ISSN 1178–2560
Decision Series
Project no. 11.04/16369

Public version

Determination

Vero Insurance New Zealand Limited and Tower Limited [2017] NZCC 18

The Commission:	Dr Mark Berry Sue Begg Graham Crombie
Summary of application:	An application from Vero Insurance New Zealand Limited seeking clearance to acquire up to 100% of the remaining ordinary shares in Tower Limited by way of a scheme of arrangement under Part 15 of the Companies Act 1993.
Determination:	Under section 66(3)(b) of the Commerce Act 1986, the Commerce Commission declines to give clearance to the proposed merger.
Date of determination:	25 July 2017

Confidential material in this report has been removed. Its location in the document is denoted by [ ].

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Executive summary

X1. The Commerce Commission (Commission) declines to give clearance for Vero Insurance New Zealand Limited (Vero) to acquire up to 100% of the remaining ordinary shares in Tower Limited (Tower) (the merger). The Commission is not satisfied that the merger will not have, or would not be likely to have, the effect of substantially lessening competition in domestic house, contents and private motor vehicle insurance (HCMV) markets in New Zealand.

X2. The merger would bring together the second and third largest HCMV insurers with a combined market share of approximately [ ]%. IAG would be the only other remaining substantial competitor in HCMV markets post-merger. Together, the merged entity and IAG would hold a market share of approximately [ ]%. The merger would eliminate Tower as the only significant independent competitor to Vero and IAG with the scale, brand strength and experience to compete effectively across the breadth of HCMV markets.

X3. Other remaining competitors – including FMG, MAS and Youi – are either small, niche, or both, and are unlikely to expand sufficiently within a two year timeframe to constrain the merged entity. We also consider it unlikely that there would be new entrants who could expand sufficiently to replace the lost competition. While our competition analysis is based on a two-year period, we also have a concern that the merger would result in an enduring structural change to HCMV markets with a shift from three main competitors to two and that the competitive effects of the merger would play out over a longer timeframe.

X4. The loss of the competition that an independent Tower provides would likely result in unilateral effects, enabling both Vero and IAG to raise prices for HCMV insurance products and/or reduce the quality of their offerings, such as by restricting the scope of coverage. There would, accordingly, likely be a deterioration in the competitive offerings across HCMV markets.

X5. We also consider that there is a real chance that the merger would give rise to coordinated effects, in particular by making it easier for the merged entity and IAG to engage in parallel accommodating conduct. The evidence shows that, in contrast to consumers, insurers can track each other's prices and terms for HCMV insurance products with a high degree of precision and have increased prices based on those observations. We have also seen some evidence of potential signalling activity in HCMV markets. The merger would eliminate Tower as the competitor best placed to disrupt coordination, and leave two reasonably symmetric insurers with incentives to coordinate.

X6. The negative impact on consumers from each of the unilateral and coordinated effects is likely to be substantial. This is in an environment where consumers are concerned about the cost of HCMV insurance[1] and there is evidence of underinsurance in New Zealand.[2]

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1 https://www.consumer.org.nz/articles/cost-of-living-survey#article-cost-of-living-pressures.

2 NZ Treasury "Home Insurance – Implications of Sum Insured Cover" (2015).

The proposed merger

Summary of the proposed merger

1. On 2 March 2017 the Commerce Commission registered an application (the application) under section 66(1) of the Commerce Act 1986 from Vero Insurance New Zealand Limited (Vero) seeking clearance to acquire up to 100% of the remaining ordinary shares in Tower Limited (Tower) by way of a scheme of arrangement under Part 15 of the Companies Act 1993 (the merger).

2. At the time that Vero's application was registered it owned 13.29% of the shares in Tower. On 14 March 2017, Vero acquired further shares in Tower to reach a shareholding of 19.99%.[3]

Applicant's rationale for the merger

3. Vero submitted that the "added efficiencies arising from the merger will assist the merged entity to continue to deliver competitive products and services into [the] market in competition with the wide range of participants, and particularly with IAG".[4] Vero predicts merger synergies of $[ ] million in its 10 year valuation model (including reinsurance, staff and IT synergies).[5]

4. A Suncorp Board document describes the merger as [ ]. It stated that Tower [ ].[6] Another Suncorp Board document notes that [ ],[7] and another [ ].[8]

Our decision

5. The Commission declines to give clearance to the merger as it is not satisfied that the merger will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand.

Our framework

6. Our approach to analysing the competition effects of the merger is based on the principles set out in our Mergers and Acquisitions Guidelines.[9]

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[3] The Commission is separately considering whether Vero's acquisition of a 19.99% stake in Tower breached section 47 of the Commerce Act 1986.

[4] Application at [5.3].

[5] [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017).

[6] [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017).

[7] [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017).

[8] [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017) at 1.

[9] Commerce Commission, *Mergers and Acquisitions Guidelines* (July 2013).

The substantial lessening of competition test

7. As required by the Act, we assess mergers using the substantial lessening of competition test.

8. We determine whether a merger is likely to substantially lessen competition in a market by comparing 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 the merger does not proceed (the scenario without the merger, often referred to as the counterfactual).[10]

9. We make a pragmatic and commercial assessment of what is likely to occur in the future, with and without the merger, based on the information we obtain through our investigation and taking into account factors such as market growth and technological changes.

10. A lessening of competition is generally the same as an increase in market power. Market power is the ability to raise price above the price that would exist in a competitive market (the 'competitive price'),[11] or reduce non-price factors such as quality or service below competitive levels.

11. Determining the scope of the relevant market or markets can be an important tool in determining whether a substantial lessening of competition is likely.

12. We define markets in the way that we consider best isolates the key competition issues that arise from the merger. In many cases this may not require us to precisely define the boundaries of a market. A relevant market is ultimately determined, in the words of the Act, as a matter of fact and commercial common sense.[12]

When a lessening of competition is substantial

13. Only a lessening of competition that is substantial is prohibited. A lessening of competition will be substantial if it is real, of substance, or more than nominal.[13] Some courts have used the word 'material' to describe a lessening of competition that is substantial.[14]

14. As set out in our Mergers and Acquisitions Guidelines, there is no bright line that separates a lessening of competition that is substantial from one which is not. What is substantial is a matter of judgement and depends on the facts of each case.[15]

15. A lessening of competition does not need to be felt across an entire market, or relate to all dimensions of competition in a market, for that lessening to be substantial.

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[10] *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [63].
[11] Or below competitive levels in a merger between buyers.
[12] Section 3(1A). See also *Brambles v Commerce Commission* (2003) 10 TCLR 868 at [81].
[13] *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 (HC) at [127].
[14] Ibid at [129].
[15] *Mergers and Acquisitions Guidelines* above n9 at [2.23].

A lessening of competition that adversely affects a significant section of the market may be enough to amount to a substantial lessening of competition.[16]

16. We usually assess competition effects over the short term (ie, two years). The relevant timeframe for assessment will, however, depend on the circumstances. A longer timeframe will be appropriate if, on the evidence, competition effects are likely to arise in later years.[17]

17. A lessening of competition or an increase in market power may manifest itself in a number of ways, including higher prices or reduced services.[18]

18. The Court of Appeal in *Woolworths* did not equate price increases of a particular level (or any other precise metric in relation to other dimensions of competition) with a substantial lessening of competition. It did note, however, that it is "…important to recognise that changes in price which might not appear to be particularly large may well reflect the presence or absence of what, from the point of view of the [suppliers], is substantial competitive constraint".[19]

19. The High Court in *Woolworths* found that price rises in a range between 1-2% and 4-5% would be a cause for concern (implying that increases above 4-5% would also be of concern), but noted that the other dimensions of competition – including quality, range and service needed to be considered. The High Court noted that even a relatively small impact on price may involve a substantial lessening of competition if other competitive dimensions were affected post-merger.[20] The High Court concluded no substantial lessening of competition was likely.

20. In overturning the High Court, the Court of Appeal in *Woolworths* considered the High Court had placed too much emphasis on the limited empirical evidence available. The Court of Appeal took the view that what constitutes a substantial lessening of competition must in the end be a matter of judgement informed by as much practical evidence as possible.[21]

When a substantial lessening of competition is likely

21. A substantial lessening of competition is 'likely' if there is a real and substantial risk, or a real chance, that it will occur. This requires that a substantial lessening of competition is more than a possibility, but does not mean that the effect needs to be more likely than not to occur.[22]

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16 *Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd* (1982) 64 FLR 238; ATPR 40-315, 43, 888.
17 *Woolworths & Ors v Commerce Commission* (HC) above n13 at [131].
18 *Mergers and Acquisitions Guidelines* above n9 at [2.21].
19 *Commerce Commission v Woolworths Ltd* (CA) above n10 at [191].
20 *Woolworths & Ors v Commerce Commission* (HC) above n13 at [156].
21 Ibid at [156].
22 Ibid at [111].

The clearance test

22. We must clear a merger if we are satisfied that the merger would not be likely to substantially lessen competition in any market.[23] If we are not satisfied – including if we are left in doubt – we must decline to clear the merger.

23. In *Woolworths* the Court held that "the existence of a 'doubt' corresponds to a failure to exclude a real chance of a substantial lessening of competition".[24]

24. The burden of proof lies with Vero, as the applicant, to satisfy us on the balance of probabilities that the proposed merger is not likely to have the effect of substantially lessening competition.[25] The decision to grant or refuse a clearance is necessarily to be made on the basis of all the evidence.[26] We will sometimes have before us conflicting evidence from different market participants and must determine what weight to give the evidence of each party.[27]

Key parties

Vero

25. Vero is a New Zealand subsidiary of Suncorp Group Limited (Suncorp), an Australian-based finance, insurance, superannuation and banking business.

26. In New Zealand, Suncorp provides personal and commercial insurance products through:

    26.1 Vero, which sells insurance via brokers and underwrites white label insurance for banks and other partners (ANZ, AMP and Warehouse Money); and

    26.2 AA Insurance, which is a joint venture insurance company owned by Vero (68%) and the New Zealand Automobile Association (NZAA) (32%). AA Insurance provides domestic house, contents and private motor vehicle (HCMV) insurance direct to consumers through a nationwide network of AA branches, a national call centre and online.

27. While Vero is the party that has applied for clearance, we have taken into account all of Suncorp's insurance activities in New Zealand in assessing the merger. Accordingly, references to Vero in this Determination include references to all of Suncorp's insurance activities in New Zealand, unless otherwise specified.

Tower

28. Tower is a New Zealand-based insurance company listed on both New Zealand and Australian stock exchanges.

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[23] Section 66(3)(a).

[24] *Commerce Commission v Woolworths Ltd* (CA) above n10 at [98].

[25] *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at [7] and *Commerce Commission v Woolworths Ltd* (CA) above n10 at [97].

[26] *Commerce Commission v Woolworths Ltd* (CA) above n10 at [101].

[27] *Brambles New Zealand Ltd v Commerce Commission* above n12 at [64].

29. Tower provides HCMV insurance direct to consumers under the Tower brand through a national call centre and online. Tower also underwrites white label personal insurance for Kiwibank, TSB and TradeMe. Tower supplies a limited amount of commercial insurance.

Other insurance providers

IAG

30. IAG (NZ) Holdings Limited (IAG) is a wholly-owned subsidiary of Insurance Australia Group Limited, an Australian general insurance company listed on the ASX.

31. In New Zealand, IAG provides HCMV insurance direct to consumers under its State and AMI brands. It also underwrites white label insurance for a number of banks (including BNZ, Westpac and ASB) and sells insurance via brokers under the NZI and Lumley brands. IAG also sells commercial insurance.

Mutuals

32. Farmers Mutual Group (FMG) is an insurance mutual (ie, its members and policy holders are also its owners). FMG sells personal and commercial insurance direct to consumers, which are predominantly in rural areas.

33. The Medical Assurance Society (MAS) is also a mutual which offers personal insurance to its members.

Youi

34. Youi NZ Pty Limited (Youi) is a wholly owned subsidiary of Youi Holdings Pty Ltd, which in turn is a subsidiary of OUTsurance International Holdings Pty Limited. Youi has been selling personal insurance direct to customers since it entered the New Zealand market in 2014.

Other relevant parties

Insurance Council of New Zealand

35. The Insurance Council of New Zealand (ICNZ) represents the interests of 30 fire and general insurance companies in New Zealand, including the parties to the merger and the other insurers referred to above.

36. The ICNZ provides a forum for Chief Executives to network with their peers across the industry. It also provides opportunities for staff development as they meet with their peers to discuss issues by sitting on working committees that cover each insurance line, regulation, communications and public education as well as employment and education.[28]

Insurance brokers

37. An insurance broker is an intermediary between the insurance company and the customer. The broker provides specialist advice on insurance protection to their

[28] http://www.icnz.org.nz/about-us/benefits-of-membership/.

clients. Brokers generally specialise in providing advice on commercial insurance products, but also offer advice on personal insurance products.

38. A broker's role is to:

    38.1 help identify the risks faced by clients;

    38.2 provide advice on the insurance products available to cover those risks; and

    38.3 approach the insurance market to obtain and arrange the best insurance protection to meet the needs of the client at the most competitive price.

39. There are around 200 insurance broking businesses in New Zealand. These range from large global broking firms, such as AON, Crombie Lockwood and Marsh, to medium-sized and small broking businesses. Brokers obtain revenue from commissions on sales of insurance contracts by underwriters.

40. Some insurance brokers have facilities to place insurance offshore. For example, Crombie Lockwood's subsidiary, Offshore Market Placements Limited, specialises in placing insurance outside New Zealand, primarily with Lloyd's.

41. Around 80% of broking businesses are members of the Insurance Brokers' Association of New Zealand (IBANZ), which represents the interests of the industry.

Banks and other white label partners

42. A number of banks and other parties (eg, Warehouse Money and TradeMe) are active in insurance markets as an adjunct to other products or services they offer.

43. None of these parties underwrite the insurance policies they sell. Instead, they contract with an underwriter to distribute the underwriter's product. This is typically done on a white label basis, where the insurance products that these parties offer are simply an insurance company's own policies re-branded with the bank or other party's logo.

44. The white label partner receives a commission on any sales and, in some relationships, a share of profits. All of the claims management services are carried out by the underwriting company.

Claims service providers

45. The merger also involves a number of markets where Vero and Tower compete to acquire services to fulfil their claim obligations. These include collision repair services and windscreen repair/replacement services.

Industry background

Types of insurance products

46. The proposed merger relates to what is generally referred to as general (or non-life) insurance. General insurance is often divided into two broad categories: personal insurance and commercial insurance.

Personal insurance

47. Personal general insurance products include home, contents, private motor vehicle and pleasure craft insurance sold to consumers for private use.

48. Personal general insurance is sold to consumers through one of three channels:

    48.1 direct to consumers;

    48.2 banks and other white label partners; and

    48.3 brokers.

49. Table 1 shows the proportion of sales of HCMV insurance for each channel on the basis of gross written premium (GWP). These figures are for the entire market and the proportions vary for individual insurers.

Table 1: Sale of personal general insurance by channel

Sales channel	Total GWP $m	%
Direct	$[ ]	[ ]%
White label	[ ]	[ ]%
Broker	[ ]	[ ]%
Total	**$[ ]**	**100%**

Source: Industry participants.

Commercial insurance

50. Commercial general insurance products include a variety of insurance products designed to protect a business, regardless of its size, from unforeseen events, such as fire, theft, property damage and third party liability. These products include insurance to cover commercial property (material damage and business interruption), commercial motor vehicle, and marine cargo.

51. Commercial insurance products are mainly sold via brokers.

Insurance underwriting

52. Insurance underwriting is the process an insurer undertakes to evaluate, accept or reject insurance risk. An insurance underwriter is the person who is responsible for underwriting an insurance contract.

Reinsurance

53. Reinsurance is the insurance purchased by insurers to mitigate their own financial risks. Insurers use it to offset some of their financial risk by, in effect, buying insurance from another insurer, the reinsurer. The reinsurer then assumes some of the original insurer's liability in the event of a major catastrophe. The object of reinsurance is to indemnify the original insurer against loss that they may sustain in their capacity as insurers.

Impact of Canterbury and Kaikoura earthquakes

54. In September 2010 and February 2011, the Canterbury region experienced major earthquakes that resulted in significant damage and loss of life. Insurers have paid out almost $20 billion for claims from both events.[29]

55. On 14 November 2016, the northern South Island and Wellington regions experienced a major earthquake which also resulted in significant damage and loss of life. Insurance claims from this event are currently $1.8 billion.[30]

56. The claims resulting from the earthquakes and the higher perceived risk of earthquakes in New Zealand have had a considerable effect on all companies providing insurance in New Zealand. In particular, the earthquakes have led to:

    56.1 insurance companies facing higher reinsurance costs;

    56.2 increased premiums; and

    56.3 temporary embargoes on new domestic house and contents policies in parts of New Zealand.

57. As a direct result of the Canterbury earthquakes, the Reserve Bank of New Zealand (RBNZ) issued new regulatory requirements for insurers, effective from 2016. The requirement is for insurers to have sufficient capital reserves to meet a 1:1,000 year insured event in New Zealand as compared to a 1:500 year event prior to these events.

