COMMERCE COMMISSION NEW ZEALAND
Te Komihana Tauhokohoko

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Statement of Preliminary Issues

Daiken New Zealand Limited and Dongwha New Zealand Limited

17 October 2017

Introduction

1. On 4 October 2017, the Commerce Commission registered an application seeking clearance from Daiken New Zealand Limited (Daiken) to acquire 100% of the shares in Dongwha New Zealand Limited (Dongwha) (the proposed merger).

2. The Commission will give clearance if it is satisfied that the proposed merger will not have, or is not likely to have, the effect of substantially lessening competition in a market in New Zealand.

3. This statement of preliminary issues outlines the competition issues we currently consider to be important in deciding whether or not to grant clearance.[1]

4. We invite interested parties to provide comments on the likely competitive effects of the proposed merger. We request that parties who wish to make a submission do so by **2 November 2017**.

The parties

5. Daiken is the New Zealand subsidiary of Daiken Corporation, a Japanese company specialising in the manufacture and supply of wood-based construction materials. In New Zealand, Daiken manufactures and supplies raw medium density fibreboard (MDF) from a plant it operates in North Canterbury.

6. Dongwha is 80% owned by Dongwha International Co., Limited (a company incorporated in Hong Kong) and 20% owned by Laminex Group (N.Z.) Limited (Laminex). Laminex is a subsidiary of Fletcher Building Products Limited.

7. In New Zealand, Dongwha manufactures and supplies raw MDF from a plant it operates in Southland. Its minority shareholder, Laminex, purchases raw MDF from Dongwha for its own wood products business in New Zealand and also on-sells raw MDF to other parties.

8. Daiken and Dongwha are two of New Zealand's three manufacturers of raw MDF. On completion of the proposed merger, Daiken and Laminex would enter into a product supply agreement under which the merged entity would continue to supply Laminex with raw MDF. Daiken submitted that it would supply Laminex with sufficient volumes of raw MDF for Laminex's wood product business and for Laminex to

1 The issues set out in this statement are based on the information available at the time of publication. They are not binding on us, and may change as our investigation progresses.

continue to compete with the merged entity and New Zealand's third raw MDF manufacturer, Nelson Pine Industries Limited (Nelson Pine), in the supply of raw MDF to customers in New Zealand.[2]

Our framework

9. Our approach to analysing the competition effects of the proposed merger is based on the principles set out in our Mergers and Acquisitions Guidelines.[3] As required by the Commerce Act 1986, we assess mergers using the substantial lessening of competition test.

10. 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).[4]

11. 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 Commerce Act, as a matter of fact and commercial common sense.[5]

12. We compare the extent of competition in each relevant market both with and without the merger. This allows us to assess the degree by which the proposed merger might lessen competition. If the lessening is likely to be substantial, we will not give clearance to the proposed merger. When making that assessment, we consider, among other matters:

    12.1 constraint from existing competitors – the degree to which existing competitors currently compete and the extent to which they would expand their sales if prices were increased;

    12.2 constraint from potential new entry – the extent to which new competitors would enter the market and compete effectively if prices were increased; and

    12.3 the countervailing market power of buyers – the potential for a business to be sufficiently constrained by a buyer's ability to exert substantial influence on negotiations.[6]

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2 Application at [4.11-4.13].

3 Commerce Commission, *Mergers and acquisitions guidelines* (July 2013). Available on our website at www.comcom.govt.nz

4 *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [63].

5 Section 3(1A). See also *Brambles v Commerce Commission* (2003) 10 TCLR 868 at [81].

6 Countervailing power is more than a customer's ability to switch from buying products from the merged entity to buying products from a competitor. Similarly, a customer's size and commercial importance is not sufficient in itself to amount to countervailing power.

