



COMMERCE COMMISSION

Decision No. 703

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

ASUREQUALITY LIMITED

and

PROFICIENCY SERVICES LIMITED

The Commission: Mark Berry
Stephen Gale
Gowan Pickering

Summary of Application: The acquisition by AsureQuality Limited and Proficiency Services Limited of shares in a new joint venture company which will acquire all of the New Zealand proficiency testing business assets of AsureQuality Limited and Proficiency Services Limited.

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

Date of Determination: 24 November 2010

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THE PROPOSAL

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 15 October 2010. The Notice sought clearance for the acquisition byASUREQuality Limited and Proficiency Services Limited of shares in a new joint venture company which will acquire all of the New Zealand proficiency testing business assets of its two shareholders.

THE DECISION

2. The Commission considers that the proposed acquisition would lead to aggregation of market share in the market for proficiency testing (PT) services to food and general laboratories in New Zealand.
3. The Commission considers that the combined entity is likely to be sufficiently constrained by:
 - the countervailing market power of purchasers of PT services, who have the ability to sponsor new entry; and
 - the potential for new entry from national and international firms,

Accordingly, the Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the relevant market.

ANALYTICAL FRAMEWORK

4. The Commission applies a consistent analytical framework to all its clearance decisions.¹ The first step the Commission takes is to determine the relevant market or markets. As acquisitions considered under s 66 are prospective, the Commission uses a forward-looking type of analysis to assess whether a lessening of competition is likely in the defined market(s). Hence, an important subsequent step is to establish the appropriate hypothetical future with and without scenarios, defined as the situations expected:
 - with the acquisition in question (the factual); and
 - in the absence of the acquisition (the counterfactual).
5. The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in the market between those two scenarios. The Commission analyses the extent of competition in each relevant market for both the factual and the counterfactual scenarios, in terms of:
 - existing competition;
 - potential competition; and
 - other competition factors, such as the countervailing market power of buyers or suppliers.

¹ Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004.

KEY PARTIES

AsureQuality Limited

6. AsureQuality is a state-owned enterprise (SOE) that provides, together with PT services, food safety and biosecurity services to the food and primary production sectors.
7. AsureQuality advises that PT is a small part of its business (utilising about 12 staff of a total of 1700). AsureQuality's contract with the New Zealand Food Safety Authority (NZFSA) for the PT of laboratories testing meat, poultry and shellfish is for []. It also has other contracts for the PT of laboratories analysing general products such as water, oils, soil, plants whose total value is [].

Proficiency Services Limited

8. Proficiency Services Ltd (PSL) is ultimately owned by four individuals. It provides PT and other related services. It was formed in 1999 as a result of a major purchaser of dairy laboratory PT services becoming dissatisfied with the standard of service provided by AsureQuality's predecessor² and sponsoring entry by some of that entity's staff. PSL was awarded the main dairy product PT contract. Minimal capital and a period of only four months was necessary. PSL advises it currently has seven staff and had revenue of [] million for the 2010 financial year.
9. PSL's largest contracts are with Fonterra and other laboratories which test dairy products. The value of those dairy programmes is []. Another set of PSL's contracts are with the "Raw Milk Laboratories Group" (who represent testers of raw milk) with a value of []. PSL also does PT for general testing laboratories to the value of [].

Other parties

10. AsureQuality and PSL are the two major food laboratory PT providers in New Zealand. Major food PT customers include:
 - New Zealand Food Safety Authority (NZFSA) which is the head contractor for the meat, poultry and shellfish laboratory PT programmes, although the costs for these programmes are met by the individual laboratories;
 - Fonterra's laboratories;
 - New Zealand Laboratories Services Limited (NZ Labs) which provides laboratory testing services to, amongst others, the food industry;
 - SGS New Zealand Limited (SGS) which provides laboratory testing services to, amongst others, the food industry; and
 - South Auckland Independent Testing Society Limited (SAITL) which tests raw milk samples on behalf of Fonterra and other dairy companies.

MARKET DEFINITION

11. PT concerns the quality assurance of individual laboratories' analytical standards. Laboratories take part in inter-laboratory comparison programmes (ILCP), where each of a number of laboratories submits its results from analysis of identical standard

² AgriQuality

samples supplied by a proficiency tester. The capability of each laboratory is determined by its variance (if any) from the norm of the total of the analysis results from all the laboratories tested. This analysis is carried out by the proficiency tester.