Context of earlier decisions

58. The Commission has assessed mergers in personal and commercial insurance markets in two recent decisions: *IAG/AMI* and *IAG/Lumley*.[31] On both occasions, the Commission gave clearance to IAG for its proposed acquisitions.

59. The context of the current application is materially different to our earlier decisions. In particular:

    59.1 as we discuss below, the proposed merger would involve the removal of Tower as a significant third competitor, resulting in a reduction of significant competitors in HCMV markets from three to two with a tail of smaller competitors with limited competitive significance. In contrast, post-merger in *IAG/Lumley*, three significant competitors remained in the HCMV markets (IAG, Vero, Tower);

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29 ICNZ "Canterbury Earthquake Progress Statistics Q1 2017" (8 May 2017).

30 http://www.icnz.org.nz/private-insurers-receive-1-8b-kaikoura-earthquake-claims/.

31 IAG (NZ) Holdings Limited and Lumley General Insurance (N.Z.) Limited [2014] NZCC 12 and IAG (NZ) Holdings Limited and AMI Insurance (Operations) Limited [2012] NZCC 6.

59.2 the proposed merger would involve a significant aggregation in the direct to consumer channel, whereas Lumley was not as active in this particular area of the market (Lumley sold HMCV insurance primarily in the white label channel through Westpac); and

59.3 we have had the benefit of observing the performance of the competitive "tail" and also entry and expansion patterns since our previous decisions. As we discuss below, neither the tail nor new entrants have been able to expand significantly, even though there appear to have been opportunities to target competitor profits, as there are likely high barriers to expansion.

60. Given the materially different context, we cannot transpose the conclusions from the Commission's earlier decisions to this application.[32] We have made our decision on the basis of all the evidence before us and taking into account the context to this application. Where relevant, we indicate where we have departed from the Commission's reasoning in *IAG/AMI* and *IAG/Lumley*.

Background to the proposed merger

61. The context for Vero's application for clearance is a contested sales process. Vero made a non-binding indicative proposal to acquire 100% of the shares in Tower for $1.30 per share on 22 February 2017. This followed an offer from Fairfax Financial Holdings Limited (Fairfax) to acquire 100% of the shares in Tower for $1.17 per share, announced on 9 February 2017. Fairfax's offer was unanimously supported by the Tower Board in the absence of a superior proposal.[33]

62. On 26 June 2017, Tower announced that it had received an updated proposal from Vero for $1.40 per share. Tower subsequently announced on 27 June 2017 that it had entered into a Scheme Implementation Agreement (SIA) with Vero and that it considered Vero's offer to be a superior proposal.[34] The Fairfax offer was subsequently terminated.[35] Vero's SIA is conditional on Commerce Commission clearance for Vero's acquisition of up to 100% of the ordinary shares in Tower. A shareholder vote on the Vero scheme of arrangement is scheduled to be held in September 2017.

63. [

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[32] Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [33]. "In our respectful submission, the Commission should approach the two decisions in the same way, as they are factually similar in all material respects (with the aggregation in this case being the same or smaller than the aggregation in IAG/Lumley), and in this case, should provide the same decision - which is granting a clearance."

[33] Tower market announcement "Fairfax Financial to Acquire Tower" (9 February 2017) https://nzx.com/companies/TWR/announcements/296540.

[34] Tower market announcement "Tower signs scheme implementation agreement with Suncorp" (27 June 2017) https://www.nzx.com/companies/TWR/announcements/303196.

[35] Tower market announcement "Mutual termination of Fairfax scheme" (29 June 2017) https://www.nzx.com/companies/TWR/announcements/303333.

][36]

Market definition

64. Market definition is a tool that helps identify and assess the close competitive constraints the merged entity would face. Determining the relevant market requires us to judge whether, for example, two products are sufficiently close substitutes as a matter of fact and commercial common sense to fall within the same market.

65. We define markets in the way that best isolates the key competition issues that arise from a merger.[37] In many cases this may not require us to precisely define the boundaries of a market. What matters is that we consider all relevant competitive constraints, and the extent of those constraints. For that reason, we also consider products and services which fall outside the market but which still impose some degree of competitive constraint on the merged entity.

66. Vero and Tower overlap in the supply of HCMV insurance and the purchase of claims-related services. We consider the relevant markets for these products and services below.

67. Vero and Tower also overlap in the provision of private pleasure craft insurance and commercial insurance. We consider that the proposed merger would be unlikely to substantially lessen competition in either of these overlap areas, given that Tower's market presence is relatively insignificant in these areas.[38] As such, we do not further consider the impact of the merger in the provision of private pleasure craft insurance and commercial insurance.

Vero's view of the relevant markets

68. Vero submitted that the relevant markets for assessing the merger are:[39]

    68.1 national markets for the insurance of:

        68.1.1 domestic house and contents;

        68.1.2 private motor vehicle;

    68.2 national buying markets for:

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36 [ ]

37 *Mergers and Acquisitions Guidelines* above n9 at [3.10-3.12].

38 Tower's share of the supply of commercial insurance is around [ ]%, while its share in private pleasure craft insurance is likely to be less than [ ]%. Additionally, the merged entity's share of the supply of private pleasure craft insurance is likely to be less than [ ]%.

39 Application at [7.7-7.8]. Vero also submitted on the relevant markets for private pleasure craft insurance and commercial insurance but, as discussed above, these are not considered further in this Determination.

68.2.1 auto-glass and windscreen repair/replacement services; and

68.2.2 collision repair services.

Our view of the relevant markets

69. The markets suggested by Vero are consistent with those defined by the Commission in its previous *IAG/Lumley* and *IAG/AMI* decisions.[40] We have received no evidence to suggest that we should depart significantly from the markets defined in those decisions.

70. Consistent with the Commission's previous decisions, we have not included commercial insurance in the same product market as personal insurance products on the basis of supply-side substitutability. We do not consider that insurance firms could easily, profitably and quickly switch between supplying personal and commercial insurance. We have also chosen not to define separate functional markets to reflect the distinction between underwriting and distribution. Rather, as the Commission did in *IAG/AMI*, we consider the underwriting and distribution components together when assessing the competition effects of the proposed merger.

71. We assessed whether we should define narrower geographic markets. We note, for instance, that some insurers had placed temporary embargoes on new domestic house and contents policies in parts of New Zealand following the Canterbury and Kaikoura earthquakes. We also saw evidence that [ ]. However, aside from the temporary embargoes (which have now been lifted) all insurers, including [ ], offer insurance throughout New Zealand. We therefore decided not to depart from our previous decisions that personal insurance markets are national.

72. Accordingly, we consider that the relevant markets are:

72.1 national markets for the provision of:

72.1.1 domestic house and contents insurance; and

72.1.2 private motor vehicle insurance;

72.2 national buying markets for:

72.2.1 auto-glass and windscreen repair/replacement services; and

72.2.2 collision repair services.

73. Consistent with the Commission's decision in *IAG/Lumley*, we assess HCMV insurance together in the competitive effects analysis, as the competitive conditions in these markets are likely to be largely the same.

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[40] IAG (NZ) Holdings Limited and Lumley General Insurance (N.Z.) Limited [2014] NZCC 12 and IAG (NZ) Holdings Limited and AMI Insurance (Operations) Limited [2012] NZCC 6.

With and without scenarios

74. To assess whether a merger is likely to substantially lessen competition in a market, we 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 the merger does not proceed (the scenario without the merger, often referred to as the counterfactual).[41]

Our approach to deciding what is likely without the merger

75. As noted by the High Court in *Woolworths*, the Commission is required to consider each of the counterfactuals that are real and substantial prospects. A relevant counterfactual involves more than a possibility but the effect does not need to be "more likely than not".[42]

76. We do not choose a counterfactual that we consider has the greatest prospects of occurring (ie, is the 'most likely'). Rather, a likely counterfactual is something that has a real chance of occurring.[43]

77. As a practical matter, we usually focus our analysis on the likely counterfactual we consider is the most competitive. If we are not satisfied that competition would not be likely to be substantially lessened when that counterfactual is compared to the factual, we must decline clearance.[44]

78. We make a pragmatic and commercial assessment of what is likely to occur in the future without the merger. This assessment is based on the information we obtain through our investigation and takes into account factors including market growth and technological changes.

79. Often the best guide of what would happen without a merger is what is currently happening (ie, the status quo). However, where a market is likely to undergo changes that will affect competition in the counterfactual, we take these changes into account.[45]

Without the merger

80. Vero submitted that, absent it acquiring Tower, Tower would remain a separate entity, implying a counterfactual scenario not materially different to the status quo.[46] It stated that Tower has not been a particularly vigorous, innovative or aggressive competitor.[47] Vero also submitted that there is not a real chance that Tower would

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41 *Mergers and Acquisitions Guidelines* above n9 at [2.29].
42 *Woolworths & Ors v Commerce Commission* (HC) above n13 at [111].
43 Ibid.
44 *Mergers and Acquisitions Guidelines* above n9 at [2.33].
45 Ibid at [2.36].
46 Application at [5.7].
47 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [70].

be acquired by Fairfax[48] nor that Tower would be more competitive in the counterfactual.[49]

81. For the reasons set out below, the Commission considers that the counterfactual is that Tower would remain as an independent competitor, either under third party ownership or as a standalone entity. Tower would continue to be of competitive significance in HCMV markets, with a real chance that Tower's competitive position would be further enhanced under third party ownership.

82. In the next sections, we first consider Tower's status as an independent competitor in the counterfactual, followed by Tower's competitive significance.

Tower as an independent competitor

83. If the merger does not proceed, there are two potential ownership scenarios for Tower:

    83.1 acquisition by a third party, [ ]; or

    83.2 no acquisition of Tower (ie, standalone entity).

84. Under either of these scenarios, Tower would remain as an independent competitor in HCMV markets.

<u>Third party purchase of Tower</u>

85. We saw evidence that the Board of Tower had recently been seeking buyers for Tower. Tower told us that Fairfax was identified by Tower as a buyer through a market search involving parties around the world,[50] while Vero stated that [ ].[51] [ ][52] A Suncorp Board document also observes [ ].[53]

86. Tower's overtures have resulted in interest from third parties in purchasing Tower. Vero's offer for Tower has come in the context of a contested sales process where Fairfax also previously made a binding offer to acquire 100% of the shares in Tower. Until recently, the Tower Board unanimously supported Fairfax's offer in the absence of a superior proposal.[54] While the Fairfax scheme was terminated on 29 June 2017, following Vero's revised offer, Fairfax told us that

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48 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [35].

49 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [12].

50 Commerce Commission interview with Tower (23 March 2017).

51 Commerce Commission interview with Vero (24 May 2017).

52 [ ]

53 [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017) at 1.

54 Tower market announcement "Fairfax Financial to Acquire Tower" (9 February 2017) https://nzx.com/companies/TWR/announcements/296540.

[

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87. [[56] [57] [58] [59]][60]

88. [[61]][62]

Tower standalone without third party acquisition

89. However, we received submissions – mainly from the merging parties – that a third party acquisition of Tower does not have a real chance of occurring. Vero submitted that Tower shareholders would be unlikely to sell to Fairfax at its offer of $1.17 per share, given that Vero's offer of $1.40 represents fair value (and that fair value will not fall away if Vero does not proceed to acquire Tower). In addition, Vero noted that the Chairperson of Tower indicated that an offer of $1.40 (or above) is necessary before he would even put an offer to Tower's shareholders.[63]

90. The Chairperson of Tower and Salt Funds Management (Salt) (a major Tower shareholder) both [ ].[64] Salt had contractually committed to vote in favour of the Fairfax scheme of arrangement, but it said [ ]. Both Salt and Tower's Chairperson

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55 E-mail from Simpson Grierson (on behalf of Fairfax) to the Commerce Commission (30 June 2017).

56 [ ]

57 [ ]

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61 [ ]

62 [ ]

63 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [25].

64 Commerce Commission call with Michael Stiassny, Chairperson of Tower (21 July 2017) and Commerce Commission interview with Salt Funds Management (20 July 2017).

considered that [ ].[65]
Tower's Chairperson said that
[

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91. Tower submitted that the correct counterfactual is a standalone Tower (ie, no acquisition), as it considered that a [ ] acquisition does not have a real chance of occurring.[66]

Tower would remain an independent competitor

92. The evidence before us on whether there would be a third party buyer of Tower in the absence of the proposed merger is conflicting. On the one hand, there is evidence that Tower and [ ] were seeking a sale of Tower,
[
]. On the other hand, Tower said that the correct counterfactual is a standalone Tower, and Vero, [ ] consider that Fairfax's $1.17 offer would not have succeeded.

93. We have weighed the evidence and we consider that there is a real chance that Tower would be acquired by a third party if the merger does not proceed. In reaching this conclusion, we note the evidence that:

93.1 Tower's share price fell to a low of about 70 cents in November 2016 and was about 80 cents immediately before Fairfax's offer of $1.17 announced on 9 February 2017. Any offers around the level of Fairfax's original offer would therefore be at a substantial premium to Tower's share price prior to the current takeover process;[67]

93.2 Tower's Board unanimously supported the Fairfax offer of $1.17 in the absence of a superior proposal and two major shareholders in Tower (Salt and ACC) had "entered into firm voting agreements under which they [had] committed to vote in favour of the Fairfax [scheme]".[68] ACC said that
[

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65 Commerce Commission call with Michael Stiassny, Chairperson of Tower (21 July 2017).

66 Commerce Commission interview with Tower (10 July 2017) and submission from Tower to the Commerce Commission (10 July 2017) at [6]. We note that Tower made this submission following it entering into the SIA with Vero, which provides that "Vero and Tower will work collaboratively… in relation to the progress of obtaining the Regulatory Approvals", which includes Commerce Commission clearance for this application. Vero/Tower SIA (27 June 2017) at 3.2(d)(v).

67 NZX Main Board – TWR: https://www.nzx.com/markets/NZSX/securities/TWR?icharts=true.

68 Tower market announcement "Fairfax Financial to Acquire Tower" (9 February 2017) https://nzx.com/companies/TWR/announcements/296540, Fairfax-Salt Tower Scheme Voting Agreement (8 February 2017), and Fairfax-ACC Tower Scheme Voting Agreement (9 February 2017).

].[69] ACC told us that [ ]; and

93.3 in the absence of a third party acquisition, a standalone Tower would need to raise capital at a discount to its existing share price.[70] Such a stock dilution would likely decrease Tower's share price. In this respect, we note Vero's submission that "a large capital raising [by Tower] at a significant discount makes the offers on the table [Fairfax's and Vero's] substantially more attractive than the likely share price post-issue".[71]

94. In this context, we consider that, in the absence of an offer from Vero to acquire Tower, there is a real chance that Tower shareholders would be open to considering offers from third party buyers at or around the price originally offered by Fairfax. Given the [ ], we consider that there is a real chance that a third party would make an offer that is acceptable to shareholders and a sale executed.

95. In any event, either under third party ownership or as a standalone entity, Tower would remain as an independent competitor in HCMV markets and, as we explain below, would continue to be of competitive significance.

Vero's 19.99% shareholding in Tower

96. We also considered what Vero would do with its 19.99% shareholding in Tower should it not proceed to acquire 100% of the shares in Tower. This was relevant to the issues of whether a third party would acquire Tower (as Vero's shareholding likely gives it the ability to block an acquisition of 100% of the shares of Tower by a third party) and also the extent to which a standalone Tower would be able to continue to compete effectively.[72]

97. Vero indicated that, [ ].[73] We therefore consider that, in a scenario where Vero does not proceed to acquire Tower, there is a real chance that Vero would sell its shareholding.[74] This would

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69 Commerce Commission interview with ACC (24 July 2017).

70 Commerce Commission interview with Tower (21 June 2017).

71 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [17].

72 As we state above in n3, we are investigating whether Vero's acquisition of a 19.99% stake in Tower breached section 47 of the Commerce Act 1986.
[ ]

73 [ ] provided under the cover of a letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) and Commerce Commission interview with Vero (24 May 2017).

74 The Commission's investigation into Vero's 19.99% shareholding in Tower under section 47 of the Commerce Act would also continue in the event that Vero did not sell its shareholding.
Our approach to the counterfactual is consistent with the High Court's decision in *Commerce Commission v New Zealand Bus & Ors* (2006) 11 TCLR 679. In that case, New Zealand Bus was seeking to acquire 100%

enable a third party acquisition of Tower or Tower to continue to compete effectively as a standalone entity.

