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COMMERCE COMMISSION

Decision No. 463

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

REYROLLE PACIFIC HOLDINGS LIMITED

and

VA TECH REYROLLE PACIFIC LIMITED

The Commission:	MJ Belgrave DR Bates QC PJM Taylor
Summary of Application:	The acquisition by Reyrolle Pacific Holdings Limited of 100% of the shares in VA Tech Reyrolle Pacific Limited.
Determination:	Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition.
Date of Determination:	01 July 2002

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THE PROPOSAL

1. A notice pursuant to section 66(1) of the Commerce Act 1986 ("the Act") was registered on 7 June 2002. The notice sought clearance for Reyrolle Pacific Holdings Limited to acquire 100% of the shares of VA Tech Reyrolle Pacific Limited, a wholly owned subsidiary of VA Tech Schneider High Voltage.

THE PROCEDURES

2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. Two extensions of time were sought by the Commission and agreed to by the applicant. Accordingly, a decision on the application was required by 2 July 2002.

3. The Commission's determination is based on an investigation conducted by staff.

4. The Commission's approach is based on principles set out in the Commission's *Practice Note 4*.[1]

THE PARTIES

Reyrolle Pacific Holdings Limited

5. Reyrolle Pacific Holdings Limited ("the Applicant") is an investment consortium, which includes the Emerald Investment Group of companies, ANQ Investments Limited, Pacific General Securities Limited, Carlton-DFK Capital Limited, and a competitor of VA Tech Reyrolle Pacific – Motorpol New Zealand Limited ("Motorpol"). Of relevance to this application is Motorpol's manufacture and supply of medium voltage electrical equipment including transformers, switchgear and accessories.

Motorpol

6. Motorpol New Zealand Limited is a privately owned Auckland based company which is involved in the manufacture and supply of, inter alia, medium voltage electrical equipment, including transformers, switchgear and accessories.

VA Tech Reyrolle Pacific Limited

7. VA Tech Reyrolle Pacific Limited ("Reyrolle") is involved in the manufacture and supply of 11kV indoor switchgear and is based at Petone. More particularly, Reyrolle manufactures LMVP (vacuum) switchgear. LMVP switchgear is the only product that Reyrolle manufactures, although it may be configured in a number of ways.

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[1] Commerce Commission, *Practice note 4: The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in section 47 – A Test of Substantially Lessening Competition*, May 2001.

OTHER RELEVANT PARTIES

ABB Limited

8. ABB is part of a global technology and engineering company, ABB Group, which has its headquarters in Switzerland. In New Zealand, ABB is mainly involved in automation, and the provision of equipment for the transmission and distribution of electricity. ABB manufactures 11KV outdoor switchgear at its plant in Henderson, Auckland.

Alstom New Zealand Limited

9. Alstom New Zealand ("Alstom") is a wholly owned subsidiary of Alstom Australia, which in turn is owned by Alstom, a large multinational company with its head office in Paris, France. In New Zealand, Alstom operates in the transmission and distribution, industrial and infrastructure sectors both for product sales and service and construction. In addition, Alstom operates in the power, telecommunications, and transport sectors.

Schneider Electric (NZ) Limited

10. Schneider Electric (NZ) Limited ("Schneider") is a subsidiary of a French based multi-national company, Schneider Electric. In New Zealand, Schneider is involved in the manufacture, import and supply of very high through to low voltage electrical equipment, as well as industrial control and automation.

Siemens

11. Siemens is a multinational company with its corporate headquarters in Munich, Germany, which is involved in electrical engineering and electronics, inter alia. In New Zealand, a subsidiary company, Siemens Energy Services NZ Limited holds the service and maintenance contract for UnitedNetworks assets. Siemens New Zealand imports electrical equipment which it supplies into the New Zealand market.

Vector

12. Vector is the electricity distribution (electricity lines) company in Central Auckland, Manakau and parts of the Papkura District.

UnitedNetworks Limited

13. UnitedNetworks is the largest distribution company in New Zealand, with networks in West and North Auckland, Thames/Coromandel, Rotorua, Taupo, Tauranga, Wellington and the Hutt Valley. As such, UnitedNetworks is a major acquirer of switchgear.

Transpower

14. Transpower is the national power grid asset owner and operator. Transpower purchases a small amount of 11kV switchgear.

INDUSTRY BACKGROUND

Switchgear

15. Switchgear is a collective term for switches of all types and their associated equipment, including circuit breakers, disconnectors, and earthing switches. In the 11kV category

(typically used in electricity distribution), there are two major types of switchgear: primary or indoor, which is metal-cased and is typically housed indoors at a sub-station, and secondary or outdoor (also known as ring main switchgear), which would typically be used nearer to electricity lines in streets. As Reyrolle only manufactures 11kV indoor switchgear, this report uses the term switchgear to refer to 11kV indoor switchgear, except where expressly stated.

16. Distribution switchgear takes electricity from the source (the local utility or the on-site engine-generators) and distributes the electricity to multiple loads. Essentially switchgear operates in the same way that a switch and circuit breaker combination operates in a domestic electricity installation, controlling the flow, and overflow, of electricity from the mains to smaller electrical appliances.

17. Switchgear typically uses one of two agents to quench arcing in the circuit breaker, either a vacuum or Sulphur Hexaflouride ("SF_6"). Whilst either of these quenching agents may be used in 11kV indoor switchgear, the more common type in New Zealand uses vacuum technology. Industry participants informed staff that SF_6 is likely to be phased out over time, due to environmental concerns.

18. Reyrolle's switchgear differs from other suppliers in that its circuit breaker is located on a vertical truck as opposed to a horizontal truck. [ ]

Switchgear Sales

19. Switchgear acquirers generally put a request for tenders ("RFT") to those suppliers that have satisfied a number of conditions, and thereby gained 'preferred supplier' status. Typically three to four suppliers would be asked to tender for the supply of switchgear.