Market definition

13. In its application, Daiken submitted that the relevant markets for assessing the proposed merger are:[7]

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

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

14. The above markets are consistent with those defined by the Commission in its 2008 *Sumitomo/CHH* decision.[8] We are likely to adopt these as relevant markets for our consideration of the proposed merger. However, in light of Daiken's submission that the degree of substitutability between raw MDF and particle board has increased,[9] we will consider whether it might be appropriate to broaden the raw MDF market to include particle board. We will also consider whether we need to define and assess the impact of the proposed merger on markets for any downstream value-added products made from raw MDF (eg, mouldings, doors, benchtops).

Without the acquisition

15. As part of our consideration of the proposed merger, we will consider what is likely to happen to Dongwha absent it being acquired by Daiken. This will include considering whether a different state of competition (other than the status quo) would be likely if a third party acquired Dongwha.

Preliminary issues

16. We will investigate whether the proposed merger would be likely to substantially lessen competition in the relevant markets by looking at the unilateral and coordinated effects that might result from the merger. The questions that we will be focusing on are:

    16.1 unilateral effects: would the merged entity be able to raise prices or reduce quality by itself?

    16.2 coordinated effects: would the merged entity be able to coordinate with rivals to raise prices?

Unilateral effects: would the merged entity be able to raise prices by itself?

17. Where two suppliers compete in the same market, a merger could remove a competitor that would otherwise provide a competitive constraint, allowing the merged entity to raise prices. A merger could also reduce competition if the target

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7 Application at [9.1].

8 Sumitomo Forestry Co Limited and Carter Holt Harvey Ltd (Building Supplies Division) (Commerce Commission Decision 637, 20 March 2008).

9 Application at [10.39].

was a potential or emerging competitor. In such a case, a merger could result in higher prices compared to the scenario without the merger.[10]

18. In its application, Daiken submitted that the proposed merger would not give rise to a material lessening of competition in the manufacture and supply of raw MDF in New Zealand because:[11]

    18.1 Dongwha NZ is a "fringe competitor" in the supply of raw MDF within New Zealand, that has long been primarily export focused and, setting aside its sales to Laminex, accounts for a very small proportion of sales in New Zealand;

    18.2 Nelson Pine is the largest competitor in the New Zealand market at present, and would continue to exert significant competitive constraint on the merged entity, including by being able to divert significant volumes destined for export to New Zealand customers if market opportunities were to arise;

    18.3 raw MDF is sold in a global commodity market, meaning that prices to New Zealand customers are pinned to conditions in that global market, rather than by standalone competitive dynamics in the New Zealand market;

    18.4 overseas manufacturers of raw MDF in Australia, Asia and South America could import and supply raw MDF in New Zealand if New Zealand manufacturers were to price raw MDF above global market levels;

    18.5 the substitutability of MDF for particle board places additional competitive constraint on the supply raw MDF in New Zealand;

    18.6 new entrants could be incentivised to enter;

    18.7 customers are highly price conscious, push back in negotiations on price increases, and are willing to switch suppliers if they can obtain a cheaper price; and

    18.8 the merger would not materially change the existing degree of competition in New Zealand because the product supply agreement that Daiken and Laminex would enter into ancillary to the merger would ensure that Laminex has sufficient volumes to continue to compete, as market opportunities arise, with the merged entity and Nelson Pine in the sale of raw MDF in New Zealand.

19. We will consider:

    19.1 the closeness of competition between Daiken and Dongwha in the supply of raw MDF in New Zealand;

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[10] Commerce Commission, *Mergers and acquisitions guidelines* (July 2013) at [3.62-3.63].

[11] Application at [1.5(c)], [10.42] and [10.44].

19.2 the closeness of competition between the Daiken and Nelson Pine in the supply of raw MDF in New Zealand;

19.3 the constraint that Laminex provides, and would provide post-merger, on the merged entity and Nelson Pine in the supply of raw MDF in New Zealand;

19.4 the ability and incentive of New Zealand raw MDF manufacturers to divert export volumes to supply raw MDF in New Zealand;

19.5 the extent to which raw MDF prices in New Zealand are constrained by prices in international markets;

19.6 entry and expansion conditions and whether entry or expansion would be likely, timely, and sufficient in extent to prevent a substantial lessening of competition;

19.7 the extent to which the supply of raw MDF in New Zealand is constrained by other, substitutable, products (eg, particle board);

19.8 potential effects on competition in downstream valued-added markets that use raw MDF as an input;

19.9 whether overseas manufacturers of raw MDF would be likely to import and supply raw MDF in New Zealand; and

19.10 the extent of countervailing power held by large customers and/or intermediaries such as building merchants.