98. [ ][75]

Tower's competitive significance in HCMV markets

99. We note that Tower's recent performance has been relatively muted and its market share has been slightly declining.[76] Tower identified an outdated IT system and the burden of Canterbury earthquake liabilities as headwinds to improving its performance.[77]

100. However, Tower is actively seeking to reposition its business to make it more competitive in HCMV markets. In Tower's FY2016 full year results announcement, it gave an overview of some of the key aspects of its intended repositioning, including its focus on the digital channel, product rationalisation, IT investment and plan to develop a challenger culture.[78] Tower set itself a medium-term GWP growth target of 4% to 6%. We saw Board-level documentation which set out this strategy in greater detail, and outlined other planned improvements including [ ].[79] Fairfax, [ ], noted that Tower [ ].[80]

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of Mana Coach Services, and already held a 26% shareholding in Mana. Noting that "a number of parties had told the Commission's staff that they would be interested in purchasing Mana" (at [118]), the Court agreed with the Commission that, should New Zealand Bus not proceed to acquire Mana, a third party would buy it. The court stated that "[w]hile a sale is obviously contingent upon a satisfactory price, it is appropriate to proceed on the basis that the counterfactual does involve sale" (at [187]). The court was also asked to consider whether the counterfactual would also involve the sale of New Zealand Bus's pre-existing stake. While the court did not find it necessary to conclude on this issue, it noted that "it is at least equally plausible that, having failed to secure its strategic objectives, NZ Bus would elect to sell" its pre-existing stake (at [188]).

75 [ ]

76 Our estimates are based on revenue data received from IAG, Vero, Tower, FMG and Youi for the years 2014-2016.

77 Tower 2016 Results Announcement (29 November 2016).

78 Ibid.

79 [ ] All documents provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017). For example, [ ]

80 [ ]

101. Tower would likely require recapitalisation to execute its strategy (due to its exposure to claims from the Canterbury earthquakes), but it has said that its strategy is viable and it would seek to raise capital should it not be acquired by Vero.[81]

102. Vero submitted that Tower has failed to deliver significant improvements to its business, has not significantly increased its competitive significance, and is still struggling to perform financially.[82] However, Tower has recently undertaken some new initiatives to improve performance. It has introduced a "simple and easy" products package, developed online quote-to-buy functionality for its core branded products and repriced its portfolios.[83] Tower's online sales are up from 9% of total transactions in March 2016, to 24% of total transactions in March 2017.[84] Tower also started a relationship in 2017 with Air New Zealand to offer Airpoints to policyholders.

103. There has also been improvement in Tower's performance. In FY2016, Tower returned to positive policy growth (up 2,509 policies) following a decline in FY2015.[85] In its FY2017 interim results, Tower announced that it had grown its core book by 2.4% GWP and added 4,949 new policies, while claims and management costs were reported to be down.[86] This is despite Tower's Chairperson suggesting that the ongoing negotiations concerning the potential sale of Tower had slowed down Tower. The Chairperson said that changes in Tower, such as IT investment, had been on hold during the takeover process.[87] Excluding regular provisioning to address escalating claims costs relating to the Canterbury earthquakes (for which Tower intends to raise capital), Tower is profitable.[88] In this respect, Fairfax described Tower [ ].[89]

104. Tower's efforts to improve its performance have been noticed by other market participants. For example, [ ] observed that Tower had been more innovative, noting its full replacement for fire policy and its SmartDriver telematics product,[90] while [ ] considered that Tower has a clear strategy of growing its direct book and

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81 Commerce Commission interview with Tower (10 July 2017). Tower told the Commission that it requires about $50 million of capital to address its solvency requirements and that it is aware of other shareholders which would support capital raising. Commerce Commission interview with Tower (21 June 2017). We also note that Tower raised $81 million in a 2009 rights issue. [ ] provided under the cover of a letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017).

82 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [63-65].

83 Tower AGM Address (30 March 2017).

84 Tower Interim Results Announcement (24 May 2017) at 16.

85 Tower 2016 Results Announcement (29 November 2016) at 13.

86 Tower Interim Results Announcement (24 May 2017).

87 Commerce Commission call with Michael Stiassny, Chairperson of Tower (21 July 2017).

88 Tower Interim Results Announcement (24 May 2017).

89 [ ]

90 [ ]

experimenting with technology platforms.[91] [ ] said that Tower appears "more focussed" and "better organised".[92]

105. Tower advised the Commission that, absent the proposed merger and subject to raising additional equity capital, it would continue to the implement the strategy outlined above.[93] While it is possible that Tower would not rapidly achieve large market share growth,[94] its actions in seeking to achieve growth are likely to mean that its presence in the market would be of continuing competitive significance.

106. Moreover, we consider that there is a real chance of further enhancement of Tower's competitive position under third party ownership.

107. [ ] identified interested buyers – [ ] – are large, well-resourced global businesses which would bring international experience and likely appoint a new Board.[95] [ ] have signalled their intention to grow the Tower business and position it to effectively compete consistent with the actions that Tower is already seeking to take in the market.
[[96] [97]]

108. A third party buyer [ ] would also likely have the capital backing to resolve Tower's capital issues, enabling Tower to move more quickly to implement its strategy and placing Tower on a more secure footing to continue to compete in the future.

109. Vero submitted that there is no evidence that a Fairfax-owned Tower would become more competitively significant.[98] However, market commentary also supports the view that there is a reasonable prospect of further enhancement of Tower's competitive position under Fairfax ownership. The CEO of ICNZ noted that a Fairfax acquisition would bring "the benefit of having a very well capitalised company with a very well capitalised owner and having the ability to inject innovation as well as potential capital into the company and that is all to the good".[99]

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91 [ ]
92 [ ]
93 Commerce Commission interview with Tower (10 July 2017).
94 Vero submitted that Tower would be unlikely to achieve significant growth. Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [64].
95 [ ]
96 [ ]
97 [ ]
98 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [47].
99 http://www.insurancebusinessmag.com/nz/news/breaking-news/industry-reacts-to-tower-acquisition-bid-59712.aspx. The CEO also noted that a Fairfax acquisition "also preserves the competitiveness within

110. A Forsyth Barr equity report on Tower, which considered the Fairfax offer, also noted that IAG and Vero may find it attractive to acquire Tower "as opposed to witnessing the establishment of another competitor with a significant balance sheet who may be more price competitive in order to gain market share through a well-known brand".[100] In noting the potential for a higher offer from IAG or Vero, it observed that "[h]aving a competitor with a far larger balance sheet than [Tower] is likely to be concerning to current players relative to the current environment".

Conclusion on relevant counterfactual

111. We consider that the relevant counterfactual is that Tower would remain as an independent competitor, either under third party ownership or as a standalone entity. Tower would continue to be of competitive significance in HCMV markets, with a real chance that Tower's competitive position would be further enhanced under third party ownership.

112. The Commission focussed its competition analysis (including development in the counterfactual) over a two year period to consider whether there is likely to be a substantial lessening of competition as a result of the proposed merger.[101]

With the merger

113. Vero currently holds 19.99% of the shares in Tower. The merger would result in Vero owning up to 100% of the shares in Tower.

114. Vero told us that [ ].[102] A Suncorp Board document indicates that [ ].[103] Tower would [ ].[104] [ ].

How the merger could substantially lessen competition

115. We have considered three possible ways in which the merger would have, or would be likely to have, the effect of substantially lessening competition:

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the industry because Tower will continue to compete as a direct insurer in personal lines which makes for a healthy insurance market".

100 Forsyth Barr "Equity Report on Tower" (9 February 2017) at 3.

101 Vero submitted that there were not sound justifications to consider a longer timeframe in this particular market. Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at 25-27.

102 Commerce Commission interview with Vero (24 May 2017).

103 [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017).

104 [ ] provided under the cover of a letter from Suncorp to the Commerce Commission (13 March 2017) at 8-9.

115.1 first, the merger could give rise to unilateral effects in the provision of HCMV insurance;

115.2 second, the merger could increase 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 quality reduces and/or prices increase in the provision of HCMV insurance; and

115.3 third, the merger could give rise to unilateral effects in the purchase of claims-related services (collision repair and autoglass/windscreen repair and replacement).

Competition analysis – unilateral effects

116. For the reasons set out below, we are not satisfied that the merger will not have, or would not be likely to have, the effect of substantially lessening competition in HCMV markets due to unilateral effects.

Summary of our view

117. We consider that the proposed merger is likely to result in a reduction in competition such that the merged entity and IAG would be likely to be able to exercise increased market power by increasing the prices of and/or reducing the quality of HCMV products.

118. In the counterfactual, we consider that Tower would continue to compete in HCMV markets to grow its sales by, amongst other things, seeking to differentiate its pricing from its competitors, repositioning its product offerings, and improving service levels. The intensity of this competition would likely be enhanced under third party ownership of Tower. The proposed merger would result in a loss of significant competition between Tower (operating under third party ownership or as a standalone entity) and Vero, and remove an independent source of competitive initiatives that would likely constrain IAG and other insurers.

119. The merger would leave the HCMV markets with only two substantial competitors (the merged entity and IAG), which together would hold a [ ]% market share. Other remaining competitors – including FMG, MAS and Youi – are either small, niche, or both, and are unlikely to expand sufficiently within a two year timeframe to replace the constraint provided by Tower. We also consider it unlikely that there would be new entrants who could expand sufficiently to replace the lost competition as a result of the merger. While our competition analysis is based on a two-year period, we also have a concern that the merger would result in an enduring structural change to HCMV markets with a shift from three significant competitors to just two and that the competitive effects of the merger would play out over a longer timeframe.

120. The removal of what would otherwise be significant competition between Tower and Vero would enable the merged entity to raise prices and/or reduce quality. In response to these actions, IAG would likely face some shift in demand towards its

products. IAG would therefore also have an incentive to increase its prices and/or undertake cost-reducing quality reductions to the extent that such strategies would not result in significant sales being diverted to other insurers in HCMV markets. We consider that, as there would be no remaining substantial competitors, such diversion is unlikely.

121. The loss of Tower as a third player in HCMV markets would also result in the merged entity and IAG facing less dynamic pressure to engage in welfare enhancing product changes and innovation.

122. Accordingly, our view is that consumers would be substantially worse off as a result of the proposed merger.

Existing competition

123. To determine whether the proposed merger would be likely to result in a substantial lessening of competition in the provision of HCMV insurance due to unilateral effects, the Commission first considered the extent to which Vero and Tower compete against each other and the extent of competition from other providers of HCMV insurance. As part of this analysis, we also considered the extent to which IAG and other insurers would be likely to constrain the merged entity.

Vero's views

124. Vero submitted that the merger would not enable the merged entity to raise prices (or decrease quality) as a result of unilateral effects because:[105]

    124.1 the degree of market share aggregation that would result from the merger is low, given Tower's market share. It also noted that the merged entity's market share would be significantly smaller than IAG's market share before it acquired Lumley;[106]

    124.2 the merged entity would face strong competition from substantial and well-established existing competitors, as well as smaller competitors. Vero submitted that firms need not be large in order to act as an effective constraint;[107] and

    124.3 Vero and Tower are not each other's closest competitors in HCMV markets. Instead, Vero said that its closest competitors are IAG and Youi.

125. For the reasons set out below, we consider that the competitive constraint that would be likely to be lost as a result of the merger would be substantial and that competition from existing competitors would be insufficient to counteract that loss of constraint.

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[105] Application at [8.1-8.24].
[106] Ibid at [8.11].
[107] Submission from Suncorp to the Commerce Commission (21 April 2017) at [5].

Nature of competition in HCMV markets

126. Competition in HCMV markets revolves around both price and non-price factors. Key non-price factors include policy coverage, policy simplicity, claims certainty,[108] and customer service.[109] Customer surveys conducted for the merging parties indicate that non-price factors are as important as price.[110]

127. Insurers regularly make comparisons to each other and some have internal documents dedicated to these comparisons. Comparisons are typically made on the more easily observable parameters of competition, such as price, scope of coverage and marketing campaigns.[111] These comparisons are sophisticated and indicate that insurers consider it necessary to understand how their offerings and those of their competitors are positioned in the market.

128. The comparison documents regularly compare product design and policy inclusions/exclusions, emphasising that a key element of competition is the scope of coverage. In one internal document, for instance, Tower discusses in detail changes made to AA Insurance's motor vehicle insurance policies.[112] In another example, an IAG internal document notes that
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].[113]

129. Branding is also a key element of competition, at least partially because of the importance consumers place on the stability and reliability of their insurer. Insurers in the direct channel invest large sums on marketing[114] and
[ ].[115]

<u>Competition between distribution channels</u>

130. Evidence indicates that, of the three distribution channels, the direct and white label channels are growing in importance over time, while the broker channel is declining

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108 That is, customers have confidence that they will be paid out on claims.

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110 [
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111 For example, one of Tower's internal documents discusses pricing movements of AA Insurance and State Insurance and notes policy changes by AMI. [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

112 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

113 [ ] provided under the cover of an e-mail from IAG to the Commerce Commission (19 April 2017).

114 [
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115 [
]

and insurers in this channel are a weaker constraint on those in the direct or white label channels. While Vero submitted that it had not seen a significant decline in volume through the broker channel,[116] Vero had previously advised the Commission that there is a market trend away from sales via brokers to the direct channel.[117] It pointed to the experience in Australia, where it estimated that [ ]. A Vero document, drawing on the experience of the wider Suncorp Group, noted that [ ].[118]

131. [ ] also noted that there has been a strong switch by consumers from the broker to direct channel and that there has been a clear shift in strategy by underwriters to move customers to the direct channel.[119] [ ] said that older customers are more likely to use brokers while younger customers are more likely to buy in the direct channel.[120] AA Insurance noted in one of its internal documents that [ ].[121] Competitor comparison documents tend to focus heavily on brands in the direct and white label channel, often to the exclusion of brands in the broker channel.[122]

132. Evidence also suggests that customers buying insurance in the broker channel tend to have different characteristics to those in the direct and white label channels. [ ] noted that their customers tend to be small businesses which purchase personal insurance as a package with commercial insurance.[123] [ ] said that customers in the broker channel are likely to be higher net worth persons or customers which have existing commercial business with the broker.[124] A Vero report on the use of brokers by SMEs in New Zealand noted that "[w]orldwide, the trend towards disintermediation is accelerating, driven partly by the increasing popularity of online channels".[125]

133. The different customer characteristics in the broker channel are likely to be because there is some differentiation between HCMV insurance sold in the broker channel compared to the direct and white label channels. [ ] said that insurance in the broker channel is priced higher than in the direct or white label channels,[126] and [ ] said that it is always more expensive than insurance sold direct because of broker

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116 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [95].

117 Commerce Commission interview with Vero (24 May 2017).

118 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (29 March 2017) at 28.

119 [ ]

120 [ ]

121 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017) at 12.

122 [ ]

123 [ ]

124 [ ]

125 Vero "SME Insurance Index 2017" available at https://www.vero.co.nz/business-insurance/sme-insurance-index.html at 6.

126 [ ]

commission.[127] There was also some indication that policy coverage tends to be broader in the broker channel.[128] [ ] told us that it doubts if it would have won much business from direct insurers, noting that it is not possible to compete with direct insurers because of price.[129] This was consistent with [ ] view that some small businesses are switching their HCMV insurance to direct insurers because it is cheaper.[130] [ ] said that while it is seeing more business from individuals, it competes primarily with other brokers rather than direct insurers.[131]

134. In contrast, there is evidence that switching occurs between the direct and white label channels.[132] However, our discussions with banks (which comprise most of the white label channel) indicated that they compete to sell insurance only to their existing customers, meaning that there is unlikely to be significant competition between banks for insurance customers.[133] There is some evidence that prices for HCMV insurance sold via banks are higher than in the direct channel, which may be at least partially attributable to the commission insurers pay to banks to compensate for distribution. A Vero document notes that
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].[134]

Evidence of customer switching

135. Consumers appear to face costs associated with searching for and comparing HCMV insurance products. For example, [ ] suggested that, in relation to offline sales channels, many consumers engage in low levels of search activity, particularly in comparison to searching online.[135] In relation to online sales, unlike other jurisdictions, there are no price comparison sites for HCMV insurance in New

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134 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (29 March 2017) at 23.

135 [
]

Zealand meaning there is less price transparency for consumers.[136] It has been reported that the two largest insurers, Vero and IAG, do not provide the information required for a price comparison website.[137] A Vero document noted that [ ].[138]

136. Data submitted by Vero provided evidence that there is some level of churn in HCMV markets.[139] This evidence was broadly consistent with the level of switching observed by the Commission in *IAG/AMI* (up to 20% per year of policy holders).[140] We saw other evidence that HCMV insurers have customer retention rates of around [ ]%,[141] and that insurers often increase prices on renewal.[142]

Level of competition in the New Zealand insurance industry

137. Vero submitted that HCMV markets are more competitive than they were following IAG's acquisition of Lumley.[143]

138. While we are required to assess whether the proposed merger would substantially lessen competition compared to a scenario without the merger, we note that some sources suggest that the level of competition in the New Zealand insurance sector may be less intense than in other sectors of the economy. The Productivity Commission and MBIE both described competition in the financial and insurance services sector as relatively weak.[144] Some market participants expressed concern with the level of competition in HCMV markets. [ ] said that it is already seeing price increases,[145] while [ ] believed that innovation had reduced in recent years.[146] [ ] said that IAG and Vero are "pushing premiums up and reducing cover in some areas of business".[147] Others, including [ ], indicated that HCMV

136 In the UK 67% of consumers who bought or renewed car insurance in the last 12 months used a price comparison website (Consumer Focus, 2013), referenced in Productivity Commission "Boosting productivity in the services sector" (May 2014) at 103. Within New Zealand there are also non-HCMV insurance price comparison websites.