20. The tender documents are written to the specifications prepared by the distribution company's design engineers, and will include basic criteria such as compliance with IEC (International Electrotechnical Commission) standards. Where a specific type of switchgear is required, the acquiring party may shape the tender accordingly.

21. Unsuccessful tenderers are advised of the party which has won the tender, and in the majority of cases, the tenderer is advised of their comparative ranking.

MARKET DEFINITION

22. The Act defines a **market** as:

> *. . . a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.*

23. For the purpose of competition analysis, a relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, could impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the '*ssnip* test'). For the purpose of determining relevant markets, the Commission will generally consider a *ssnip* to involve a five percent increase in price for a period of one year.

24. It is substitutability at competitive market prices which is relevant in defining markets. Where the Commission considers that prices in a given market are significantly different from competitive levels, it may be necessary for it to assess the effect of a *ssnip* imposed upon competitive price levels, rather than upon actual prices, in order to detect relevant substitutes.

25. The Commission will seek to define relevant markets in terms of four characteristics or dimensions:
    - the goods or services supplied and purchased (the product dimension);
    - the level in the production or distribution chain (the functional level);
    - the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic extent); and
    - the temporal dimension of the market, if relevant (the timeframe).

26. The Commission will seek to define relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration. A relevant market will ultimately be determined, in the words of the Act, as a matter of fact and commercial common sense.

27. Where markets are difficult to define precisely, the Commission will initially take a conservative approach. If the proposed acquisition can be cleared on the basis of a narrow market definition, it would also be cleared using a broader one. If the Commission is unable to clear the proposed acquisition on the basis of the narrower market, it will be necessary to review the arguments and evidence in relation to broader markets.

Product Dimension

28. The delineation of relevant markets as a basis for assessing the competitive effects of a business acquisition begins with an examination of the goods or services offered by each of the parties to the acquisition. Both demand-side and supply-side factors are generally considered in defining market boundaries. Broadly speaking, a market includes products that are close substitutes in buyers' eyes on the demand-side, and suppliers who produce, or are able easily to substitute to produce, those product on the supply-side.

29. The Commission takes the view that the appropriate time period for assessing substitution possibilities is the longer term, but within the foreseeable future.[2] The Commission considers this to be a period of one year, which is the period customarily used internationally in applying the 'ssnip' test (see below) to determine market

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[2] In *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [1988] 2 NZLR 351 Smellie J and the Court of Appeal on appeal approvingly quoted an earlier decision of the Commerce Commission in *Edmonds Food Ind Ltd v W F Tucker & Co Ltd* (Decision 21, June 1984) where the Commission had ruled: "A market has been defined as a field of actual or potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive". See also *News Limited v Australian Rugby Football League Limited &Ors* (1996) ATPR at 41,687, where Burchett J stated: "Long term prospects that can be more or less clearly foreseen are, to that extent, a present reality, from the point of view of identifying the constraints upon commercial action. This fact emphasises the importance of the principle . . . that substitution possibilities in the longer run may be very significant for market delineation." Also *Re Tooth & Co Ltd v Tooheys Ltd* (1979) 39 FLR 1 emphasises longer run substitution possibilities.

boundaries. The Commission will take into account recent, and likely future, changes in products, relative prices and production technology in the process of market definition.

Demand-side substitution

30. Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so by a small change in their relative prices.

31. Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. Unequivocal substitutes are combined. For each initial market so defined, the Commission will examine whether the imposition of a ssnip would be likely to be profitable for the hypothetical monopolist. If it were, then all of the relevant substitutes must be incorporated in the market. If not, then the next most likely substitute good or service will be added to the initial market definition and the test repeated. This process continues until a combination of products is found which defines the product dimension of a relevant market, namely, the smallest combination of goods or services for which a ssnip would be profitable.

32. On the demand-side, the technical viability of one good or service as a substitute for another must be assessed. However, even where another product may technically be suitable as an alternative for the product in question, its price may be so much higher that it may be a poor substitute in an economic sense, at least for the great majority of buyers. In judging economic substitutability between products, the Commission will have regard to relative prices, quality and performance when assessing whether they are, in fact, close substitutes in the eyes of buyers.

33. The Applicant submitted that the relevant market for the purposes of its application is that for the supply of manufactured medium voltage electric distribution and power equipment. The Applicant defined medium voltage as 3kV to 33kV.

34. Switchgear is available in various voltage ratings with the most common in the medium voltage range being 11kV and 33 kV. Reyrolle produces just one product: 11kV indoor switchgear.

35. Industry participants considered the 11kV indoor switchgear market to be discrete, and generally rejected the proposal that other products were substitutes for 11kV indoor switchgear. Switchgear with higher voltage ratings, particularly 33kV switchgear, could feasibly be used in place of 11kV switchgear, but the former is more expensive than 11kV switchgear and is unlikely to be used. Switchgear with a lower voltage rating cannot be used where the voltage rating is 11kV.

36. The Commission considered whether outdoor 11kV switchgear might be substitutable for indoor switchgear. Industry responses indicated this option was possible, but only after the outdoor switchgear had been modified for indoor use. Industry participants did not consider indoor and outdoor switchgear to be substitutable.

37. Additional products supplied to the market include parts, repairs and acceptance of a degree of fault liability. Given the expected life of switchgear, these services might be called upon long after the initial purchase. These are mostly non-transferable between brands, so that an investment in one company's switchgear implies a future demand for

its spares, repairs and reparations in case of damage. Given the delay that may occur between installation of the switchgear and the requirement of spare parts, the Commission considers that parts, repairs and acceptance of fault liability form part of the market for the supply of switchgear.

