturing suppliers, which is likely to reflect market prices, which may (in turn) be prone to coordination.

<u>Evidence suggests entry of a new manufacturer or via imports is unlikely</u>

65. Daiken submitted that the threat of imports and the dynamics of import/export pricing will continue and therefore prevent the potential for any pricing coordination between the New Zealand raw MDF manufacturers. Daiken also submitted that new entrants could be incentivised to enter the market for the the manufacture and supply of raw MDF in New Zealand if they identified opportunities in the global raw MDF market.

66. At this stage, the evidence currently before us suggests that entry by a new raw MDF manufacturer or via imports is unlikely.

67. Our preliminary view is that difficult conditions of entry in the market for the manufacture and supply of raw MDF in New Zealand reduce the likelihood of entry and timeliness within which any entry might occur. This is for the reasons observed by the Commission in *Sumitomo/CHH* and also because constraints on the availability of wood fibre inputs impact on the feasibility of any entry. We have found no evidence suggesting that de novo entry into the market for the manufacture and supply raw MDF in New Zealand is likely to be sufficient in extent in a timely fashion to be a constraint on the merged entity.

68. There are currently no material imports of raw MDF into New Zealand. Imports may be viable only if there was a large price increase post-merger, which means that imports may not constrain smaller but still significant price increases. Export parity pricing may set a price floor and import parity a price ceiling in the supply of raw MDF in New Zealand, and that the threat of export diversion could drive prices to export parity. We note that the dynamics of import/export pricing, including whether the prices (and margins) at which raw MDF is supplied in New Zealand are at import or export parity, and the correlation between domestic and export prices, is something that we are considering as part of our assessment of the issues.

69. We also received feedback that customers would factor in a number of non-price considerations if they were to consider importing (eg, quality of the raw MDF, ability to make the required sheet sizes, shipping costs, delivery time, reliability of supply, exchange rate risk, warehousing and distribution costs) which could outweigh any cheaper cost of imports from an overseas factory.

70. Accordingly, at this stage, we are not satisfied that entry or imports would counteract any substantial lessening of competition.

Yours sincerely

Susan Brown
Senior Investigator