137 http://www.stuff.co.nz/business/industries/9880509/Insurers-shun-online-scrutiny.

138 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (29 March 2017) at 28.

139 [ ] provided under cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (29 June 2017).

140 IAG (NZ) Holdings Limited and AMI Insurance (Operations) Limited [2012] NZCC 6 at [66] and [70].

141 [ ]

142 [ ]

143 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at 24.

144 For example, New Zealand Productivity Commission "Boosting productivity in the services sector" (May 2014) at Chapter 5: Competition in the services sector and MBIE "Competition in New Zealand Industries: Measurement and Evidence" (April 2016).

145 [ ]

146 [ ]

147 [ ]

markets are competitive.[148] We saw evidence that there is a high degree of cross-subsidisation in HCMV markets, particularly between high and low-risk earthquake regions but also between high and low-risk drivers.[149] Cross-subsidisation can be an indicator of market power.

Market shares in HCMV insurance

139. Table 2 provides estimated market shares for the major insurers that underwrite personal insurance products, based on GWP. The table shows market shares for Vero, Tower and IAG for each of the distribution channels they operate in.

Table 2: Market shares in HCMV insurance

		Total HCMV		House and contents	Motor vehicles
Party		$m	%	%	%
Vero	Direct	[ ]	[ ]%	[ ]%	[ ]%
	White label	[ ]	[ ]%	[ ]%	[ ]%
	Broker	[ ]	[ ]%	[ ]%	[ ]%
	Total Vero	**[ ]**	**[ ]%**	**[ ]%**	**[ ]%**
Tower	Direct	[ ]	[ ]%	[ ]%	[ ]%
	White label	[ ]	[ ]%	[ ]%	[ ]%
	Total Tower	**[ ]**	**[ ]%**	**[ ]%**	**[ ]%**
Merged entity		**[ ]**	**[ ]%**	**[ ]%**	**[ ]%**
IAG	Direct	[ ]	[ ]%	[ ]%	[ ]%
	White label	[ ]	[ ]%	[ ]%	[ ]%
	Broker	[ ]	[ ]%	[ ]%	[ ]%
	Total IAG	**[ ]**	**[ ]%**	**[ ]%**	**[ ]%**
FMG		[ ]	[ ]%	[ ]%	[ ]%
MAS		[ ]	[ ]%	[ ]%	[ ]%
Youi		[ ]	[ ]%	[ ]%	[ ]%
All others		[ ]	[ ]%	[ ]%	[ ]%
Total		**$[ ]**	**100%**	**100%**	**100%**

Source: Industry participants and the RBNZ.

140. Vero submitted that ICNZ data and other market share figures did not support our estimated market shares, noting that it considered that insurers other than IAG, Vero and Tower account for [ ]% of HCMV markets.[150] Our market share calculations are based on HCMV-specific revenue data provided by Vero, IAG, Tower, FMG and Youi. For the remaining insurers, we used HCMV-specific data provided by the RBNZ,

148 [ ]

149 [ ]

150 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [92-94].

which is based on submissions from insurers. Vero's estimates appear to be based on ICNZ data, which discloses only the total general insurance (commercial and personal) revenue for each major insurer. We therefore do not consider that Vero's estimated market shares are accurate.

141. Table 2 shows that IAG, Vero and Tower are currently the top three suppliers of HCMV insurance in terms of market share.[151]

142. Vero submitted that HCMV markets would not be highly concentrated post-merger.[152] However, in its 2014 submission to the Commission on the *IAG/Lumley* clearance application, Suncorp stated that HCMV markets are "already highly concentrated".[153] The table shows that the merged entity and IAG together would account for around [ ]% of HCMV markets. The next largest insurer, FMG, would have a [ ]% market share with the next two largest each having less than [ ]%. We consider that the market shares indicate that already concentrated HCMV markets would be highly concentrated post-merger.

143. Vero also submitted that the Commission cleared IAG's acquisitions of Lumley and AMI which involved the aggregation of a larger market share than Vero's proposed merger with Tower, and the Commission did not characterise those acquisitions as involving a significant change in IAG's market share.[154] However, the Commission noted in *IAG/AMI* that the merged entity would continue to face competition from Vero, Lumley and Tower, which the Commission described as "well-resourced and established insurance companies with trusted and respected brands".[155]

144. In *IAG/Lumley*, Lumley's market share in HCMV markets was [ ] Tower's current market share.[156] Approximately [ ] of its market share was in the white label channel, with [ ] in the direct channel.[157] In that decision, the Commission noted that the merged entity would continue to face competition from Vero and Tower.[158]

145. If the proposed merger proceeded, only Vero would remain of those insurance companies listed above which we previously identified as being well-resourced, established and with trusted and respected brands. This level of concentration raises significant competition concerns.

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151 [ ]

152 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [60].

153 Submission from Suncorp to the Commerce Commission on *IAG/Lumley* clearance application (21 February 2014) at 10.

154 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [65].

155 IAG (NZ) Holdings Limited and AMI Insurance (Operations) Limited [2012] NZCC 6 at [66].

156 Lumley's market share was approximately [ ]%.

157 IAG (NZ) Holdings Limited and Lumley General Insurance (N.Z.) Limited [2014] NZCC 12 at 15.

158 Ibid at [112-113].

Competitive constraint that would be lost as a result of the merger

146. We assessed the extent to which Tower would continue to compete with Vero, IAG and other insurers in the counterfactual to understand the competitive constraint that would be lost as a result of the merger.

147. Vero submitted that Vero and Tower are not each other's closest competitors in HCMV markets.[159] It stated that Tower has not been a particularly vigorous, innovative or aggressive competitor and its removal from the market would not significantly reduce the competitive constraints on IAG or Vero.[160]

148. For the reasons set out below, we consider that, without the merger, there would continue to be significant competition between Tower and Vero and that the constraint that would be lost as a result of the merger would likely be substantial. We consider that Tower would also continue to be an independent source of competition to IAG and other insurers.

Constraint between Tower and Vero

149. Vero and Tower are likely to be considered close substitutes by many customers.[161] The strongest area of competition between Vero and Tower is likely to be in the direct channel, where Vero's joint venture AA Insurance and Tower both sell HCMV insurance.

150. AA Insurance and Tower both have well-established and high-profile general insurance brands which score highly on brand-awareness.[162] The strength of Tower's brand is a key attraction for parties interested in acquiring Tower. Suncorp Board documents discussing the merger [ ],[163] while Fairfax told us that [ ].[164] However, AA Insurance noted that [ ].[165] This is potentially reflected in Tower's lower market share.

159 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [96].

160 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [70].

161 We also note that it is not necessary for the two merging firms to be each other's closest substitutes overall, as long as a significant proportion of consumers consider the merging firms' products to be close substitutes. See Shapiro "The 2010 Horizontal Merger Guidelines: From Hedgehog to Fox in Forty Years" at [719-720].

162 [ ]

163 [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017).

164 Commerce Commission interview with Fairfax (7 April 2017).

165 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017).

151. [[166]

[167]

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152. There is currently some differentiation between the two brands as AA Insurance tends to score higher on key brand metrics than Tower. Tower's brand has struggled with some negative perceptions in more recent times, while AA Insurance is the market leader in terms of positive perceptions.[168]

153. However, Tower's current strategy involves re-positioning its brand, to compete more effectively with AA Insurance.[169] For example, Tower intends to shift to a brand proposition based on "simple and easy insurance from someone you trust", with a focus on simple products and a "simple and easy claims process".[170] Similarly, AA Insurance markets itself as "New Zealand's most trusted insurer" with "easy, stress-free claims".[171] Tower told the Commission that [ ].[172]

154. [ ] indicate that AA Insurance and Tower supply broadly similar products in HCMV insurance although there is some differentiation.[173] This is consistent with Tower's assessment of the product offerings of it and AA Insurance.[174]

155. AA Insurance's internal documents generally indicated [ ].

155.1 Tower was the first major insurer in New Zealand to resume offering full replacement cover for fire for house insurance following an earlier market-wide shift to sum insured after the Canterbury earthquakes. AA Insurance

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166 [ ]

167 [ ]

168 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

169 Commerce Commission interview with Tower (30 May 2017).

170 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017) at 6.

171 https://www.aainsurance.co.nz/.

172 Commerce Commission interview with Tower (30 May 2017).

173 [ ]

174 Commerce Commission interview with Tower (23 March 2017).

noted that [ ].[175] AA Insurance has since introduced full replacement cover for fire, as well as flood and storm,[176] while Vero launched its SumExtra product, which offers additional cover of up to 10% of the sum insured.[177]

155.2 Tower was also the first insurer in New Zealand to introduce a telematics product with its SmartDriver app.[178] The app, which won the Innovation of the Year award at the 2014 New Zealand Insurance Industry awards, utilises a smartphone's inbuilt GPS and accelerometer to measure how far, and how well, the policy-holder drives.[179] AA Insurance considered that [ ].[180] No other insurer has developed a telematics product in response, although IAG acquired a telematics business in April 2017.[181] [ ][182]

155.3 In a review of competitors' online offerings, AA Insurance noted that [ ].[183] AA Insurance [ ]. Another document noted that [ ].[184]

155.4 A NERA report submitted by Vero shows that, [ ].[185]

156. AA Insurance makes a number of observations [ ]. For

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175 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017).

176 https://www.aainsurance.co.nz/newsroom/press-releases/aa-insurance-introduces-replacement-cover.html.

177 https://www.vero.co.nz/newsroom/vero-announces-sumextra.html.

178 http://www.nzherald.co.nz/personal-finance/news/article.cfm?c_id=12&objectid=11271711.

179 http://smartdriver.tower.co.nz/.

180 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017).

181 http://www.stuff.co.nz/business/money/91237755/insurer-iag-buys-telematics-company.

182 [ ]

183 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017) at 6.

184 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017).

185 Report from NERA (on behalf of Vero) to the Commerce Commission (19 May 2017).

example, one of its Board documents commented that
[
].[186]

157. Tower's internal documents also indicated that it closely monitors its competitors' pricing movements – including AA Insurance – and seeks both to proactively price more competitively to grow sales and also to respond to changes in competitors' pricing.

157.1 In October 2016, Tower's Chief Executive reported to the Board that "AA Insurance continues to marginally adjust their house prices in addition to changes they put through in September. Similar to Tower's recent house price changes, AA Insurance have removed some cross subsidisation in the house market. This resulted in their Wellington company premium going up by 3.5% with other regions dropping 1.5%".[187]

157.2 In January 2016, Tower noted that "[t]here is continued uplift in sales from [TradeMe] and strong sales in TOWER Direct brand compared to FY15 due to more competitive pricing".[188]

157.3 In response to a concern about lower sales, Tower noted that "the trend is expected to improve with changes to House pricing coming and Redbook re-pricing for Motor achieving a more competitive market position once implemented and also from development of a range of tactical responses aimed at improving GWP".[189]

157.4 A June 2015 document, which discusses portfolio growth as a key focus, notes "[t]argeted pricing interventions for renewing customers continue, and additional price reductions have been applied to new business Direct and Alliance channels. We are monitoring these closely to test whether they are increasing policy sales volume".[190]

157.5 In April 2016, Tower stated that "we are looking at making a rapid change to Cover4Car online Motor pricing in order to attract customers online to quote and buy without the need for the sales agent. In this rapid review we are adjusting price to be more competitive, where justified from a loss ratio point of view, in order to grow those segments. In addition to the pricing change,

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186 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017) at 7.

187 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

188 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

189 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

190 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

customer functionality will be updated and there will be marketing activity to lead customers to this channel".[191]

157.6 In relation to motor vehicle insurance, Tower noted in July 2016 that "[w]ith claim results adverse to plan, strong policy growth and small competitor price increase over the last few months there appears to be room to reduce the average 10% new business discount compared to renewal premium we are currently applying at point of sale for TOWER Direct".[192]

157.7 Tower describes its multi-policy discount of up to 20% across three or more policies as "market leading".[193] In a pricing proposal for [ ], Vero noted that a [ ].[194] [ ] also observed that Tower had been "aggressive in bundling contents, house and motor vehicle insurance".[195]

158. The evidence also indicates that Tower views AA Insurance as a strong source of competition. Tower's internal documents refer to AA Insurance as a top performer,[196] and Tower told us that [ ].[197]

159. Absent the merger, there would likely continue to be competitive interaction between Vero and Tower through their underwriting of white label insurance. Vero currently underwrites for ANZ, AMP and Warehouse Money, while Tower underwrites for Kiwibank, TSB and TradeMe.

160. In particular, TradeMe's entry into HCMV markets has caught the attention of competitors. Tower noted that its TradeMe platform "has significantly higher flexibility than our own and will allow us to rapidly target [pricing] changes".[198] Tower told us that TradeMe is the only market participant with a full end-to-end digital offering (from quote to buy to claims).[199] AA Insurance observed that [ ].[200]
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191 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

192 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

193 [ ]

194 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017) at 5.

195 [ ]

196 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017) at 12.

197 Commerce Commission interview with Tower (30 May 2017).

198 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017).

199 Commerce Commission interview with Tower (10 July 2017).

200 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017) at 10.

[ ][201] NERA's report showed that [ ].[202]

161. Some third parties indicated that Tower imposes a significant competitive constraint. For example, [ ] said that Tower has kept Vero and IAG "honest",[203] while [ ] considered that the removal of Tower as an independent competitor could impact on pricing and innovation.[204] [ ] said that the merger would give Vero and IAG collective control of a significant portion of personal lines markets, skewing offers for consumers.[205] [ ] view was that the market would see restrictions to cover and changes to pricing of risk following the merger. Dr Michael Naylor (an academic expert on insurance) described Tower as the last "remaining competitor of any significance" and considered that "its removal would have a significant adverse impact on the market".[206]

162. The evidence above indicates that Tower is currently generating competitive tension in HCMV markets and exerting a significant constraint on Vero, despite its relatively muted performance in recent years. As we noted above, Tower is actively seeking to reposition its business to make it more competitive in HCMV markets. We expect to see Tower continuing to generate competitive tension in HCMV markets by investing in a new IT platform, innovating, improving its products and services, growing its online presence, and engaging in more sophisticated pricing. The loss of competition between Tower and Vero would therefore be material.

163. Under third party ownership, we consider that Tower would likely generate additional competitive tension. The proposed merger would eliminate this prospect of a more vigorous third player in HCMV markets competing against Vero and other insurers.

164. Accordingly, we consider that Tower (under third party ownership or as a standalone entity) would continue to generate competitive tension in HCMV markets, and the loss of the constraint between Tower and Vero would be material. We also consider that the intensity of competition between Tower and Vero would likely be enhanced under third party ownership of Tower.

Constraint Tower imposes on IAG and other insurers

165. We also assessed the constraint that Tower imposes on IAG and other insurers in HCMV markets. While this constraint would continue to exist to some extent with

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201 [ ]

202 Report from NERA (on behalf of Vero) to the Commerce Commission (19 May 2017).

203 [ ]

204 [ ]

205 [ ]

206 Submission from Dr Michael Naylor to the Commerce Commission (6 April 2017).

Tower under Vero ownership, the merger would eliminate an independent source of differentiated price, product and service competition, given that [ ].[207]

166. [ ]

166.1 [ ][208]

166.2 [ ][209]

166.3 [ ][210]

166.4 [ ][211]

166.5 [ ][212]

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[207] See above at [114].

[208] [ ]

[209] [ ]

[210] Ibid.

[211] [ ]

[212] [ ]

167. When asked about its view of Tower in HCMV markets, IAG stated that [ ].[213] [ ]

168. We expect that Tower (under third party ownership or as a standalone entity) would continue to seek to adopt differentiated pricing positions, innovate, and reposition its products and service levels in order to compete against IAG. Given [ ], the merger would result in the loss of that independent source of competition. In this context, we note that Vero's valuation of Tower contemplates [ ][214] [ ].[215] This indicates that it is likely there would be little independent decision-making of substance in relation to Tower with the merger.

169. We found a limited amount of evidence on the extent to which Tower competes against other insurers with a smaller market presence. The main focus of Tower's competitor comparisons was on Vero and IAG, which likely reflects that they currently account for about [ ]% market share in HCMV markets.

170. [ ] told the Commission that the merger would remove Tower as one of its competitors.[216] [ ] said in an interview that Tower is a fading brand and is not the same strong competitor of the larger insurers.[217] [ ] comment likely reflects Tower's recent muted performance. However, as we discuss above, the evidence shows that Vero and IAG view Tower as a significant source of competition and that Tower exerts a significant competitive constraint.

<u>Conclusion on constraint that would be lost as a result of the merger</u>

171. In conclusion, we consider that Tower and Vero would continue to be significant competitors to each other should the merger not proceed, and that competition is likely to intensify with Tower under third party ownership. The evidence indicates that Vero closely observes Tower's behaviour in HCMV markets and is likely to take that into account when deciding on its competitive offering. Tower also closely monitors Vero's behaviour and [ ]. The loss of competition between Tower (under third party ownership or as a standalone entity) would therefore likely be significant.