Supply-side substitution

38. Close substitute products on the supply-side are those between which suppliers can easily shift production, using largely unchanged production facilities and little or no additional investment in sunk costs, when they are given a profit incentive to do so by a small change in their relative prices.

39. Commission staff understand that once component parts have been sourced, the assembly of switchgear is relatively simple. For instance, ABB, which manufactures 11kV outdoor switchgear at its Henderson plant, could manufacture indoor switchgear relatively easily, if it wished. [ ]

    Technically, then, there is little to prevent established electrical equipment suppliers from offering 11kV indoor switchgear to the New Zealand market.

Undifferentiated/Differentiated Products

40. In some instances, market definitional problems arise because of the differentiated nature of the goods or services involved in a business acquisition, caused by differing technical specifications, branding, packaging, warranties, distribution channels and other factors.

41. Despite the simple function of 11kV switchgear, there is a degree of differentiation in this market. Buyers and potential and actual sellers of 11kV indoor switchgear explained that the following aspects of the product were either crucial or very important to sales:

    - The reputation of the seller and the product. The relevant industry is highly conservative, a common characteristic in markets where the cost of failure is high. Purchasers scrutinise the history of the parties that tender for the supply of switchgear. Suppliers must be able to demonstrate that their switchgear is reliable and that if required, that they could supply replacement parts promptly. In addition, their product must be tested and comply with IEC standards. Purchasers often require suppliers to offer reference sites before considering the product: that is, the switchgear must be shown to be installed and working elsewhere, usually in New Zealand. Mistakes and parts defects are long remembered and manufacturers go to great lengths to impress upon purchasers that they have quality parts and techniques.

    - Technical characteristics. Sales of switchgear are project-based, meaning that products are supplied according to buyers' specifications. These specifications include physical dimensions, isolated access to the circuit-breaker (vertical or horizontal), the quenching agent (SF_6 or vacuum), control panels and busbar configuration. Each company offers various configurations of these features and all modify their basic product according to customer demand, but [

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- Colour. The preferred colour for the cabinets housing 11kV indoor switchgear is a dark grey. Any variation on this—a lighter grey, for example—is likely to be questioned by a number of customers. Some customers also use equipment colour as a functional code. The Commission understands that colour preference is linked to the conservatism of the industry.

- Timeliness. Different views were expressed on the issue of timeliness of supply. Reyrolle suggested that local manufacture gave them the advantage of being able to supply products more quickly, particularly in response to urgent demand. Other industry participants suggested that demand was rarely so urgent that proximity alone would make the locally made product more attractive.

- Price. [

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42. The market seems, in general, to prefer one type of product. Unable or unwilling to undercut Reyrolle's prices, rivals have promoted the technical advantages of their products. Attempts at product differentiation based on performance characteristics and technical innovation have not persuaded many of Reyrolle's customers who perceive the local firm to be supplying a reliable, quality product, albeit older technology. While there is a premium on brand names, and past association with a product and company, Reyrolle still need to keep their prices low to avoid losing business to rivals. The industry's view is that the market does change over time, albeit slowly, in response to demonstrated technical advantages. Vacuum and SF_6 based switchgear, for example, is replacing old oil-encased switchgear because of the inherent dangers associated with oil-encased equipment. In turn, vacuum is preferred in some cases over SF_6 because the latter is a potent greenhouse gas. However, SF_6 is still considered acceptable.

43. Some degree of product differentiation does exist, however it would seem that the major differentiator is price.

44. The Commission therefore concludes that for the purpose of assessing the competition implications of the proposed acquisition, the appropriate product market is the market for 11kV indoor switchgear.

Geographic Extent

45. The Commission will seek to define the geographical extent of a market to include all of the relevant, spatially dispersed, sources of supply to which buyers can turn should the prices of local sources of supply be raised. For each good or service combination, the overlapping geographic areas in which the parties operate are identified. These form initial markets to which a ssnip is applied. Additional geographic regions are added until the smallest area is determined within which the hypothetical monopolist could profitably impose a ssnip.

46. Generally, the higher the value of the product to be purchased, in absolute terms or relative to total buyer expenditure as appropriate, the more likely are buyers to travel and shop around for the best buy, and the wider the geographic extent of the market is likely to be.

47. Where transport costs are high relative to the final value of a product, a narrower geographic market is more likely to be appropriate. Where product perishability and other similar practical considerations limit the distance that a product may be transported, this may limit the geographic extent of the market. The timeliness of delivery from alternative geographic sources is similarly relevant.

48. Although buyers and sellers of a particular good or service may interact in markets that are apparently local or regional in extent, those markets may themselves overlap and interrelate so as to form a market covering a larger geographical area. In these situations, the larger market is likely to be the appropriate one for analysing the competitive effects of a business acquisition.

49. The Commerce Act defines a market to be a "market in New Zealand". However, in many markets New Zealand buyers purchase products from both domestic and from overseas suppliers. Where imported products are close substitutes for domestic products, the overseas suppliers will be part of the relevant market. In such circumstances the Commission, in order to comply with the wording of the Act, is likely to define a national market and then, as discussed later in the competition analysis, to consider the extent to which overseas suppliers exercise a competitive constraint on the participants in the domestic market.

50. Motorpol is situated in Auckland and Reyrolle in Petone. Both parties sell to geographically spread customers. Similarly, importers of switchgear supply to customers throughout New Zealand.