12. PT functions include:
 - the preparation of homogeneous standard samples containing pathogens or other physical contaminants that will not decay or otherwise change during transport;³
 - the logistics surrounding despatch to laboratories within the relevant testing programme;
 - receiving, analysing, reporting and storing of the test results; and
 - commissioning repeat tests from failing laboratories where necessary.
13. A critical component of PT is to ensure that a sufficient number of laboratories participate in each programme, so as to make comparison results more statistically significant.⁴ To maintain this minimum number of participating laboratories (perhaps between 6 and 10) in New Zealand's small-sized laboratory markets it is usually necessary to have only one provider, certainly for the food laboratory PT programmes.
14. A sufficiently large sample size is critical and the number of laboratories in each sector in New Zealand is small. Therefore, it is axiomatic that the PT provider that supplies PT services to the largest laboratory services operator (or group of operators) in each food industry will also be used by the other laboratory operators in the industry. Thus, there is only one firm currently providing PT programmes for each of the milk, dairy and meat industries. Competition generally occurs just when a principal contract in each industry comes up for tender. That competition is effectively competition for the market (or, in this instance, market segment).
15. The applicants have proposed the following markets:
 - the national tender market for the provision of PT services to the meat industry;
 - the national tender market for the provision of PT services to the dairy industry;
 - the national tender market for the provision of PT services to the milk industry; and
 - the national market for the provision of general PT services, excluding the tender markets referred to above.
16. However, the Commission considers that a broader market is likely to be more appropriate in this case as PT service providers appear to be readily able to switch between providing services to the dairy, milk, meat or general food laboratories. For example, AsureQuality, which had not been involved in a dairy PT programme since 1999, tendered for Fonterra's 2010 dairy PT contract. [

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³ It is noteworthy that PSL contracts out some of the microbiological preparation of its samples whereas AsureQuality does that work itself. Thus although PSL employs one microbiologist, it does not have a laboratory at all – merely a small sample preparation room.

⁴ Because the proficiency tester does not itself know the absolute correct answer as to the level of pathogen or other contaminant in the standard sample – instead it relies on the fact that if there are a sufficient number of laboratories in the programme the correct answer will be established as the mean of the test results from a number of laboratories. It is the outliers that the proficiency testing programme is attempting to expose.

17. The core requirements for a PT service supplier are the same whether the services are provided to any of the dairy, milk, meat or general food laboratories. Those core requirements are sample preparation, the logistics of sample distribution and statistical analysis of the laboratories' analytical results. It is possible for PT providers to outsource sample preparation to specialist laboratories. For example, PSL outsources some of its more technically specialised sample preparation operations.
18. Some samples are also more difficult than others to transport internationally, due to the properties of the relevant product and regulatory requirements. For example, raw milk degrades quickly and there may be delays due to border controls.⁵ However, industry participants advised the Commission that it would be possible for an overseas provider to overcome these issues and provide a New Zealand PT service by sourcing its samples from a local New Zealand office, while still undertaking the contract administration and statistical analysis from its offshore base.
19. Therefore, the Commission considers that a hypothetical monopolist in any of the above markets that the applicants identified, would be unlikely to be able to sustain a small price increase if there was an independent PT service provider in another of those suggested markets. The Commission does not consider that these narrow markets are appropriate. Rather, the Commission considers that the relevant market is that for the provision of PT services to the food and general laboratory testing industry in New Zealand.

COUNTERFACTUAL AND FACTUAL

Factual

20. The applicants advised that the main rationale for the proposed acquisition includes the current vulnerability of both PT providers to overseas competition. In the applicants' view, the acquisition would allow the combined entity greater scale and, as such, increase its ability to build the requisite testing mass to ensure statistically significant results for each testing programme. A firm with greater scale would also have increased ability to retain specialist competencies and expertise.
21. In the applicants' view, the above advantages would enhance the combined entity's ability to compete in overseas markets, which would help ensure the continuation of a viable New Zealand-domiciled PT provider in the future.
22. The applicants also advised of potential lower long-run costs for the joint venture through the rationalisation of duplicated capabilities.
23. The Commission considers that, in the factual scenario, the proposed joint venture company would continue to provide PT services to all current food and general laboratory programmes.

Counterfactual

24. Both AsureQuality and PSL advised the Commission that, absent the acquisition, they would both continue to compete in the PT market. []

⁵ Transitional facilities are approved by MAF to hold and manage imported risk goods that are brought into New Zealand. Transitional facilities are generally higher specification laboratories and not all laboratories requiring PT services would likely meet the requisite standards to be a transitional facility.

25. The Commission notes the current vulnerability of the two PT providers to the loss of their largest contracts. []. However, given the timing of the next tender rounds [] we consider it likely that both AsureQuality and Proficiency Services would remain viable businesses in the counterfactual over the next two years at least.
26. Accordingly, the Commission considers that the likely counterfactual would be the status quo.