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213 Commerce Commission interview with IAG (6 April 2017).

214 [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017).

215 [ ] provided under the cover of a letter from Suncorp to the Commerce Commission (13 March 2017).

216 [ ]

217 [ ]

172. The proposed merger would also result in the loss of Tower as a significant independent source of competition to IAG and other insurers. This would reduce the dynamic pressure on IAG and other insurers to engage in welfare-enhancing product changes and innovation.

173. We therefore consider that the constraint lost as a result of the merger is likely to be substantial. In the next section, we assess whether there would remain sufficient competition in HCMV markets from other insurers such that the merger would not be likely to result in a substantial lessening of competition.

Constraint from existing competitors

174. We consider that the constraint from other existing competitors would not be sufficient to counteract the loss of constraint which would be likely to result from the proposed merger.

Constraint from IAG

175. Vero submitted that IAG (along with Youi) is its closest competitor and the most significant competitive constraint on Vero in HCMV markets, by a large margin.[218]

176. IAG is the largest supplier of HCMV insurance in terms of market share. It has two direct brands (AMI and State Insurance), several large banks as white label partners, and two brands (NZI and Lumley) operating in the broker channel. Some third parties suggested that IAG is "dominant" in HCMV markets.[219]

177. We consider that the main area of competition post-merger would be between IAG and the merged entity given their combined market share of [ ]% and IAG's size and presence in each of the distribution channels. This is especially the case because, as we discuss below, the remaining competitors are small, lack scale, are less well-known brands and are likely to have a limited competitive impact.

178. We therefore considered whether the constraint from IAG would be sufficient to counteract the loss of Tower as an independent competitor. Vero submitted that the merged entity and IAG would "compete fiercely" following the merger.[220] However, our view is that IAG could not be relied on to counteract the constraint lost from the merger.

179. First, this merger would result in the reduction of significant competitors in HCMV markets from three to two. In our *Warehouse* decision, we noted that "[a]s a general rule of thumb, a merger that reduces the number of competitors from three to two is, *a priori*, likely to reduce levels of rivalry to the detriment of customers".[221]

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218 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at 72.

219 [ ]

220 Submission from Suncorp to the Commerce Commission (21 April 2017) at [35].

221 Foodstuffs (Auckland) Ltd, Foodstuffs (Wellington) Co-operative Ltd, Foodstuffs (South Island) Ltd and The Warehouse Group Limited (Commerce Commission Decision 606, 8 June 2017) and Woolworths Limited and The Warehouse Group Limited (Commerce Commission Decision 607, 8 June 2017) at [193].

180. On appeal of that decision, the Court of Appeal held that "the Commission was right to give weight to the theoretical concerns raised by a 3:2 merger in markets such as these, characterised by high barriers to entry".[222] Given our view below that significant expansion in HCMV markets is unlikely if the merger proceeds, the reduction in significant competitors from three to two as a result of this merger raises significant competition concerns.

181. Second, standard economic theory suggests that it is likely that, post-merger, a profit-maximising non-merging rival like IAG would likely raise its prices or reduce quality in response to a price increase or quality reduction by the merged entity. Indeed, this response is predicted by a merger simulation conducted by NERA on behalf of Vero, which we discuss below.[223]

182. In this case, we consider that the merged entity would likely raise its prices and/or reduce quality given the removal of the significant competition between Vero and Tower.[224] IAG would then likely face some shift in demand towards its products (particularly those sold via its direct and white label channels) as some customers of the merged entity would switch away. This shift in demand would give IAG the incentive to respond by raising prices and/or reducing quality to the extent that doing so would not result in significant sales being diverted to other non-merging insurers in HCMV markets. For the reasons outlined below regarding the constraint provided by other non-merging insurers, our current view is that such diversion is unlikely. The outcome of this dynamic would be a post-merger equilibrium characterised by higher prices and reduced quality across HCMV markets compared to the pre-merger equilibrium.

183. Therefore, rather than IAG competing post-merger in a way which would prevent a deterioration in the competitive offerings of it and Vero, we expect that IAG would likely raise prices and/or reduce quality in response to Vero's price increases and quality reductions. We also note that IAG would be unable to replicate Tower as an independent source of product changes, pricing positions and innovation.

184. Vero submitted that "the suggestion that Suncorp and IAG would not compete hard against each other is not borne out by real market evidence. Those two competitors

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222 *Commerce Commission v Woolworths Ltd* (CA) above n10 at [200].

223 NERA's simulation predicted market-wide price increases which incorporated increases by the merged entity and non-merging competitors. Non-merging competitors' predicted price increases varied in proportion to their market shares, and IAG's were accordingly the largest. This is a common result from simulations, like NERA's, that are based on models of 'Bertrand' competition appropriate to markets for differentiated products. We note that the price increases attributed to different firms can depend on the model of demand employed, as demonstrated by Crooke et al, 'Effects of Assumed Demand Form on Simulated Post-merger Equilibria', *Review of Industrial Organisation*, (1999). Predicted price increases can also depend on how the demand model is calibrated to pre-merger data. The seminal result that rivals can generally be expected to raise prices in response to mergers in Bertrand settings was demonstrated by Deneckere and Davidson, 'Incentives to Form Coalitions with Bertrand Competition', *RAND Journal of Economics*, (1985). It is taken up by Werden and Froeb, 'Unilateral Competitive Effects of Horizontal Mergers' in *Advances in the Economics of Competition Law*, MIT, (2005).

224 Again, this effect is predicted by NERA's simulation.

do compete strongly today, as they do in Australia".[225] We address the claim that Vero and IAG would compete hard against each other in the coordinated effects section below. The evidence that we detail there shows that there is a real chance that, rather than competing hard, Vero and IAG would engage in parallel accommodating conduct. This raises the prospect of higher prices and quality reductions in addition to those predicted in our unilateral effects analysis.

Constraint from other insurers

185. A number of other small insurers are currently active in HCMV markets. We are not satisfied that these other insurers, either individually or in combination,[226] would be likely to provide sufficient additional constraint to counteract the loss of competition as a result of the merger.

186. Overall, these small insurers do not provide as significant a constraint as the main competitors because they target only certain market niches or supply only via certain channels, and lack the scale, brand awareness or reputation of Tower, Vero or IAG. In this regard, these competitors are materially different in key facets to the three largest HCMV firms.

187. FMG, at [ ]% market share, is the largest of the other insurers. FMG describes itself as "New Zealand's leading rural insurer", and is a mutual owned by its members.[227] FMG is incorporated under the Farmers' Mutual Group Act 2007, which provides that the principal business of FMG "must at all times consist of the provision by [FMG]…of rural risk insurance". FMG's constitution defines "rural risk insurance" as any contract of insurance which is "predominantly rural in character".[228]

188. FMG sells insurance direct to consumers and has no involvement in the broker or white label channels. It told the Commission that
[ ].[229]
[ ]

189. Our view is that FMG is significantly differentiated from the larger mass-market insurers which target customers in all areas. FMG told the Commission that
[
].[230]
[

[225] Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [31].

[226] Vero submitted that the aggregate impact of other competitors is more significant than Tower, claiming that the market share of other insurers is [ ]% compared to Tower's [ ]%. However, our market share calculations show that other insurers account for less than [ ]% market share, while Tower's share is about [ ]%. Further, that [ ]% market share consists of a fragmented tail of small competitors which, as we discuss below, have limited competitive impact.

[227] https://www.fmg.co.nz/about-fmg/the-fmg-difference/why-fmg/.

[228] FMG Constitution.

[229] Commerce Commission interview with FMG (3 April 2017).

[230] Ibid.

]231

190. This view is consistent with the views of third parties. [ ] observed that FMG is a specialist insurer focussing on insurance of rural farms on the commercial side more than personal general insurance,[232] while [ ] described FMG as "just a rural player".[233] Dr Michael Naylor said that FMG (as well as MAS) cannot be regarded as being in the same market place as Vero, as it pursues a different customer base.[234] In Suncorp's 2014 submission to the Commission on the *IAG/Lumley* clearance application, it described FMG as operating "in a niche, servicing almost exclusively rural customers".[235]

191. Given FMG's rural focus, it is likely competing for a niche of the IAG, Vero and Tower customer base. While the constraint that FMG exerts in relation to that subset of customers is likely to be material, we do not consider that it would be likely to strongly constrain the merged entity.[236]
[
]

192. MAS is the next largest insurer in HCMV markets, but with a much smaller market share of [ ]% achieved since it began operating in 1921. It is a mutual which targets members typically from the medical or other professions.[237] Non-professionals can apply for membership, although MAS assesses such applications on a case-by-case basis. Because MAS is small, offers insurance to its members only, and has a niche focus on professionals, we do not consider that it would be likely to significantly constrain the merged entity.

193. Youi is the only other competitor with a market share of over [ ]%. Vero submitted that Youi (alongside IAG) is its closest competitor, and has made an impact which belies its size.[238]

194. The evidence suggests that Youi had a significant impact when it first entered HCMV markets in 2014 as it invested heavily in advertising and gained brand awareness.

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231 Ibid.

232 [ ]

233 [ ]

234 Submission from Dr Michael Naylor to the Commerce Commission (6 April 2017).

235 Submission from Suncorp to the Commerce Commission on *IAG/Lumley* clearance application (21 February 2014) at 5.

236 Vero submitted that competition is for customers, not geographic areas or customer segments, and therefore FMG's brand presence in rural areas does not mean it is not a significant constraint to Vero. Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [111].
[
]

237 https://mas.co.nz/about-mas/.

238 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [74].

[[239]][240]

195. A number of industry participants acknowledged that Youi's entry has had an impact on the market and resulted in an increase in competition. [ ], for instance, stated that there is more competition with the entry of Youi, particularly in motor vehicle insurance.[241] [ ] comment appears to reflect Youi's divergent market shares for house and contents insurance ([ ]) and motor vehicle insurance ([ ]).

196. However, Youi remains small, with a market share of [ ]%. [ ][242] Youi told the Commission that [ ].[243] Youi also indicated that [ ].[244]

197. Some industry participants have observed the challenges that Youi has faced in growing market share.

197.1 In June 2016, Tower internally commented that Youi's growth had plateaued.[245] Tower also noted that Youi has not achieved a huge amount of penetration.[246]

197.2 In September 2016, AA Insurance internally commented that [ ].[247]

197.3 [ ][248] [ ][249]

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239 [ ]

240 [ ]

241 [ ]

242 E-mail from Youi to the Commerce Commission (21 April 2017).

243 Commerce Commission interview with Youi (6 April 2017).

244 E-mail from Youi to the Commerce Commission (21 April 2017).

245 [Tower "ICNZ Market Share Summary June 2016" (June 2016)] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017) at 3.]

246 Commerce Commission interview with Tower (23 March 2017).

247 [ ] provided under the cover of an e-mail from AA Insurance to the Commerce Commission (19 April 2017) at 13.

248 [ ]

249 [ ]

198. We also note that Youi is significantly differentiated from mass-market insurers such as AA Insurance and Tower. [ ][250] AA Insurance estimated that [ ],[251] and Youi said that [ ].[252]

199. Youi told us that [ ].[253] [ ][254]

200. Accordingly, while we consider that Youi has had a competitive impact even at [ ]% market share since its entry, particularly in certain areas and in relation to certain customers, we do not consider that Youi could be relied on to replace the competitive constraint that would be provided by Tower in the counterfactual.

201. A number of other insurers (eg, QBE, Chubb and Ando) are currently minor players in HCMV insurance offering cover through brokers. None of these insurers have a market share of more than [ ]%.

202. We are not satisfied that these competitors, at their current size, would be likely to significantly constrain the merged entity. Additionally, the evidence discussed above suggests that insurers selling in the broker channel are a weaker constraint on insurers in the direct and white label channels.

Constraint from white label partners

203. Vero submitted that white label partners provide a competitive constraint by negotiating with underwriters for better prices and terms for the HCMV products they distribute.[255]

204. Currently, Vero and Tower are two of only three insurers (the other being IAG) with experience in New Zealand of underwriting for banks and other white label partners. No other industry participants have underwritten white label insurance offerings in the last decade.

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250 Commerce Commission interview with Youi (6 April 2017) and [ ].

251 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017) at 9.

252 Commerce Commission interview with Youi (6 April 2017).

253 Ibid.

254 [ ]

255 Application at [8.43].

205. Some white label partners that we spoke to were concerned about the potential impact of the merger, indicating that it would result in the loss of an option and therefore less bargaining power. [ ] said that, aside from [ ], Tower is the only other viable option to underwrite for it.[256] It considered that the presence of Tower and Vero assists in its negotiations with [ ]. [ ] told us that, should it re-tender its underwriting requirements, the removal of Tower could make a big difference to the quality of offerings.[257] [ ] was concerned that the reduced choice would leave it with less negotiating power.[258] [ ], on the other hand, did not express any concerns.

206. [ ][259]

207. This means that there remains the prospect for the merger to reduce options for all white label partners. In any event, we consider that the impact of the merger could be particularly significant for challenger banks and non-traditional white label partners. We note, for example, that [ ].

208. We therefore consider that the merger would likely remove a credible option available to white label partners, which would reduce their bargaining power.

209. In any event, there is evidence which suggests that white label partners do not strongly seek to constrain insurers on pricing and terms, as they appear to be concerned with broadly meeting the market, rather than beating or leading it. This is different to the Commission's conclusion in *IAG/Lumley*, which was based primarily on interviews with banks, where the Commission considered that banks were price sensitive.[260] However, in this investigation, we saw documentary evidence that partners are price sensitive only to the extent that prices are within a reasonable range of average market prices.[261] This is consistent with the evidence noted above that prices in the white label channel tend to be higher than in the direct channel.

210. Vero's review of HCMV policies for [ ] provides an example. After the same terms and prices had been in place for some years,

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256 [ ]
257 [ ]
258 [ ]
259 [ ]
260 IAG (NZ) Holdings Limited and Lumley General Insurance (N.Z.) Limited [2014] NZCC 12 at [98]-[103].
261 [ ]

[ ].[262]
[

][263]

211. In another example, a pricing document produced by Vero for [ ] stated that the [ ].[264]
Another document for [ ] described one of Vero's key roles as
[ ].[265]

212. A pricing proposal by Vero for [ ] compared
[ ]. For example, the document noted that
[

].[266] This indicates that
[ ].

213. Therefore, given the loss of Tower as a credible option for white label partners, and the evidence that partners do not seek to strongly constrain underwriters on pricing and terms, we do not consider it likely that white label partners would provide a significant competitive constraint.

Conclusion on existing competition

214. Accordingly, we expect that the loss of Tower as a significant third player (either under third party ownership or as a standalone entity) is likely to substantially reduce competition in HMCV markets. This concern is heightened by the fact that the proposed merger would result in only two independent competitors with the scale, brand strength, reputation, expertise and experience that, based on the current market, appears to be required for success in HCMV markets.

215. Therefore, we consider that existing competition is not likely to be sufficient to counteract the loss of competitive constraint as a result of the merger.

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262 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017).

263 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017).

264 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017) at 3.

265 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (29 March 2017) at 8.

266 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017) at 12.

Potential competition

216. In assessing whether the merger would be likely to have the effect of substantially lessening competition, we also assess whether, if prices increase and/or quality decreases, existing competitors would expand their sales, or new competitors would enter and effectively compete with the merged entity.

217. The mere possibility of entry or expansion is insufficient for us to conclude that it would constrain the merged entity.[267] We assess whether entry by new competitors or expansion by existing competitors is likely to be sufficient in extent in a timely fashion to constrain the merged entity and prevent a substantial lessening of competition. This is referred to as the 'LET test'.[268]

218. In general, we consider that entry and expansion within a reasonably short time period following a price increase or other exercise of market power is sufficiently timely. As noted above, the Commission has focussed its competition analysis over a two year period.

219. Vero submitted that the barriers to entry in HCMV markets are not significant, as evidenced by recent entry and expansion in these markets in the past two years. It stated that there is a high likelihood of entry and expansion in HCMV markets that would constrain the merged entity.[269] The tenor of this submission differs from Suncorp's 2014 submission on the *IAG/Lumley* clearance application, where it said that while "barriers can be overcome to an extent, a new entrant is likely to stick to niche areas rather than enter organically on a broad scale".[270]

220. For the reasons set out below, we consider that new entry into HCMV markets is possible, given the entry in recent years of Youi, QBE, Ando and Chubb. We saw evidence which suggested that [ ].[271]

221. However, each of those entrants remains small and we consider that neither they nor any other entrants are likely to expand sufficiently (either on their own or collectively) within a two year timeframe in response to the exercise of market power to prevent a substantial lessening of competition within the timeframe for assessment.

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267 *Mergers and Acquisitions Guidelines* above n9 at [3.98].