Coordinated effects: would the merged entity be able to coordinate with rivals to raise prices?

20. A merger can substantially lessen competition if it increases the potential for the merged entity and all or some of its remaining competitors to coordinate their behaviour and collectively exercise market power such that output reduces and/or prices increase across the market. Unlike a substantial lessening of competition which can arise from the merged entity acting on its own, coordinated effects require some or all of the firms in the market to be acting in a coordinated way.[12]

21. In its application, Daiken submitted that merger would not increase any risk of coordinated effects in the manufacture and supply of raw MDF in New Zealand because:[13]

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

21.2 the market is highly competitive between Daiken and Nelson Pine in the sale of raw MDF to New Zealand customers;

12 Commerce Commission, *Mergers and acquisitions guidelines* (July 2013) at [3.84].

13 Application at [10.53-10.54].

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

21.4 the threat of imports, and the dynamics of import/export pricing will continue and, therefore, prevent the potential for any pricing coordination between the New Zealand manufacturers;

21.5 Daiken and Nelson Pine have, and would continue to have, materially different cost structures; and

21.6 applying the "ingredients for coordination", the significant majority of factors demonstrate that there would be no materially increased risk of coordination.

22. We will assess whether any of the relevant markets are vulnerable to coordination, and whether the merger would change the conditions in the relevant market so that coordination is more likely, more complete or more sustainable. Some of the factors we will consider are:

22.1 whether the characteristics of the product or service makes coordination likely. This may be the case when:

22.1.1 the products are homogenous;

22.1.2 there is little innovation and stable demand;

22.1.3 firms can easily observe each other's prices; and

22.1.4 there is repeated interaction;

22.2 whether the merger will leave any markets with only a few rivals or eliminate a vigorous competitor;

22.3 whether the firms in the market are similar (for example, in size and cost structure) such that they will have similar incentives to coordinate;

22.4 the extent to which the threat of imports and export prices will constrain the incentives and ability of the firms to coordinate in the domestic market;

22.5 whether interactions between suppliers enhance the potential for coordination; and

22.6 whether the threat of entry or the countervailing power of customers or suppliers would disrupt any attempts to coordinate.

Next steps in our investigation

23. The Commission is currently scheduled to make a decision on whether or not to give clearance to the merger by **30 November 2017**. This date may change as the investigation progresses.[14] In particular, if we need to consider the issues identified above further, the decision date is likely to extend.

24. As part of our investigation, we will be identifying and contacting parties we consider will be able to help us assess the preliminary issues identified above.

Making a submission

25. If you wish to make a submission on this merger, please send it to us at registrar@comcom.govt.nz with the reference "Daiken/Donghwa" in the subject line, or by mail to The Registrar, PO Box 2351, Wellington 6140. Please do so by close of business on **2 November 2017.**

26. Please clearly identify any confidential information contained in your submission and provide both a confidential and a public version. We will be publishing the public versions of all submissions on the Commission's website.

27. All information we receive is subject to the Official Information Act 1982 (OIA), under which there is a principle of availability. We recognise, however, that there may be good reason to withhold certain information contained in a submission under the OIA. For example, if disclosure would unreasonably prejudice the supplier or subject of the information. In assessing the confidentiality of information contained in submissions for the purposes of publication on our website, we intend to apply an approach that is consistent with the OIA.

[14] The Commission maintains a clearance register on our website where we update any changes to our deadlines and provide relevant documents: http://www.comcom.govt.nz/clearances-register/