51. The Commission concludes that the geographical market relevant to the present application is that for New Zealand.

Functional Level

52. The production, distribution and sale of a product typically occur through a series of functional levels – for example, the manufacturing/import level, the wholesale/distribution level and the retail level. It is often useful to identify the relevant functional level in describing a market, as a proposed business acquisition may affect one horizontal level, but not others.[3] Alternatively, some acquisitions, such as those involving businesses at different vertical levels, may raise issues related to vertical integration. Generally, the Commission will seek to identify separate relevant markets at

[3] *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473, 502 The High Court (Greig J, Shaw WJ, Prof M Brunt) noted: "If we ask what functional divisions are appropriate in any market definition exercise, the answer, …, must be whatever will best expose the play of market forces, actual and potential, upon buyers and sellers. Wherever successive stages of production and distribution can be co-ordinated by market transactions, there is no difficulty: there will be a series of markets linking actual and potential buyers and sellers at each stage. And again, where pronounced efficiencies of vertical integration dictate that successive stages of production and distribution must be co-ordinated by internal managerial processes, there can be no market."

each functional level affected by an acquisition and assess the impact of the acquisition on each.

53. Motorpol and Reyrolle both manufacture the switchgear that they supply to the New Zealand market. Other participants in the market such as ABB, Schneider, and Alstom import switchgear through their parent companies, and only minimal assembly is usually required. However all parties are suppliers of 11kV indoor switchgear to the New Zealand market.

54. The Commission is of the view therefore, that the functional level in this instance is that of supply.

The Timeframe

55. Generally, the Commission will view markets as functioning continuously over time. However, where a market is characterised by, for example, infrequent transactions, the Commission may seek to define a separate time dimension as part of its market definition process. Time considerations are also important where there are long-term contracts, and where there are depletable resources.

56. 11kV indoor switchgear is a durable capital good, with an expected life of around 40 years. Replacement purchases are infrequent, which means that demand from industrial customers and smaller distributors is irregular, although larger customers invite tenders more regularly. Although technology is changing, the view of industry participants was that demand for products currently supplied to the market would continue for the medium to long term.

57. The Commission therefore defines the timeframe as continuous over time.

Conclusion on Market Definition

58. The Commission concludes that the relevant market is:

The New Zealand market for the supply of 11kV indoor switchgear (“11kV switchgear market”).

COMPETITION ANALYSIS

Substantially Lessening Competition

59. Section 47 of the Act prohibits particular business acquisitions. It provides that:

> A person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.

60. Section 2(1A) provides that substantial means “real or of substance”. Substantial is taken as meaning something more than insubstantial or nominal. It is a question of

degree.[4] What is required is a real lessening of competition that is not minimal. The lessening needs to be of such size, character and importance to make it worthy of consideration.[5]

61. Section 3(2) provides that references to the lessening of competition include references to the hindering or preventing of competition.[6]

62. While the Act defines the words "substantial" and "lessening" individually it is desirable to consider the phrase as a whole. For each relevant market, the Commission will assess:

- the probable nature and extent of competition that would exist in a significant section of the market, but for the acquisition (the counterfactual);
- the nature and extent of the contemplated lessening; and
- whether the contemplated lessening is substantial.[7]

63. In interpreting the phrase "substantially lessening competition", the Commission will take into account the explanatory memorandum to the Commerce Amendment Bill (No 2). The memorandum notes that:

> Two of the 3 key prohibitions are strengthened to bring New Zealand into line with Australian competition law, which will facilitate a more economic approach to defining anti-competitive behaviour.

and, in relation to s47:

> This proposed new threshold is the same as the threshold for these types of acquisitions in section 50 of the Trade Practices Act 1974 (Australia).

64. For the purposes of the analysis, the Commission takes the view that a lessening of competition and a strengthening of market power may be taken as being equivalent, since they are the two sides of the same coin. Hence, it uses the two terms interchangeably. Thus, in considering whether the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market, the Commission will take account of the scope for the exercise of market power, either unilaterally or through co-ordination between firms.

65. When the impact of enhanced market power is expected predominantly to be upon price, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and able to be sustained for a period of at least two

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[4] *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406, 434; *Mobil Oil Corporation v The Queen in Right of NZ* 4/5/89, International Centre for Settlement of Investment Disputes, Washington DC, International Arbitral Tribunal ARB/87/2 (paras 8.2, 19, 20).

[5] *Dandy Power Equipment Ltd v Mercury Marina Pty Ltd* (1982) ATPR 40-315, 43-888; *South Yorkshire Transport Ltd v Monopolies & Mergers Commission* [1993] 1 All ER 289.

[6] For a discussion of the definition see *Commerce Commission v Port Nelson Ltd*, supra n 6, 434.

[7] See *Dandy*, supra n 5, pp 43–887 to 43-888 and adopted in New Zealand: *ARA v Mutual Rental Cars* [1987] 2 NZLR 647; *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [1988] 2 NZLR 352; *Fisher & Paykel Ltd v Commerce Commission* [1990] 2 NZLR 731; *Commerce Commission v Carter Holt Harvey*, unreported, High Court, Auckland, CL 27/95, 18/4/00.

years, for the lessening, or likely lessening, of competition to be regarded as substantial. Similarly, when the impact of increased market power is felt in terms of the non-price dimensions of competition, these also have to be both material and able to be sustainable for at least two years for there to be a substantial lessening, or likely substantial lessening, of competition.

The Counterfactual

66. The Commission will continue to use a forward-looking, counterfactual, type of analysis in its assessment of business acquisitions, in which two future scenarios are postulated: that with the acquisition in question, and that in the absence of the acquisition (the counterfactual). The impact of the acquisition on competition can then be viewed as the difference between those two scenarios. It should be noted that the status quo cannot necessarily be assumed to continue in the absence of the acquisition, although that may often be the case. For example, in some instances a clearly developing trend may be evident in the market, in which case the appropriate counterfactual may be based on an extrapolation of that trend.