268 Ibid at [3.96].

269 Application at [8.25] and [8.36].

270 Submission from Suncorp to the Commerce Commission on *IAG/Lumley* clearance application (21 February 2014) at 8.

271 [ ]

222. The view we have reached here differs to some extent from the view the Commission reached in *IAG/AMI,* where the Commission considered that barriers to entry in HCMV markets were not significant.[272] Since that decision in 2012, we have had the benefit of observing entry and expansion patterns in HCMV markets and we also obtained a substantial amount of evidence in this investigation on the issue.

223. The sum of this evidence shows that, while entry is possible, expansion is difficult. In particular, we note that the most aggressive of the recent new entrants (Youi) has been unable to expand beyond [ ] market share despite operating for around three years, investing heavily in advertising and having opportunities to target competitor profits. [ ] Youi's experience indicates that there are high barriers to expansion which are likely to continue to prevent any significant expansion by smaller competitors in the event of the exercise of market power following the merger.

224. Accordingly, while there may be some prospect for new entry into HCMV markets, we do not consider it likely that new entry and/or expansion would prevent a substantial lessening of competition.[273] Nor do we consider that any threat of entry and/or expansion is likely to discipline the merged entity, given the demonstrated difficulty of significant entry and expansion.[274]

225. While we have focussed our competition analysis over a two year period, we consider that the conditions of expansion are such that there is a not real chance that significant expansion would occur over a longer timeframe. Rather, there is a real risk that barriers to entry and expansion would increase following the merger and that this merger would therefore result in a lasting structural change to HCMV markets.

Conditions of entry and expansion

226. The expected profitability of entry and expansion depends on the costs and risks associated with entry and expansion. Such conditions can reduce the likelihood, extent and/or timeliness of entry and expansion, and are relevant to the LET test.[275]

227. We consider that there is a set of conditions of entry and expansion in HCMV markets which make entry and/or expansion costly and challenging.

228. A number of conditions of entry are relevant to all three of the distribution channels.

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[272] IAG (NZ) Holdings Limited and AMI Insurance (Operations) Limited [2012] NZCC 6.at [82].

[273] [ ]

[274] See *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at [86]-[93], where the Court of Appeal, discussing the threat of entry or expansion, noted that "[i]n order to demonstrate that its proposed acquisition of Aetna will not result in a proscribed effect, Southern Cross must show that such barriers to entry and expansion as exist, as regards the medical insurance market in New Zealand, are at a level that the threat of entry or expansion is a sufficient constraint on its ability to exercise such market power as its market share might otherwise involve".

[275] *Mergers and Acquisitions Guidelines* above n9 at [3.107].

228.1 Regulatory conditions: an insurer must be licenced under the Insurance (Prudential Supervision) Act 2010. This requires the insurer to satisfy the RBNZ of a number of matters, including that it meets the RBNZ's fit and proper policy, holds an appropriate financial strength rating, and holds sufficient capital to comply with relevant capital requirements. The RBNZ's capital requirements were raised in 2016, as it implemented a new requirement for insurers to hold sufficient capital reserves to meet a 1:1,000 year insured event (previously 1:500). Vero submitted that the new capital requirement would [ ].[276] The ICNZ did not distinguish between personal and commercial insurance when it said that the new requirement "will likely discourage investment in New Zealand and be a significant barrier to entry to the New Zealand market".[277] [ ] said that it is more expensive to set up in New Zealand than overseas because of capital requirements.[278]

228.2 Obtaining underwriting data: insurers require underwriting data (including, in particular, data on risks) in order to understand, properly price and manage the risks in the market.[279] There was some indication that such data has become easier to obtain now that insurers can reverse engineer competitors' pricing data from online sources.[280]

228.3 Claims servicing capability: insurers require staff to handle claims and also access to repair networks.[281]

228.4 Reinsurance: all existing insurers, as well as any new entrant, need to access and obtain reinsurance cover.[282]

228.5 Scale: there is evidence that some level of scale is necessary to reduce costs. Vero and IAG are the two largest insurers and account for the large majority of profits in HCMV markets. Collectively, the other insurers are loss-making.[283] Indeed, a key part of Suncorp's rationale for the merger is [ ].[284]

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276 [ ]. Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [19].

277 ICNZ "Submission to Productivity Commission" (8 June 2012).

278 [ ]

279 Application at [8.25] and submission from AIG to the Commerce Commission (13 April) at [3.10].

280 [ ]

281 [ ] and submission from AIG to the Commerce Commission (13 April) at [3.13].

282 Application at [8.25].

283 Macquarie "Report on Suncorp" (June 2017). See also submission from Suncorp to the Commerce Commission on *IAG/Lumley* clearance application (21 February 2014) at [4.2].

284 [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017).

228.6 Strategic conditions: Given the scale and profitability of Vero and IAG, there appears to be scope for them to engage in strategic entry deterrence. For example, they could signal through present or past conduct that entry would provoke an aggressive response.[285] The scope for this would be enhanced following the merger, given Vero would have additional scale with Tower.

229. Other conditions of entry and expansion are more specific to a particular distribution channel.

229.1 In the direct channel, the need to invest in building a brand and advertising appears to be the most significant barrier, particularly given that those costs are sunk.[286] These costs were identified by some insurers as the main reason for not entering into the direct channel.[287] There is also likely a significant cost in setting up a call centre network, although there is also evidence that the growth of online sales is reducing distribution costs in the direct channel.[288]

229.2 In the white label channel, banks in particular are risk-sensitive and require insurers with credibility, capacity and a good reputation.[289] There are also switching costs, as there is usually a level of integration of IT systems, and banks appear to value long term relationships.[290] We discuss these conditions of entry in greater detail below.

229.3 In the broker channel, the key condition of entry appears to be the need to develop relationships and credibility with brokers.[291]

230. Some of the conditions of entry discussed above are also conditions of expansion.

230.1 A lack of scale is likely to make it costly for small insurers to expand. We saw evidence that a lack of scale makes it difficult to cover the costs of marketing which is necessary to continue to build a brand[292] and to negotiate lower prices for claims services.[293] For example, Youi noted that

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285 *Mergers and Acquisitions Guidelines* above n9 at [3.11]

286 Application at [8.25], [ ].

287 [ ]

288 [ ]

289 [ ]

290 [ ]

291 [ ]

292 [ ] and submission from AIG to the Commerce Commission (13 April 2017) at [3.13].

293 [ ]

[ ].[294]
[ ][295]

230.2 Expanding would require additional access to claims service providers, but this appears to be difficult given the scarcity of collision repair providers.[296] Youi also noted that
[ ].[297]

230.3 Strategic responses by incumbents by, for example, engaging in short-term aggressive responses to attempts at expansion.

230.4 Regulatory conditions: Youi said that,
[
].[298]
[
]

231. The evidence of entry in recent years by Youi, QBE, Ando and Chubb indicates that, while conditions of entry make it costly and challenging to enter, those conditions can be overcome. This appears to be the case particularly in the broker channel, where the conditions of entry appear to be lowest.

232. However, none of these new entrants have expanded significantly and Youi, which is the largest at [ ]% market share, remains small. FMG, which is a more established competitor in the direct channel,
[
].[299]

233. The opportunity to expand does not appear to have been limited by the absence of competitor profits to target. Vero and IAG have made the large majority of profits in HCMV markets for the last five years while all other insurers have been collectively loss-making.[300]
[
301 302

294 Commerce Commission interview with Youi (5 April 2017).
295 For example, see [ ] provided under the cover of a letter from Suncorp to the Commerce Commission (13 March 2017) at 12.
296 MTA submitted that MTA there is "a severe skills shortage in the collision repair industry. There are simply not enough qualified tradespeople to address the work required". Submission from MTA to the Commerce Commission (13 April 2017).
297 Commerce Commission interview with Youi (5 April 2017).
298 Ibid.
299 Our estimates are based on revenue data received from IAG, Vero, Tower, FMG and Youi for the years 2014-2016.
300 Macquarie "Report on Suncorp" (14 June 2017).
301 [ ]

[303]]

234. Accordingly, we consider there to be strong evidence that barriers to expansion are high in HCMV markets, making significant expansion difficult.

Entry and/or expansion in HMCV markets

235. We have identified three possible entry and/or expansion scenarios:

235.1 expansion by existing small competitors in HCMV markets (Youi, FMG, MAS, QBE, Ando, Chubb);

235.2 entry into HCMV markets and expansion by commercial lines insurers ([ ]) or competitors not currently offering general insurance in New Zealand; and

235.3 entry and expansion in HCMV markets by an underwriter securing a white label partner contract.

236. We have assessed each scenario separately below.

<u>Expansion by existing small competitors</u>

237. We are not satisfied that, should the merged entity increase its prices or reduce quality, any of the existing small competitors in HCMV markets (Youi, FMG, MAS, QBE, Ando, Chubb) would likely expand sufficiently (either on their own or collectively) to prevent a substantial lessening of competition.

238. As discussed above, Youi entered HCMV markets in 2014. On entry, it expected to become profitable within three to four years[304] [ ].

239. Youi cited a number of reasons for why it has struggled to expand significantly:

239.1 [ ];

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302 [ ]

303 [ ]

304 https://www.interest.co.nz/business/71212/south-african-insurer-youi-officially-launches-nz-targeting-iag-dominated-car-home.

239.2 [ ].[305] It also expressed concern that the merger would make it more difficult to access claims service providers, as it would further increase the numbers of service providers captured by the two large insurers.[306]
[ ];[307]

239.3 the strategic responses of incumbents: Youi told the Commission that [ ].[308] It says it has observed large insurers using cross-subsidies from classes of business or regions which a new entrant does not participate in to fund losses in the classes of business that a new entrant does offer.[309]

240. Youi told the Commission that [ ].[310] It is concerned that the merger would "potentially create an even more significant barrier to entry for new general insurance entrants into the New Zealand market".[311]

241. We have seen some evidence that is consistent with Youi's submission on the strategic responses of incumbents. AA Insurance noted that [ ].[312]
[ ] State Insurance also ran a selective marketing campaign targeting Youi and its business model,[313] [ ].[314]

242. Given Youi's [ ], and the high barriers to expansion, we are not satisfied that it would be likely to expand significantly in response to any price increases or quality reduction or that the threat of its expansion would be a material constraint.
[

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305 Commerce Commission interview with Youi (6 April 2017).
306 Submission from Youi to the Commerce Commission (6 April 2017) at 2-3.
307 Commerce Commission interview with Youi (6 April 2017).
308 Commerce Commission interview with Youi (6 April 2017).
309 Submission from Youi to the Commerce Commission (6 April 2017) at 2.
310 Commerce Commission interview with Youi (6 April 2017).
311 Submission from Youi to the Commerce Commission 6 April 2017) at 4.
312 Letter from AA Insurance to the Commerce Commission (19 May 2017).
313 http://stoppress.co.nz/news/comparative-advertising-story.
314 [ ]

]315

243. Vero submitted that FMG is well-placed to expand and stated that it had grown its GWP by about [ ]% since 2014 (although it is not clear whether this includes commercial insurance sales).316
[
]

244. We do not consider that FMG is likely to expand significantly in response to any price increases or quality reductions following the merger.
[
]317

245. FMG also told the Commission
[
] we do not expect that FMG would be likely to expand from its current niche rural focus.

246. Like FMG, MAS also has a distinct market positioning based on a niche market of medical and other professionals and would face significant barriers to expansion (including the need to shift to a mass-market brand positioning). We do not consider that it is likely that MAS would expand significantly.

247. QBE started offering HCMV products about 18 months ago through brokers and currently has $[ ] of GWP (less than [ ]% market share). QBE
[
].318 QBE stated that
[ ] we are not satisfied that it is likely that QBE would expand significantly, [ ]. In any event, as discussed above, we consider that the constraint from the insurers in the broker channel is weaker.

315
[
]

316 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [119].
317 Commerce Commission interview with FMG (3 April 2017).
318 Commerce Commission interview with QBE (5 April 2017).

248. Ando started operating in January 2016 and offers HCMV insurance through brokers. Its current HCMV insurance business in New Zealand is $[ ] GWP,[319] but [ ].[320] Ando [ ].[321] [ ] We are therefore not satisfied that it is likely that Ando would expand significantly in response to any price increases or quality reductions following the merger.

249. Chubb started offering house and contents insurance in New Zealand in January 2017. [ ] Chubb's current HCMV insurance business in New Zealand is currently less than $[ ] GWP.[322] Chubb's prospects for significant expansion appear remote.

Entry and expansion by insurers not currently in HCMV markets

250. AIG and Allianz currently sell commercial insurance in New Zealand. We are not satisfied that entry and/or expansion by these insurers or other de novo entrants would be likely to be sufficient to prevent a substantial lessening of competition.

251. AIG stated that [ ].[323]

252. [ ][324] [ ][325]

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319 Vero submitted that Ando had grown its GWP to $[ ] million. Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [119]. [ ]

320 Commerce Commission interview with Ando (26 April 2017). [ ]

321 Commerce Commission interview with Ando (26 April 2017).

322 Commerce Commission interview with Chubb (2 May 2017).

323 Commerce Commission interview with AIG (6 April 2017).

324 [ ]

325 [ ]

[

][326]

253. [

]
[327] [ ][328]
[ ]

254. Allianz exited the New Zealand domestic house and contents market in 2011. It advised us that
[
][329]

255. Apart from [ ], there is no evidence suggesting that significant de novo entry by any other insurers in New Zealand HCMV markets is likely. We consider that, given that entry or expansion in the scenarios described above is unlikely, entry and expansion by a new competitor is also unlikely.

Competitor securing a white label partner contract

256. Vero submitted that if an incumbent provider was to seek to increase prices or reduce features it offers to a white label partner, the partner would shop around for a more competitive offering. Vero said that there are a number of insurers which are well-positioned to tender for a white label contract.[330]

257. A competitor would need to secure a contract with a relatively large white label partner to impose some constraint in HCMV markets. This would likely be limited to the larger New Zealand banks.
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][331]

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326 [ ]
327 [ ]
328 [ ]
329 E-mail from Allianz to the Commerce Commission (12 April 2017) and Commerce Commission interview with Allianz (6 July 2017).
330 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [85].
331 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017) at 8.

258. We note that in *IAG/Lumley* the Commission considered that there were likely to be non-incumbent insurers that have the ability and intention to bid for bank tenders. In this investigation, we asked a number of banks about insurers entering and expanding in HCMV markets by acquiring a distribution relationship with a bank, and also a number of insurers about their prospects for securing a relationship. One bank that previously indicated it could sponsor entry is now less optimistic about doing so.[332]

259. Securing a relationship with one of the larger banks appears to be difficult. Large banks very rarely switch between insurers and often do not go to market when renewing their relationships. Instead, banks tend to develop long-term partnerships with one insurer.[333] BNZ, ASB and Westpac have all been with IAG since the mid to late 1990s, while Vero has been the underwriter for ANZ since 2008.[334]

260. However, the evidence we have seen indicates that it is possible that one or more of these large banks would seek to go to market at some point in the next three to five years and there may be additional motivation to do so if terms offered by incumbent insurers were to deteriorate.[335] We therefore talked to a number of banks about whether there are barriers to securing an underwriting contract. Banks tended to emphasise three significant barriers:

260.1 the costs of switching between insurers. These include costs associated with IT integration between insurer and bank, staff retraining and risks of a negative customer experience;

260.2 having the necessary capacity and infrastructure to handle claims processes; and

260.3 credibility and experience in New Zealand markets.[336]

261. [ ][337] A lack of capacity or capability were also relevant to [ ] which indicated that they

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[ ]

332 [ ]

333 Vero acknowledged that white label contracts with the major banks do not come up very often, noting that the [ ] contract has not come up for tender since IAG acquired Lumley.

[ ]

334 Westpac was previously with Lumley, which was acquired by IAG in 2014.

335 [ ]

336 [ ]

337 [ ]

would be unlikely to bid for a bank contract.[338] [ ] told us that it is well known that it does not have the capability to underwrite for white label partners.[339]

262. Although one large bank we talked to said it would consider non-incumbent insurers when it next goes to market, the last time it went to market it negotiated primarily with only [ ] (the incumbent) following initial discussions with [ ].[340] We consider that the long and stable relationships banks have historically demonstrated, coupled with the significant barriers to entry noted above, mean that, despite the view the Commission reached in *IAG/Lumley,* it is unlikely that with even further consolidation in HCMV markets a non-incumbent competitor would secure an underwriting contract with one of the larger banks in the short or even medium term. Banks appear to be risk-sensitive and have therefore not demonstrated a willingness to experiment with untested insurers with no significant New Zealand experience.[341]

263. [ ][342]
[ ][343]
[ ][344]
[ ]

264. Accordingly, we consider there is not likely to be significant new entry in the white label channel.

Conclusion on entry and expansion

265. We therefore consider that there is unlikely to be significant entry and/or expansion (either by individual competitors or collectively) in response to price increases or

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338 [ ]

339 [ ]

340 [ ]

341 [ ]

342 [ ]

343 [ ]

344 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017) at 8.

quality reductions following the merger. In particular, there are high barriers to expansion in HCMV markets, as demonstrated by Youi's difficulties in gaining significant market share, which are likely to prevent expansion, and/or undermine the threat of expansion, to a degree that would prevent a substantial lessening of competition. There is also a real risk that, as some market participants indicated above, barriers to entry and expansion would increase following the merger, making the prospect of significant new entry and expansion even more remote.