COMPETITION ASSESSMENT

Existing Competition

27. AsureQuality and PSL are currently the two main PT providers to food and general laboratories in New Zealand. Table 1 shows the estimated market shares for PT for the 2010 financial year.

Table 1: Estimated Market Shares

| Parties | Annual revenue | Market Share |
|------------------------|-----------------------|---------------------|
| AsureQuality | [] | [] |
| Proficiency Services | [] | [] |
| <i>Combined entity</i> | <i>[]</i> | <i>[]</i> |
| Others | [] | [] |
| Total | [] | 100% |

Source: The applicants

28. Post-acquisition, the applicants' market share would be such that existing competition would be insufficient to place a competitive constraint on the combined entity.

Potential Competition

29. The applicants advised the Commission that potential entrants could readily enter the market should the opportunity arise. The applicants argued that these potential entrants pose such a competitive threat so as to constrain the combined entity.
30. Potential entrants, in the applicant's view, include 'near' domestic competitors, such as independent food testing laboratories. The applicants have argued that many of these firms have the requisite skills, experience and reputation that would allow them to relatively easily enter the PT market if they so choose.
31. However, industry participants advised the Commission of a number of reasons why such near competitors would be unlikely to enter the market:
- The New Zealand PT market is too small and commercial opportunities too limited to make entry worthwhile.
 - There is a potential conflict of interest for laboratory testing firms who also engage in PT work. Not only would such a firm be required to certify its own work but it would gain knowledge of the analytical standards of its competitors who may not wish that to occur. We received advice that AsureQuality currently has such a conflict of interest and that this conflict has provided a fillip to PSL's business.

- PT is not a core business for the so called near competitors, and thus they would prefer to outsource to an independent provider.
 - In most PT market segments, the competition is for the entire market (or market segment). Therefore, there is a risk in terms of unrecoverable sunk costs if a firm 'scales up' to compete but does not win a major contract.
32. Nevertheless, the Commission has identified one domestic near competitor with an interest in entering the market. [
-]
33. There is also the potential for international PT providers to serve the New Zealand market and thus place a competitive constraint on the combined entity.
34. NZFSA is currently letting a contract for PT services for the meat, poultry and shellfish industries. Tenders closed on 4 November 2010 and NZFSA expects to award the contract in December 2010. Under regulations relating to the quality of New Zealand's food exports, NZFSA is the head contractor for these PT services.
35. The applicants suggested that overseas PT providers would be interested in tendering for this contract. NZFSA expressed some concerns as to whether international providers would be able to send samples to New Zealand in a timely and reliable manner because of potential border quarantine issues, however, it was willing to consider international providers on their merits.
36. [
-]
37. Fonterra also undertook a tender in the last few months for a PT provider for its dairy products programmes. [
-], and PSL retained the contract. Fonterra's contract with PSL essentially includes all dairy PT business in New Zealand as other dairy company laboratories prefer to be in the same programme as Fonterra.
38. [
-]
39. The application states that international competitors are unlikely to compete in raw milk PT services due to New Zealand's onerous quarantine restrictions for raw milk imports and also due to samples becoming sour en route. SAITL, the largest raw milk PT customer, disagrees and considers that an international PT provider for raw milk laboratories could be a viable option.
40. The application states that some PT customers already use international providers, particularly for soil and plant material testing. IFM advises that it already has some PT

customers in New Zealand, and that it is hoping to increase its presence here. In general, international competition in the general PT services area appears more viable due to the relative ease of transporting less hazardous samples (e.g. oils, water, etc.). Moreover, for many of these programmes viable sample sizes are difficult to achieve in New Zealand, and therefore participation in an international programme provides more statistically significant results for customers.

41. As well as potential entry from near competitors and international providers, there is also the potential for de novo entry. For instance, in 1999, PSL entered the market quickly and with relatively low start up costs, on the basis of sponsorship by the, then major purchaser of dairy PT services. This confirms the relative ease of entry for a new firm, provided they have the requisite industry experience and reputation, should a major customer provide an opportunity.
42. In this regard, the Commission considers that entry conditions for PT are benign. This is evidenced by the following:
 - Specialist technical skills and the laboratory equipment are readily available. Moreover, some of the more demanding laboratory processes, such as sample preparation, can be contracted to third parties. For instance, PSL currently outsources some of its culture preparation work to NZ Labs. Other than that, the PT business requires skills only in ensuring the logistics of sample distribution, reception of test results, and that statistical analysis occur efficiently.
 - The only assets required to enter this market are a small warehouse, an industrial freezer, rudimentary laboratory equipment (on the basis of contracting out some of the specialised sample preparation), a data base, and small office set-up.
 - The set up time for a new PT provider is relatively short. The lengthiest part of the process is obtaining accreditation from International Accreditation New Zealand (IANZ). The Commission has been advised that this process could be as short as six months for committed firms with experienced staff.
 - Customers appear willing and able to switch PT providers if required. For instance, Fonterra and NZFSA have both recently gone to the market for their respective PT contracts.
43. The Commission therefore considers that potential entry from national or international market participants is sufficiently likely so as to place a competitive constraint on the combined entity.