67. The present state of competition in a market can be referred to in order to illuminate the future state of the market where there is a range of possible scenarios should a merger not proceed.[8]

68. [ ] In the absence of the proposed merger, the Commission considers that the status quo is the most appropriate approximation for the counterfactual, as Reyrolle could continue to operate as a supplier in the 11kV switchgear market.

69. The Commission therefore proposes to use the status quo as the counterfactual.

Potential Sources of Market Power

70. Two types of market situation conducive to the exercise of substantial unilateral market power are now considered. These involve making the distinction between undifferentiated and differentiated product markets. That distinction may also have a bearing on the scope for co-ordinated behaviour in a market.

71. In undifferentiated product markets, where buyers make their purchases largely on the basis of price, and the production capacities of firms are an important element in competition, a business acquisition may have the potential to substantially lessen competition when the combined entity has acquired a market share below that required for dominance. This is especially likely in circumstances where the rivals of the combined entity cannot easily expand production to offset its output contraction within a one year time frame.[9] The inability of rivals to expand may result either from their facing binding capacity constraints, or because additional capacity is significantly more expensive to operate.

72. In differentiated products markets, where the product offerings of different firms vary, and in which buyers make their purchase decisions on the basis of product characteristics as well as of price, the products of firms are by definition not perfect

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[8] *Stirling Harbour Services Pty Ltd v Bunbury Port Authority* (2000) ATPR 41 at paras 113 & 114.

[9] See, for example, Roger D Blair and Amanda K Esquibel, "The Roles of Areeda, Turner and Economic Theory in Measuring Monopoly Power" (1996) *Antitrust Bulletin*, 781, especially pp 791-95.

substitutes for each other. The substitutability between products will vary depending upon differences in their various characteristics, which may include their physical specifications, brand image, associated services and location of sale. In simple terms, differentiated products can be thought of as being arranged in a "chain of substitutes", where those in adjacent positions in the chain tend to be close substitutes, and those positioned further apart are less close substitutes.

73. The supply-side characteristics of differentiated products markets are important, as the potential market power of the combined entity may be offset by the actions of rivals. However, rivals may not be able to offer a competitive constraint where they are unable either to re-position their products closer to that of the combined entity to replace the lost localised competition, or to strengthen the promotion of existing products. A further possible constraint would be lost if it were not possible for new products to be added through new entry.

Conclusion – Competition Analysis Principles

74. The Act prohibits business acquisitions that would be likely to have the effect of substantially lessening competition in a market. The Commission makes this assessment against a counterfactual of what it considers would be likely to happen in the absence of the acquisition. In the present case the counterfactual is considered to be the status quo. A substantial lessening of competition is taken to be equivalent to a substantial increase in market power. A business acquisition can lead to an increase in market power by providing scope either for the combined entity to exercise such power unilaterally, or for the firms remaining in the market to co-ordinate their behaviour so as to exercise such power.

75. In broad terms, a substantial lessening of competition cannot arise from a business acquisition where there are sufficient competitive constraints upon the combined entity. The balance of this Decision considers and evaluates the constraints that might apply in the 11 kV switchgear market under the following headings:

- existing competition;
- potential competition from entry; and
- other competition factors.

ANALYSIS OF EXISTING COMPETITION

Introduction

76. One consequence of a merger between competitors is that the number of firms competing in a market is reduced or, put another way, concentration is increased. This raises the possibility that competition in the market may be substantially lessened through the exercise of unilateral or coordinated market power. These are the subject of the analysis in this section.

Scope for Unilateral Market Power

Introduction

77. An examination of concentration in a market post-acquisition can provide a useful guide to the constraints that market participants may place upon each other, including the combined entity. Both structural and behavioural factors have to be considered. However, concentration is only one of a number of factors to be considered in the assessment of competition in a market. Those other factors are considered in later sections, as noted above.

78. Market shares can be measured in terms of revenues, volumes of goods sold, production capacities or inputs (such as labour or capital) used. All measures may yield similar results in some cases. Where they do not, the Commission may, for the purposes of its assessment, adopt the measure which yields the highest level of market share for the combined entity. The Commission considers that this will lead to an appropriately conservative assessment of concentration, and that the factors which lead to the other different market share results are more appropriately considered elsewhere during the assessment of the acquisition.[10]

79. In determining market shares, the Commission will take into account the existing participants (including 'near entrants'), inter-firm relationships, and the level of imports. This is followed by a specification of the Commission's 'safe harbours', an estimation of market shares, and an evaluation of existing competition in the market. Each of these aspects is now considered in turn.

Existing Participants

80. There are a number of participants in the 11kV switchgear market apart from the Applicant and target companies: ABB, Alstom, and Schneider, all of which are subsidiaries of large multinational companies.

Inter-firm Relationships

81. Companies that are part of the same corporate grouping, or that have similar strong relationships, cannot be relied upon to provide an effective competitive constraint to one another. Other less formal relationships between companies may also give rise to limitations on the extent of rivalry between them. Relationships between persons in the relevant market and other businesses may also affect rivalry in a market.

82. The Commission is of the view that inter-firm relationships are very limited and that a high degree of rivalry exists in the 11kV switchgear market. None of the firms relevant to this application is interconnected or associated with one another.

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[10] For example, where market share measured in terms of capacity produces a significantly lower share of the market in the hands of participants than a measure in terms of sales volumes, the constraint on a combined entity from that unemployed capacity might be taken into account when identifying near entrants or the constraint from new market entry. In some cases, the model of market power being used may influence the choice as to which market share measure is used.