Countervailing power

266. A merged entity's ability to increase prices profitably may be constrained by the ability of certain customers to exert substantial influence on negotiations.[345] Countervailing power is more than a customer's ability to switch from buying products from the merged entity to buying products from a competitor. Countervailing power exists when a customer possesses a special ability to substantially influence the price the merged entity charges.[346]

267. Vero submitted that the countervailing power of individual consumers, banks and brokers would continue to provide a significant constraint on the merged entity in personal insurance markets.[347]

268. For the reasons set out below, we are not satisfied that countervailing power would be sufficient to offset the loss in competition from the merger.

269. In relation to individual consumers, we do not consider that they possess any special ability to substantially influence the price the merged entity charges, other than the simple ability to threaten to switch provider.

270. In relation to brokers, we saw evidence that brokers seek to negotiate prices and terms with insurers on behalf of their clients.[348] To the extent that brokers' negotiating power depends on the threat of switching, the removal of Tower would eliminate an outside option for brokers. [ ] said that it could access overseas markets if it was not satisfied with the terms if was being offered locally.[349] However, [ ] said that it does not want to use overseas underwriters because it wants local representation in the event of an earthquake or other event.[350]

271. Given that the constraint from insurers in the broker channel is likely to be weaker on those in the direct and white label channels, and the mixed evidence on whether brokers would use overseas underwriters, we are not satisfied that any broker countervailing power would significantly constrain the merged entity from raising prices or reducing quality.

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345 *Mergers and Acquisitions Guidelines* above n9 at [3.113].

346 For examples of the types of characteristics that may give rise to countervailing power see *Mergers and Acquisitions Guidelines* above n9 at [3.115].

347 Application at [8.41-8.49].

348 [ ]

349 [ ]

350 [ ]

272. We have considered whether white label partners would be able to exercise countervailing power by sponsoring new entry or by underwriting their own insurance (ie, self-supply). However, as a general point, we note our point made above that white label partners seek to ensure that prices and terms broadly meet the market. White label partners may therefore only seek to exercise countervailing power where they are not satisfied with the commission offered or where the service provided by an underwriter is risking the reputation of the partner.

273. We consider it unlikely that white label partners would exercise any countervailing power they might possess. As discussed earlier under potential competition, it is unlikely that a non-incumbent would secure a significant contract with a white label partner, as banks in particular are unlikely to risk introducing an untested underwriter with little New Zealand experience. Additionally, the evidence we found indicates that white label partners do not consider self-supply a plausible option, given the risks and complexity associated with underwriting insurance.[351]

Estimated unilateral price effects of the merger

274. Vero submitted that gaining Tower's market share would result in a small or very moderate increase to Vero's market share, and therefore minimal change to competitive conditions in relevant markets.[352]

275. In support of its position, Vero submitted a report by NERA which outlined the findings of a merger simulation.[353] Although NERA did not claim that available merger simulations are the best way to model the insurance industry,[354] Vero said that this simulation supported its view that the merger would not result in significant effects.[355]

276. The simulation assumed differentiated Bertrand competition and used a PCAIDS model of demand. It considered a notional market for all HCMV insurance, aggregating each insurer's shares of direct, white label and broker sales into a single share of all HCMV sales. It predicted varying post-merger price increases, by the merged entity and its rivals, depending on how its parameters were set. The parameters reflect the key assumptions of the simulation, and are:

276.1 a market-wide price elasticity of demand;[356]

276.2 a residual price elasticity of demand for Vero;[357]

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351 [ ]

352 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [61].

353 Report from NERA (on behalf of Vero) to the Commerce Commission (19 May 2017).

354 Ibid at [34].

355 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [66].

356 A measure of how much less HCMV insurance that all consumers, in aggregate, would buy in response to a given price increase by all insurers.

357 A measure of how much less HCMV insurance that Vero's customers would buy from it in response to a price rise by Vero only, given that some consumers may switch to its rivals.

276.3 assumptions about how substitutable consumers find different insurers' HCMV policies to be;[358] and

276.4 assumptions about cost efficiencies that the merged entity may realise.

277. Price increases predicted by the simulation in various scenarios (combinations of parameter settings) are shown in Table 3 below.[359]

Table 3: Simulation scenarios submitted by NERA[360]

Scenario	Market-wide predicted price increase	Merged entity predicted price increase
More elastic demand[361]	[ ]%	[ ]%
More inelastic demand[362]	[ ]%	[ ]%
Broker sales removed from the market + more elastic demand	[ ]%	[ ]
Cost efficiencies of [ ]% assumed for Tower + more elastic demand	[ ]%	[ ]

Source: NERA.

278. The NERA modelling demonstrated that price increases were likely post-merger, however, we note that NERA used estimated market shares which are significantly different to our market share estimates. For example, NERA assumed that competitors other than Vero, Tower and IAG account for [ ]% market share, while we calculated that the competitive tail accounts for less than [ ]%. For the reasons we discussed above, we do not consider NERA's market share estimates to be accurate.[363]

279. Using the Commission's estimate of market shares and an assumption of more inelastic demand, the NERA model predicts post-merger market-wide price increases of 5.7% and a merged entity predicted price increase of 9.1%. Using assumptions of more inelastic demand and marginal cost efficiencies at Tower of [ ]% produced a

358 This is usually effected by changing the 'nesting parameters' in a PCAIDS simulation. However, to analyse one of our concerns – that broker sales may be weaker substitutes for direct and white-label customers – NERA excluded broker sales from insurers' market shares, for technical reasons.

359 All scenarios predict uneven post-merger price increases across firms. Typically, the merged entity is predicted to raise prices the most, and to raise Tower prices by more than Vero prices. Rivals are predicted to raise their prices also, but by less, as optimal responses to winning sales diverted from the merged entity by its price increases. Hence predicted market-wide price increases can mask sometimes much higher predicted increases by the merged entity. This results from the fact that, in any differentiated Bertrand setting, the merged entity would internalise diversion between the parties as well as reacting to its rivals' best-response pricing functions, while the rivals would only respond to the merged entity's best-response pricing function.

360 These and some further scenarios were submitted across reports from NERA (on behalf of Vero) to the Commerce Commission dated 19 May 2017 and 7 July 2017.

361 A market-wide elasticity of [ ] and a residual elasticity for Vero of [ ].

362 A market-wide elasticity of [ ] and a residual elasticity for Vero of [ ].

363 See above at [140]. Vero and NERA appear to have employed the same estimate of market shares.

market-wide predicted price increase of 5.2% and a merged entity predicted price increase of 8.3%.[364]

280. The price increases predicted by each scenario resulted broadly as follows:

280.1 assuming more elastic demand tends to limit the price increases predicted as this assumption is effectively that consumers switch or stop buying insurance more readily as prices rise. Conversely, assuming less elastic demand leads to larger predicted price increases;

280.2 removing broker sales from the HCMV 'market' leads to larger predicted price increases because direct and white-label providers are effectively assumed to have higher market shares and more market power;[365] and

280.3 assuming cost efficiencies can reduce predicted price increases because affected insurers may then have lower profit-maximising prices.

281. NERA submitted that the Commission should give more weight to the smaller price increases predicted by the simulation, especially the market-wide increases of [ ]% to [ ]% (which were, in any event, based on inaccurate market share estimates). In particular, NERA submitted that:[366]

281.1 it is more appropriate to model demand for HCMV insurance as being relatively elastic and to discount the larger price increases produced when taking demand as being relatively inelastic;

281.2 assuming merger efficiencies (which could reduce marginal costs) reduces the price increases predicted; and

281.3 the simulation does not capture factors that may arguably constrain price increases, such as some dimensions of competition (including non-price competition and the threat of new entry) and insurers' governance and profit-share arrangements with channel partners. NERA submitted more detailed arguments regarding the latter, that:

281.3.1 Vero is restricted in its ability to raise prices, given it does not have full control of AA Insurance (and the other shareholder, NZAA, would not benefit from diversion away from AA Insurance), and white label partners are able to resist price rises; and

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364 Using our calculation of market shares leads to higher predicted price increases because doing so gives greater weight to the simulation's predictions that the merged entity would raise prices by more than rivals would.

365 The Commission had asked NERA to model the effects of brokered HCMV insurance potentially being a weaker substitute for direct and white-label customers. For technical reasons, NERA did so by removing brokered sales from the model. Doing so implies that brokered sales are not substitutable at all for consumers, rather than merely less so, and NERA argued that predicted price increases would thus be overestimates for the intended scenario.

366 Report from NERA (on behalf of Vero) to the Commerce Commission (7 July 2017) at [54-62].

281.3.2 Vero's incentive to raise prices on Tower products is muted because diversion would be to AA Insurance and its white label partners, and it must share profits with those businesses.

282. However, we consider that there is no clear evidence to support focusing exclusively on the smaller predicted price increases. Rather, we consider that equally reasonable assumptions affect the results by similar magnitudes in opposite directions. This means that the full range of modelling results should be considered. Specifically:

282.1 there is no clear evidence that it is more appropriate to assume relatively elastic demand;[367 368 369]

282.2 in relation to marginal cost efficiencies, we note that Vero's predicted synergies appear to relate mainly to [ ] and that it is difficult to measure [ ] accurately.[370] Nor were we provided with any evidence on the likely [ ] efficiencies resulting from the merger; and

282.3 we agree that the omission of some factors of competition from merger simulations can lead to larger predicted price increases, but we also note that other omissions can limit the price increases predicted. Notably, simulations

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367 NERA submitted that it was most appropriate to use [ ] for the market-wide price elasticity and [ ] for Vero's residual price elasticity. However, there is evidence that the market-wide value could be less elastic than [ ], which then reduces the residual elasticity in absolute terms.

368 Regarding the market-wide value, motor estimates are consistently around [ ], as acknowledged by NERA, and in studies other than those NERA cited. (See for example, Wong (2014), 'Applications of Price Elasticities in Auto Insurance', report by CSAA Insurance Group for the 2014 Actuarial Research Conference. Estimated new-business elasticities are larger (in absolute terms) than [ ] while retention elasticities are smaller). NERA argued that values for house and contents could be closer to [ ] largely because an Australian study estimated a value of around [ ]. But there is a significant prospect that this is an overestimate, since the same authors estimated a value of [ ] in a 2007 study (Tooth, R (2007), *An Analysis of the Demand for House and Contents Insurance in Australia*, Report for the Insurance Council of Australia, cited in the Insurance Council of Australia's *Submission to the review of Australia's future tax system*, (October 2008). Differences in the estimates could indicate statistical issues or that Australian elasticities have increased over time due to particularities of that market). Moreover, we consider it reasonable to model the chance that New Zealand demand for house insurance may be less elastic than Australian demand due to the potentially extreme catastrophe risks here.

369 NERA argued that Vero's residual elasticity should be calculated according to a formula in Landes, W and Posner, R (1981), "Market Power in Antitrust Cases", *Harvard Law Review*, 94(5), 937-996. This article suggests that a firm's residual elasticity is a multiple of the market-wide value, with the multiple decreasing as the firm's market share grows larger, and increasing when rivals can more easily expand production in response to its price increases. NERA noted that this could imply a residual elasticity for Vero of at least [ ], assuming a market-wide elasticity of [ ]. Report from NERA (on behalf of Vero) to the Commerce Commission (7 July 2017) at [56]. But with a market-wide elasticity of [ ], the Vero value is predicted to be closer to [ ].

370 Vero has estimated synergies with
[
] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (12 June 2017).

cannot capture our concern that product innovation and other dynamic competition may be more muted absent an independent Tower.

283. In relation to Vero's, and potentially the merged entity's, governance and profit-share issues, we do not consider that the merged entity's ability or incentive to raise prices would be materially limited.

283.1 In relation to Vero's ability to raise AA Insurance's prices, [ ]. We therefore consider Vero is in a position to effectively control the commercial and strategic policy of AA Insurance.[371] Vero and NZAA have agreed to [ ][372]].[373] We consider that AA Insurance would be likely to raise prices post-merger. This is because this would be an optimal profit-maximising response to an increase in Tower's prices which would result in some diversion towards (or increased demand for) AA Insurance's products. Further, to the extent that NZAA did not wish to negatively impact NZAA members, its members can be shielded from higher prices by increasing the discounts they currently receive on AA Insurance.[374] We also note that [ ][375]

283.2 In relation to NERA's suggestion that white label partners could resist price rises, the evidence discussed above indicates that white label partners are concerned with broadly meeting the market in terms of pricing, rather than beating or leading it. We therefore do not expect white label partners to seek to materially constrain any price rises.

283.3 We consider that Vero's incentives to raise Tower's prices would not be materially diminished by its profit-sharing arrangements at AA Insurance and with its white label partners.

283.3.1 AA Insurance has [ ],[376] and its internal documents [ ].[377]

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371 NERA submitted that AA Insurance is operated as a 50/50 joint venture and that the Vero chair's casting vote is not in practice exercised. Report from NERA (on behalf of Vero) to the Commerce Commission (19 May 2017) at [30]. However, we consider that the governance structure gives Vero the ability to effectively control the commercial and strategic policy of AA Insurance and there is no evidence that Vero would not exercise that ability in the future.

372 [ ]

373 [ ]

374 http://www.aa.co.nz/membership/benefits/.

375 As discussed earlier at [114].

376 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017) at 12. The document notes that

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283.3.2 The commissions Vero pays to its white label partners (between [ ]% and [ ]%) would be offset by avoiding sales and marketing expenses which are required in the direct channel. Moreover, Vero's [ ] policies are relatively expensive and have very high customer renewal rates.[378] Accordingly, the profits that Vero receives from sales diverted to white label partners as a result of an increase in prices would also approximate those earned in the direct channel.

284. Overall, the factors discussed above demonstrate that the merger simulation is sensitive to assumptions. We agree with NERA that simulations are most useful for complementing a fuller analysis including qualitative evidence.[379] Here we consider that the simulation underlines our concerns about unilateral effects, and that the evidence concerning the full range of predicted price increases should be considered. In any event, we consider that even the more modest price increases predicted could be substantial in absolute terms.

285. The average of the predicted price rises above would increase total costs to consumers post-merger by $90 million per year in HCMV markets.[380] We consider that price increases of this magnitude in HCMV markets are likely to be material to consumers, particularly as consumers in New Zealand are worried about the cost of HCMV insurance.

Conclusion on unilateral effects

286. Therefore, having regard to the likely impacts of the merger, not only in relation to price but also in terms of quality and the service offered in HCMV markets, we are not satisfied that the proposed merger will not, or would not be likely to have, the effect of substantially lessening competition in HMCV markets in New Zealand due to unilateral effects.

[ ].

377 [ ] provided under the cover of a letter from AA Insurance to the Commerce Commission (19 April 2017) at 62.

378 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017) at 10-11 and 54.]

379 Report from NERA (on behalf of Vero) to the Commerce Commission (7 July 2017) at [68]. See also US DOJ and FTC "Horizontal Merger Guidelines" (19 August 2010) at 21. "The Agencies do not treat merger simulation evidence as conclusive in itself, and they place more weight on whether their merger simulations consistently predict substantial price increases than on the precise prediction of any single simulation".

380 The range of predicted price rises would result in increased costs to consumers of between $[ ] million and $[ ] million.

Competition analysis – coordinated effects

287. 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 quality reduces and/or prices increase across the market.

288. 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. Such behaviour need not be unlawful, and includes tacit collusion such as accommodating price responses or parallel conduct.

289. Vero submitted that the relevant markets do not have any of the structural features that potentially facilitate coordinated conduct.[381] It submitted that entry is "not prohibitive" and that new entry, or expansion by fringe players, would prevent IAG and the merged entity from coordinating.[382] It also submitted that coordination in HCMV insurance would be difficult given the multifaceted nature of insurance products, the complexity in the way those products are priced and the number of channels to market.[383]

290. For the reasons set out below, we are not satisfied that the merger will not have, or would not be likely to have, the effect of substantial lessening of competition in HCMV markets due to coordinated effects. We see a substantial risk that the merged entity and IAG would closely observe each other's prices and terms, recognise that they can reach a more profitable outcome if they accommodate each other's price increases (or quality reductions), and act accordingly. This risk is likely to be substantially increased by the proposed merger, as it would reduce the number of significant competitors to coordinate with from three to two, remove Tower as the competitor best placed to disrupt coordination, and make the remaining significant competitors (IAG and the merged entity) more symmetric.

291. In carrying out our assessment, we have applied the two stage process set out in our Mergers and Acquisitions Guidelines:[384]

    291.1 we first asked whether HCMV markets have characteristics which make them vulnerable to coordination; and

    291.2 we then asked whether the merger is likely to change conditions in HCMV markets so that coordination is more likely, more complete, or more sustainable.

Are HCMV markets vulnerable to coordination?