Countervailing Power

44. The applicants submitted that PT customers will have the ability to exercise countervailing power on the combined entity.
45. Fonterra, NZFSA and the Raw Milk Laboratories Group are significant customers and have the ability to broker entry, should they so choose, and thus could possess countervailing power during contract negotiations with the combined entity. [

]. Moreover, there is some history of sponsorship as it was the NZ Dairy Board who sponsored PSL into the market in 1999.

46. Raw milk PT customers are likely to have additional countervailing power because raw milk customers appear to have a greater ability to self-supply, if required. This is due to an apparent greater willingness to share laboratory results with others in the industry (they already do this via weekly “ring labs” – which is essentially a mini self-supplied PT programme).
47. While smaller PT customers are likely to have less countervailing power than the entities discussed above, the combined entity would be concerned to retain sufficient laboratories in its programmes in order to have statistically significant sample sizes. We have been advised that one of the dairy PT programmes has as few as six participant laboratories. If the laboratories such as NZ Labs, SGS, Hills and others became concerned at a hypothetical strategy of the joint venture to differentially price between Fonterra and the others, withdrawal from the programme would be serious for both the joint venture, whose PT programme would lose all efficacy, and for Fonterra itself.
48. Indeed, beyond the concerns outlined in the vertical effects section below, PT customers spoken to by the Commission were generally supportive of the merger as they considered there were sufficient alternative options available should they become dissatisfied with the combined entity’s service. As discussed below, customers recognised that potential increased sample sizes that could arise from the merger would be beneficial to the testing programmes.

Other Competition Factors

Vertical effects

49. [], which compete withASUREQuality in laboratory testing markets, have concerns in relation to vertical effects of the merger. They are concerned that if ASUREQuality gets a monopoly in the PT market then it could increase their PT costs significantly and make it more difficult for them to compete in the downstream laboratory testing market.
50. However, in the Commission’s view even if the combined entity were able to increase prices above a competitive level, the proportion of laboratory testing costs accounted for by PT (approximately []) is unlikely to be large enough to implement such a price squeeze.

Efficiencies

51. PT customers have advised the Commission that, while price is always an important consideration, quality of service was the most important factor for PT programmes. [] advised that it did not want its PT provider to be on its “bare bones forcing it to cut corners” – a mistake by an analytical laboratory which missed a pathogen or contaminant in one consignment of meat or dairy products which was not identified by the relevant PT programme, could cost the food company concerned many millions of dollars. The industry recognises that PT providers need scale and surety in order to retain their business and staff.

52. Moreover, as sample size (the number of laboratories in a programme) is very important to the quality of the service, the merger may be positive for customers in programmes where AsureQuality and Proficiency Services currently overlap (e.g. water, oils).
53. The market is reducing in size as the number of laboratories consolidate, posing a risk to the future viability of some programmes. Having one provider could increase its ability to expand overseas, thus increasing the total sample size.

Conclusion

54. The Commission considers that the combined entity will be sufficiently constrained by the:
 - benign conditions of entry and the presence of at least one international market participant who is keen to enter; and
 - countervailing power of the major purchasers of PT services who have the ability to broker, and who have in the past brokered, entry.
55. Accordingly, the Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the market for the provision of PT services to the food and general laboratory industry market.

OVERALL CONCLUSION

56. The Commission has considered the probable nature and extent of competition that would exist, subsequent to the proposed acquisition, in the market for the provision of PT services to the food and general laboratory testing industry in New Zealand.
57. The Commission considers that potential competition and the countervailing power of customers is likely to be sufficient to constrain the combined entity, post-acquisition.
58. Accordingly, the Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the relevant market.

DETERMINATION ON NOTICE OF CLEARANCE

Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance to the acquisition by AsureQuality Limited and Proficiency Services Limited of shares in a new joint venture company which will acquire all of the New Zealand proficiency testing business assets of AsureQuality Limited and Proficiency Services Limited.

Dated this 24th day of November 2010

Dr Mark Berry
Chair