Imports

83. In markets where imports are present, the Commission will consider whether actual competition from imported products is the equivalent to that from domestic supply. In undertaking this evaluation, the Commission will take into account the existence of any limits on quantities of imported product (the price elasticity of supply), and the effects on trade of various factors. Imports channelled through the parties to an acquisition, or persons associated with them, will be added to their domestic production in assessing market share, rather than being treated as independent sources of supply.

84. There are a significant number of imports in the market for 11kV switchgear that currently provide constraint in the market. Imported switchgear is subject to an 8% tariff. In addition, importers bear the cost of transportation from overseas countries. Despite this, imports are reasonably competitively priced in the market, which is borne out by the fact that importers of switchgear win tenders more than just occasionally.

Safe Harbours

85. Once the relevant market has been defined, the participants have been identified, and their market shares estimated, the Commission's 'safe harbours' can be applied. Under these safe harbours, a business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

- where the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is below 70%, the combined entity (including any interconnected or associated persons) has less than in the order of a 40% share; or

- where the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is above 70%, the market share of the combined entity is less than in the order of 20%.

86. As noted below, market shares by themselves are insufficient to establish whether competition in a market has been lessened. Other relevant issues are discussed in later sections.

Market Shares

87. The market shares provided in the application are not relevant to the market definition used in the present analysis because, as explained above, the present analysis defines the market more narrowly. This section presents estimates of shares of the 11kV indoor switchgear market.

88. In the 11kV indoor switchgear market, market shares are volatile because sales are irregular. A large contract won by one supplier might win it a market share well in excess of that which it had the year before. Some suppliers may sell 11kV switchgear one year, but nothing the next. [ ] The market shares in Table 1 should be considered to vary each year by at least ±5%.

89. There are no exact data on annual industry sales and therefore no exact market share estimates. Suppliers were able to provide estimates of how many 11kV indoor switchgear units they had sold in the past and their approximations of market shares were similar, [ ] Perceptions of market share may exclude a number of sales, for example to industrial customers that might deal directly with suppliers or sales by tenders which do not attract more than one bid.

90. Revenue estimates in Table 1 are based on an estimated total turnover for the market of [ ]. As with market shares, the dollar value of the market fluctuates with sales.

Table 1 – Estimated National Market Shares for the 11kV Indoor Switchgear

Company	**Revenue estimates ($ million)**	**Market Share (%)**
Reyrolle	[ ]	[ ]
Motorpol	[ ]	[ ]
ABB	[ ]	[ ]
Alstom	[ ]	[ ]
Others including Schneider	[ ]	[ ]
Total	**[ ]**	**100**
Current 3-Firm Concentration Ratio		**[ ]**
Post-Merger 3-Firm Concentration Ratio		**[ ]**
Reyrolle/Motorpol		**[ ]**

91. The current three firm concentration is [ ]. Post merger, the three firm concentration ratio would be [ ] with the merged entity having a [ ] share. These figures are outside the Commission's safe harbours.

92. However, the current three firm ratio is already high and the degree of aggregation post acquisition would be minimal.

93. [

]

94. As already noted, market shares are insufficient in themselves to establish whether competition in a market has been lessened. It is the interplay between a number of competition factors, of which seller concentration is only one that has to be assessed in determining the impact of a business acquisition on competition. Other competition factors include entry conditions; the presence of an aggressive, innovative or maverick firm; countervailing power of buyers or suppliers; rapid innovation in the market; and others. These are considered for the relevant market in subsequent sections.

State of Existing Competition

95. The acquisition would result in the merged entity becoming the largest provider of switchgear with a national aggregated market share of [ ]%. Despite this, the merged entity would face strong competition from existing participants in the market.

96. Most sales are by tender, with purchasers sending their preferred suppliers an RFT. RFTs include a set of specifications that suppliers must meet. On the evidence of market share alone, it seems that Reyrolle is competitive in meeting specifications at attractive prices. [ ]

97. [ ]

98. Although larger rivals believe that they offer a technically superior product, industry conservatism and discount prices draw buyers back to the brand they know. [ ]

99. [ ]

100. [ ]

101. Despite Reyrolle's low pricing, the tender process for the sales of switchgear ensures that pricing remains competitive. Importers regularly win tenders for the supply of switchgear. As subsidiaries of large multinational companies, importers often submit low priced bids in an attempt to secure other supply contracts, for instance 33kV switchgear and related accessories. [ ]

102. [ ]

103. [ ]

104. The Commission notes that all participants in the market commented that Reyrolle's need to sustain low prices indicates that there is vigorous competition in the market for 11kV switchgear. Furthermore, industry participants did not consider that the situation would change post acquisition.

Conclusions – Unilateral Market Power

105. The merged entity would be constrained by current competition. The merged entity faces strong competition from a number of importers of switchgear, all of which are subsidiaries of large multinational companies.

Scope for the Exercise of Coordinated Market Power

Introduction

106. A business acquisition may lead to a change in market circumstances such that coordination between the remaining firms either is made more likely, or the effectiveness of pre-acquisition coordination is enhanced. Firms that would otherwise compete may attempt to coordinate their behaviour in order to exercise market power by restricting their joint output and raising price. In extreme cases, where all firms in the market are involved and coordination is particularly effective, they may be able to behave like a collective monopolist. Where not all firms are involved, and market share in the hands of the collaborators is reduced, coordinated market power becomes more difficult to exercise because of competition from the independent firms in the market.

107. In broad terms, successful coordination can be thought of as requiring two ingredients: 'collusion' and 'discipline'. 'Collusion' involves the firms individually coming to a mutually profitable expectation or agreement over coordination; 'discipline' requires that firms that would deviate from the understanding are detected and punished (thereby eliminating the short-term profit to be gained by the firm from deviating).