292. A range of market features are commonly accepted as making a market more vulnerable to coordination. That is, these are market features that make it more

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381 Application at [8.51].
382 Ibid.
383 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (19 May 2017) at [94].
384 *Mergers and Acquisitions Guidelines* above n9 at 35-36.

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.[385]

293. We have identified a number of features of HCMV markets which we consider make them vulnerable to coordination.

Asymmetric transparency over prices and terms

294. Though insurance products are differentiated and prices and terms can appear complex and are not transparent for many consumers, internal documents indicate that insurers track, model and summarise rivals' prices and terms, and respond to changes in a sophisticated manner. Therefore, we consider that prices and terms for HCMV insurance products are sufficiently transparent between insurers for accommodating conduct on prices and terms to be achieved.

295. NERA submitted that the complexity of the way insurance products are priced would make any coordination difficult. However, the evidence we saw suggests that competitors' analysis of each other's pricing is detailed, and provides sufficient confidence to be used as a basis for adjusting prices.[386] We note, for instance, that [ ].[387]

296. As an example, Vero's review of [ ] policies [ ].[388] Accordingly, Vero appears confident that it can pitch its prices to rivals' with a high degree of precision – in one case commenting that: [ ].[389] Tower's own internal documents also indicate that it can accurately observe competitors' pricing and terms.[390]

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385 Ibid at [3.89-3.90].

386 Baker also notes that coordination can occur in the presence of complexity if some non-competitive outcome becomes 'focal', noting, for example, that "the use of across-the-board price increases (or common price increases for large classes of products) can simplify the task of reaching a consensus and make coordination practical for firms that cannot communicate with each other about price". Jonathan Baker "Mavericks, Mergers and Exclusion: Proving Coordinated and Competitive Effects Under the Antitrust Laws" 77 NY University Law Review 135, 161.

387 [ ]

388 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017) at 3-12.

389 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017) at 7.

390 See above at [157].

297. As pointed out by NERA,[391] in the ACCC's 2007 investigation of the merger of Suncorp and Promina it found that "…it is increasingly possible for a new or existing insurer to 'reverse engineer' a competitor's pricing book by obtaining numerous quotes via call centres and the internet".[392] NERA said that data mining techniques are likely to be significantly more sophisticated since this decision and it understands that Suncorp
[
].[393]

298. Despite NERA's submission, Vero said that,
[
]. Vero said that it
[
].[394]

299. We saw evidence that, contrary to its submission, Vero
[ ]. A document produced by Vero
[
]. The document noted that
[ ].[395] Vero then
[
].[396] And in relation to contents insurance,
[ ].[397]

300. Our Mergers and Acquisitions Guidelines note that coordinated behaviour involves firms recognising that they can reach a more profitable outcome if they accommodate each other's price increases.[398] The above conduct, where Vero has observed that [ ].

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391 Report from NERA (on behalf of Vero) to the Commerce Commission (19 May 2017) at [61].
392 ACCC "Suncorp Metway Limited – proposed acquisition of Promina Group Ltd" Public competition assessment (12 January 2007).
393 Report from NERA (on behalf of Vero) to the Commerce Commission (19 May 2017) at [60-62].
394 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [149].
395 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017) at 2.
396 Ibid at 6.
397 Ibid at 8.
398 *Mergers and Acquisitions Guidelines* above n9 at [3.85].

Accordingly, this type of conduct raises real concerns that HCMV markets are conducive to coordinated effects.[399]

301. The ability of insurers to observe competitors' pricing and make adjustments based on those observations contrasts with the degree of pricing transparency available to consumers, particularly in the absence of price comparison websites in New Zealand that are common elsewhere. As such, the complexity and range of HCMV products which may make product comparisons difficult for consumers, do not present the same difficulties for insurers themselves. Vero submitted that, "in any event, the same data [that insurers have access to] is readily available to customers, journalists, consumer groups, and any other interested parties as well".[400] We do not consider it plausible that customers and other groups would engage in the sophisticated data mining that insurers demonstrably do.

302. Furthermore, while HCMV insurers offer portfolios of differentiated products, as noted above, [ ] indicate that AA Insurance and Tower supply similar products within their respective HCMV insurance portfolios.[401] There is also evidence that differences between similar products offered by rival insurers do not tend to persist and that policy terms may be largely standardised across insurers for many products. For example, following the Canterbury earthquakes, almost all insurers switched from providing full replacement cover to sum-insured cover for house and contents policies. Following Tower's reintroduction of full replacement for fire, other insurers followed suit.

303. Vero submitted that, for the purpose of assessing whether coordination is likely, Vero's, IAG's and Tower's activities are heterogeneous because each relies on direct, white label and broker channels to different degrees.[402] We do not consider that this would prevent insurers from coordinating, within or between channels, if doing so would be profitable and so long as policies are transparent enough for coordination to be maintained. To date, all insurers have offered fairly similar terms through the bank and direct channels, and there is little evidence of banks or other white label

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399 Joseph E Harrington "Evaluating Mergers for Coordinated Effects and the Role of 'Parallel Accommodating Conduct'" [2013] 78 Antitrust Law Journal 3, at 660."A market for which price is very transparent and a firm can react to a rival's price quickly is a market that is especially ripe for coordinated effects because implementation conditions are easy to satisfy and, if price leadership and matching is likely to be embedded in firms' prior beliefs, then coordination may not to be too difficult. Thus, a market for which price leadership and matching can work is a market for which one should be especially concerned with [parallel accommodating conduct]-generated coordinated effects".

400 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [149].

401 [

]

402 Application at [8.51].

partners strongly demanding more competitive market positioning from their underwriters.[403]

Signalling activity

304. There is evidence of HCMV insurers publicly signalling future changes to their premiums and terms. For example, IAG and Vero have been quoted in the media commenting on rising claims costs in motor insurance while announcing increases to premiums[404] and excess levels.[405] These statements increase the transparency between insurers, and see them appearing to match each other's moves.

305. One article sees IAG announcing "double-digit" increases to premiums, with an AA Insurance spokesperson noting that "increasing costs were being reflected in its premiums but increases would be gradual".[406] Another article reports IAG's annual results announcement that it had started a programme to raise standard excesses on motor insurance from $300 to $400, and Suncorp's response that it is investigating whether to follow suit.[407]

306. Vero's internal documents also imply signalling activity. For example, [ ].[408]

307. A Tower internal document also indicates that insurers notice signalling activity. The document notes that "AMI recently increased its excess on comprehensive policies from $300 to $400 while holding premium rates. IAG have signalled via the media that other IAG brands will follow suit".[409]

Incentives to coordinate

308. We consider that there are incentives for insurers to coordinate.

309. Vero has submitted that the nature of demand would not favour coordination, suggesting that demand is changeable because claims rates can change suddenly.[410] However, this source of cost shocks may in fact align the incentives of reasonably

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403 [ ]

404 NZ Herald, 'More claims drive higher car insurance premiums' (12 June 2017): http://www.nzherald.co.nz/personal-finance/news/article.cfm?c_id=12&objectid=11874595.

405 Stuff, 'New Zealanders are crashing so much, giant insurer IAG is raising excesses' (4 September 2016): http://www.stuff.co.nz/business/83793500/New-Zealanders-are-crashing-so-much-giant-insurer-IAG-is-raising-excesses.

406 NZ Herald article above n404.

407 Stuff article above n405.

408 [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017) at 1.

409 [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017) at 10.

410 Application at [8.51].

symmetric insurers, since the shocks are unavoidable and common to all insurers while aggregate demand for HCMV insurance appears fairly stable and slow-growing.[411]

Limited number of significant competitors

310. As we discuss above, there are currently three significant competitors in HCMV markets with Vero, Tower and IAG. Together, these insurers account for [ ]% of market share.

Points of contact

311. HCMV insurers have points of contact through the ICNZ, in particular, which circulates quarterly industry statistics, organises working groups on key issues, and holds annual conferences. Although such points of contact are fairly common in other industries, and ICNZ statistics are market-wide averages,[412] we consider that these arrangements could favour coordination in markets as concentrated as HCMV insurance in New Zealand. For example, the ICNZ's market-wide statistics on loss ratios – a key cost – are relatively informative about losses at IAG and Vero given they currently account for [ ]% market share, which would increase to about [ ]% following the merger.

Conclusion on whether HCMV markets are vulnerable to coordination

312. We consider that HCMV markets have characteristics that make them vulnerable to coordination. In particular, product prices and terms are sufficiently transparent to competing insurers, while being opaque to many consumers, and there are incentives to achieve coordination. Additionally, coordination need not apply to all product characteristics to be beneficial to insurers.[413]

313. We also note that insurers appear to have coordinated in overseas HCMV markets that show parallels to New Zealand. Coordination has notably affected private motor markets where loss ratios can be high. For example, in Ireland – with a similar population to New Zealand's but less concentrated personal insurance markets – the Competition and Consumer Protection Commission is investigating insurers' public signalling of their future pricing intentions for motor policies, having investigated soft competition several times before.[414] We also note that authorities in the UK have investigated information exchange between personal insurers.[415]

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411 For example, [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017) at 5 and 16. New home growth is near constant and vehicle registrations are on a consistent trend, though volatile about it. HCMV markets are shown as growing at between 3% and 16% a year.

412 ICNZ quarterly statistics reports for members provide a similar level of detail as can be seen on the ICNZ's public pages at: http://www.icnz.org.nz/statistics-data/industry-data/.

413 For example, coordination only on claims excesses would reduce costs for insurers to the detriment of consumers.

414 CCPC announcement of 15 September 2016: https://www.ccpc.ie/business/opening-statement-relation-motor-insurance-premiums/.

415 In the UK, an investigation by the Office of Fair Trading (OFT) in 2010-11 found that insurers active in the personal motor market were exchanging information on future pricing intentions. The OFT accepted

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

314. 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.

315. For the reasons set out below, we consider that the merger is likely to change conditions in HCMV markets so that coordination is more likely, more complete and/or more sustainable.

Merger would materially alter the structure of the market

316. The merger would further concentrate HCMV markets by reducing the number of significant competitors from three to two. Vero submitted that reducing the number of players in HCMV markets by one should not give rise to any material coordinated effects concerns.[416] However, given the high barriers to expansion, this change would make undertaking coordinated conduct much easier to establish and/or entrench because it is easier to coordinate with only one significant rival than with two.[417] [418]

IAG and the merged entity would be more symmetric

317. Vero submitted that the fact the merger would have the effect of narrowing the market share gap between Vero and IAG does not in itself make the two more symmetrical and should not create a coordination concern.[419] However, we consider that the merger would increase the degree of symmetry between IAG and Vero.

318. The merger would increase Vero's scale significantly by adding Tower's market share and, as we discuss above, scale is important in HCMV markets. Indeed, one of Suncorp's Board documents discussing its rationale for the merger notes that

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commitments from the insurers to limit data exchange: https://www.gov.uk/cma-cases/private-motor-insurance-exchange-of-data.

[416] Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [147].

[417] Joseph E Harrington "Evaluating Mergers for Coordinated Effects and the Role of 'Parallel Accommodating Conduct'" [2013] 78 Antitrust Law Journal 3, at 661-662. "[After discussing experimental research on how coordinated effects can emerge without any communication among subjects] This body of research suggests that a merger resulting in two firms encompassing most of the market could be at significant risk of coordinated effects. Compare what happens when firm A raises price… with two rivals versus just one. With two rivals, firm B has to properly interpret firm A's price increase as an invitation to collude and it must believe that firm C has the same interpretation. In addition, firm C must have an analogous belief and interpretation. At a minimum, firm A is probably not going to raise price unless it believes: (1) firms B and C will interpret it as an invitation to collude; (2) firm B believes firm C will interpret it as an invitation; and (3) firm C believes firm B will interpret it as an invitation. In comparison, with only one rival, it may be enough that firm A believes that firm B will interpret the price increase as an invitation to collude. Thus, a merger that reduces the number of strategic-minded firms to two (there could still be a competitive fringe) could substantially reduce the amount of mutual understanding needed to generate coordinated effects".

[418] [ ] provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (29 March 2017) at 28 noted that [ ] This merger would further entrench [ ].

[419] Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [147].

[ ].[420] This increase in symmetry builds on the existing level of symmetry between Vero and IAG. Both would be large and serve all customers in the national HCMV markets, exposing them to similar loss ratios over the cycle. Their expense ratios would also likely be similar. Currently IAG's and Vero's ratios are both around [ ]%,[421] when insurers' ratios can range from 16% to 45%.[422]

Merger would eliminate competitor best placed to disrupt coordination

319. Vero submitted that Tower is [ ].[423]

320. We consider that Tower is the only insurer other than IAG and Vero with scale and a significant presence and brand in HCMV markets. Therefore, it is the best placed, and perhaps only, HCMV insurer that is sufficiently large, or could expand, such that it could successfully disrupt coordination between IAG and Vero.

321. Tower's intention to improve its own performance by challenging incumbent insurers indicates that, in the counterfactual, it would have the incentive to disrupt coordination that may otherwise exist between IAG and Vero. This is because, whether or not Tower achieves its objective to expand, key elements of its strategy relate to differentiation.[424] Tower is also likely to have a greater incentive to disrupt coordination given its market share and cost asymmetry compared to IAG and Vero.

322. We also consider that there is previous evidence of Tower disrupting the market in important ways that have benefitted consumers. One of these is its partnering with TradeMe and [ ][425] [ ].[426] Tower was also the first insurer to reintroduce full replacement cover for fire,[427] which appears to have generated a competitive response by Vero who also adopted this policy. In addition, Tower was the first insurer in New Zealand to introduce a telematics product with its SmartDriver app.[428]

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420 [ ] provided under the cover of an e-mail from Russell McVeagh (on behalf of Vero) to the Commerce Commission (26 May 2017).

421 Vero stated that its own cost ratio is [ ]% while it understands IAG's cost ratio is [ ]%. Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [149].

422 Macquarie research note (28 June 2016) provided via USB by Russell McVeagh (on behalf of Vero) to the Commerce Commission (17 March 2017) at 10-11 and [ ] provided via USB by Chapman Tripp (on behalf of Tower) to the Commerce Commission (24 March 2017) at 7.

423 Letter from Russell McVeagh (on behalf of Vero) to the Commerce Commission (7 July 2017) at [151].

424 See above at [102-103].

425 [ ]

426 http://www.stuff.co.nz/business/money/67908628/shop-around-for-insurance-chop-the-cost.

427 See above at [155.1].

428 http://www.nzherald.co.nz/personal-finance/news/article.cfm?c_id=12&objectid=11271711.

323. We consider that these examples illustrate how the presence of Tower, despite its market share being lower than IAG or Vero, can and does have a significant impact in HCMV markets to the benefit of consumers. This impact is consistent with examples in other markets where third players have had significant impacts on markets notwithstanding their smaller market shares. Although the specific characteristics of different markets can make comparisons more or less suitable, one example is the introduction of 2degrees in the New Zealand telecommunications market and the benefit its entry had for consumers.[429]

Conclusion on coordinated effects

324. For the reasons above, we are not satisfied that the merger will not have, or would not be likely to have, the effect of substantial lessening of competition in HCMV insurance markets due to coordinated effects.

Competition analysis – buyer markets

325. A merger between competing buyers could lessen competition if it increases the merged entity's ability to profitably reduce prices it pays to suppliers below the competitive level for a significant period of time. The result may be that suppliers could no longer cover their supply costs and so withdraw supply from the market.[430]

326. We consider that the merger would be unlikely to substantially lessen competition in the markets where Vero and Tower compete to buy services (eg, collision repair services, windscreen repair/replacement services).

327. The Motor Trade Association (MTA) submitted that the merger would increase buyer power in the market for collision repair services.[431] However, Tower's purchases in buying markets are likely to be less than [ ]% of the total market. This market share is lower than Tower's share in HCMV markets because commercial insurers and non-insurers also purchase claims services and Tower's market share in private motor vehicle insurance is lower than its share in home and contents insurance. A number of other significant buyers of services would remain following the merger, including [ ] which each have about an [ ]% market share in commercial motor insurance.

328. Accordingly, we consider that the merger would be unlikely to strengthen the buying power of Vero in these markets post-merger such that a substantial lessening of competition is likely to result.

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429 See, for example, Commerce Commission "Annual Telecommunications Monitoring Report 2009" (23 April 2010) at 7. We note that the cost structure of the mobile telecommunications market different significantly from that of HCMV insurance, so that the competitive dynamics and outcomes may also differ significantly. Nevertheless, we consider it provides a useful illustration of the impact of a third player in a previous two-player market.

430 *Mergers and Acquisitions Guidelines* above n9 at [4.2].

431 Submission from MTA to the Commerce Commission (13 April 2017) at 4.

Determination on notice of clearance

329. We are not satisfied that the merger will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand.

330. Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commerce Commission determines to decline to give clearance to Vero Insurance New Zealand Limited to acquire up to 100% of the remaining ordinary shares in Tower Limited by way of a scheme of arrangement under Part 15 of the Companies Act 1993.

Dated this 25th day of July 2017

Dr Mark Berry
Chairman