108. When assessing the scope for coordination in the market during the consideration of a business acquisition, the Commission will evaluate the likely post-acquisition structural and behavioural characteristics of the relevant market or markets to test whether the potential for coordination would be materially enhanced by the acquisition. The intention is to assess the likelihood of certain types of behaviour occurring, and whether these would be likely to lead to a substantial lessening of competition.

Collusion

109. "Collusion" involves firms in a market individually coming to a mutually profitable expectation or agreement over coordination. Both explicit and tacit forms of such behaviour between firms are included.

110. The structural and behavioural factors that are usually considered to be conducive to collusion are set out in the left-hand column in Table 2. The significance of these is explained more fully in the Commission's *Practice Note 4*. The right-hand column of the Table then assesses the extent to which those factors are present, or are likely to be enhanced post-merger, in the market. A high proportion of 'yes' responses would suggest that the market was particularly favourable to 'collusion'; a high proportion of 'no' responses the reverse.

TABLE 2
Testing the Potential for 'Collusion' in the New Zealand Market for the Supply of 11kV Switchgear

Factors conducive to collusion	Presence of factors in the market
High seller concentration	Yes – The three firm concentration exceeds prescribed safe harbours.
Undifferentiated product	No – there is some degree of product differentiation.
New entry slow	No – entry can be effected relatively quickly.
Lack of fringe competitors	No – AB, Schneider and Alstom.
Price inelastic demand curve	No – demand for 11kVswitchgear is relatively elastic as customers have discretion over their replacement schedules.
Industry's poor competition record	No – not in the New Zealand market.
Presence of excess capacity	No.
Presence of industry associations/fora	No.

111. The assessment of the relevant structural and behavioural conditions in the 11 kV switchgear market in Table 2 suggests that the market is not particularly likely to be susceptible to collusion, even after the acquisition. Accordingly, the Commission has found it unnecessary to determine the potential for discipline in the 11kV switchgear market.

Conclusions – Co-ordinated Market Power

112. The Commission concludes that the scope for the exercise of co-ordinated market power in the 11kV switchgear market would not be enhanced by the acquisition.

Conclusions – Existing Competition

113. The Commission considers that existing competition will alleviate any concerns of unilateral power being exercised by the merged entity.

114. Furthermore, the Commission considers that the scope for the exercise of coordinated market power would not be enhanced by the acquisition.

CONSTRAINTS FROM MARKET ENTRY

Introduction

115. A business acquisition is unlikely to result in a substantial lessening of competition in a market if behaviour in that market continues to be subject to real constraints from the threat of market entry.

116. Where barriers to entry are clearly low, it will not be necessary for the Commission to identify specific firms that might enter the market. In other cases, the Commission will seek to identify likely new entrants into the market.

117. The Commission will consider the history of past market entry as an indicator of the likelihood of future entry. The Commission is also mindful that entry often occurs on a relatively small scale, at least initially, and as such may not pose much of a competitive constraint on incumbents within the relevant time frame.

Barriers to Entry

118. The likely effectiveness of the threat of new entry in constraining the conduct of market participants, following a business acquisition that might otherwise lead to a substantial lessening of competition in a market, is determined by the nature and height of barriers to entry into that market.

119. The Commission considers that, for the purpose of considering this issue, a barrier to entry is best defined as an additional or significantly increased cost or other disadvantage that a new entrant must bear as a condition of entry. In evaluating the barriers to entry into a market, the Commission will generally consider the broader 'entry conditions' that apply, and then go on to evaluate which of those constitute entry barriers.

120. It is the overall obstacle to entry posed by the aggregation of the various barriers that is relevant in determining whether entry is relatively easy or not, and therefore whether or not potential entry would prevent a substantial lessening of competition.

121. For entry to act as an antidote to a substantial lessening of competition stemming from a business acquisition, it must constrain the behaviour of the combined entity and others in the market.

122. In order to enter the market for the supply of 11kV switchgear, a potential entrant would require an amount of technical expertise, a source of reliable product that meets IEC standards, industry contacts, a reference site, and possibly a small assembly facility.

The "LET" Test

123. In order for the threat of market entry to be such a constraint on the exercise of market power as to alleviate concerns that a business acquisition could lead to a substantial lessening of competition, entry of new participants in response to the exercise of market power must be likely, sufficient in extent and timely (the *let* test). If they are to act as a constraint on market participants following a business acquisition which might

otherwise lead to a substantial lessening of competition in a market, entry must be relatively easy, or to put it another way, barriers to entry must be relatively low.

Likelihood of Entry

124. The mere possibility of entry is, in the Commission's view, an insufficient constraint on the exercise of market power to alleviate concerns about a substantial lessening of competition. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational firm will be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on its investment, including allowance for any risks involved.

125. In general, it is the pre-merger price that is relevant for judging whether entry is likely to be profitable. That in turn depends upon the reaction of incumbents to entry in terms of their production volume, together with the output volume needed by the entrant in order to lower its unit costs to the point where it can be competitive.

126. [

]

127. The Commission concludes that entry to the market for the supply of 11kV switchgear is therefore likely.

Extent of Entry

128. If entry is to constrain market participants, then the threat of entry must be at a level and spread of sales that is likely to cause market participants to react in a significant manner. The Commission will not consider entry that might occur only at relatively low volumes, or in localised areas, to represent a sufficient constraint to alleviate concerns about market power.

129. Small-scale entry into a market, where the entrant supplies one significant customer, or a particular product or geographic niche, may not be difficult to accomplish. However, further expansion from that "toe-hold" position may be difficult because of the presence of mobility barriers, which may hinder firm's efforts to expand from one part of the market to another. Where mobility barriers are present in a market, they may reduce the 'extent' of entry.

130. [

]

131. The Commission concludes that entry can be effected on sufficient scale to constrain the merged entity.

Timeliness of Entry

132. If it is effectively to constrain the exercise of market power to the extent necessary to alleviate concerns about a substantial lessening of competition, entry must be likely to occur before customers in the relevant market are detrimentally affected to a significant extent. Entry that constrains must be feasible within a reasonably short timeframe from the point at which market power is first exercised.

133. In some markets where goods and services are supplied and purchased on a long-term contractual basis, buyers may not immediately be exposed to the detrimental effects stemming from a potential substantial lessening of competition. In such cases, the competition analysis, in a timing sense, begins with the point at which those contracts come up for renewal.

134. [ ] Other industry participants also advised the Commission that entry to the market could be effected relatively quickly.

135. Motorpol's entry to the 11kV market, and its ability to gain [ ] market share in four to five years suggests that entry is possible. [ ]

136. The Commission concludes that entry to the 11kV switchgear market can be effected within a reasonably short timeframe.

Conclusion on Barriers to Entry

137. The Commission concludes that there are not sufficient barriers to entry to deter expansion or new entry. Potential competition is likely to provide constraint on the merged entity, and the industry as a whole.

OTHER COMPETITION FACTORS

Elimination of a Vigorous and Effective Competitor

138. Sometimes an industry contains a firm that is in some way non-typical, or has different characteristics, or is an innovator, or is regarded as a maverick. The independent or less predictable behaviour of such a firm may be an important source of competition in the market, and may undermine efforts by other firms to engage in coordination. Such a firm need not be large to have an impact on competition out of proportion to its relative market size. Should it become the target of a business acquisition, the resulting elimination of a vigorous and effective competitor could have the effect of substantially lessening competition in the market (especially if there are barriers preventing the entry of new, effective competitors).

139. Although both Reyrolle and Motorpol manufacture locally and supply to the New Zealand market as opposed to importing switchgear, the Commission does not consider either party to be markedly different from other industry participants. Post acquisition, there will remain a local manufacturing entity. Given the other constraints listed above, the merging of the entities is unlikely to have a disproportionate effect on competition in the markets.

Constraint from Buyers or Suppliers

140. The potential for a firm to wield market power may be constrained by countervailing power in the hands of its customers, or alternatively, when considering buyer (oligopsony or monopsony) market power, its suppliers. In some circumstances, it is possible that this constraint may be sufficient to eliminate concerns that a business acquisition may lead to a substantial lessening of competition.

141. Where a combined entity would face a purchaser or supplier with a substantial degree of market power in a market affected by the acquisition, the Commission will consider whether that situation is such as to constrain market participants to such an extent that competition is not substantially lessened.

142. As previously discussed, purchasers of switchgear wield a significant degree of market power through their ability to shape tenders to favour a particular supplier of switchgear. The Commission was advised by all parties interviewed that any attempt by the merged entity to impose a significant price increase, would see the distribution companies alter the specifications of their RFT to favour one of the imported products.

143. Furthermore, the Commission understands that around 10% of switchgear sales are made to industrial purchasers. Industry participants advised Commission staff that it is commonplace for industrial purchasers to use overseas consultants when designing and commissioning their substations, and that the preference of those consultants is for the type of switchgear offered to the market by importers rather than that by Reyrolle.

144. Therefore, the Commission is of the view that purchasers of switchgear will pose considerable constraint on the merged entity.

Efficiencies

145. The Commission recognises that there may be circumstances where efficiencies are relevant to an application for clearance.[11] In the context of a business acquisition, the combined entity might be able to make efficiency gains that are not obtainable by other means, such that its unit cost of production would decline. This could result in the entity reducing its price below that obtaining prior to the acquisition, even though with the acquisition it would otherwise be considered to have substantially lessened competition, and would be able to raise price above costs.

146. Where the applicant can make a sound and credible case that such efficiencies will be realised, that they cannot be realised without the acquisition, and that they will enhance competition in the relevant market, the Commission will include them in the broader analysis of all of the competitive effects of the acquisition in the course of assessing whether or not competition is likely to be substantially lessened. However, the Commission envisages that efficiency claims of the required magnitude and credibility

[11] In *Fisher & Paykel*, considered under s 27, the Court held that in assessing "substantial lessening of competition", a net approach to assessing anti-competitive effects was required: "The majority correctly accepted that it had to 'net out' the pro and anti-competitive effects and that, if it could be shown that the net effect of the EDC was to promote competition, then there could be no substantial lessening of competition." *Fisher & Paykel v Commerce Commission* [1990] 2 NZLR 731 at 740. See also: *Commerce Commission v Port Nelson*, supra n 6,433; *Shell (Petroleum Mining) Company Ltd v Kapuni Gas Contracts Ltd*, (1997) 7 TCLR 463, 531.

will only very rarely overturn a finding that competition would otherwise be substantially lessened.

147. The applicant has not argued that efficiencies are relevant to this application for clearance. The Commission does not consider that it is necessary to form a view on efficiency gains in the context of this application.

OVERALL CONCLUSION

148. The Commission has considered the probable nature and extent of competition that would exist in the New Zealand market for the supply of 11kV indoor switchgear but for the acquisition.

149. The proposed acquisition would result in the merged entity obtaining a market share that falls outside the Commission's safe harbour guidelines.

150. The Commission has also considered the nature and extent of the contemplated lessening, in terms of the competitive constraints that would exist following the merger from:

- existing competition;
- potential competition from entry; and
- other competition factors.

151. The Commission is therefore satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the New Zealand market for the supply of 11kV indoor switchgear.

DETERMINATION ON NOTICE OF CLEARANCE

152. Accordingly, pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the acquisition by Reyrolle Pacific Holdings Limited of 100% of the shares in VA Tech Reyrolle Pacific Limited.

Dated this 1st day of July 2002

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John Belgrave
Chair