



COMMERCE COMMISSION

Commerce Commission

Decision No. 602

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

Carter Holt Harvey Limited

and

Lakesawn Lumber Limited

The Commission: Paula Rebstock
Peter JM Taylor
Denese Bates

Summary of Application: The acquisition by Carter Holt Harvey Limited of the sawn timber business of Lakesawn Lumber 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: 9 May 2007

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CONTENTS

EXECUTIVE SUMMARY	I
THE PROPOSAL	1
PROCEDURE	1
STATUTORY FRAMEWORK	1
ANALYTICAL FRAMEWORK	2
PARTIES	3
Carter Holt Harvey Limited ('CHH')	3
The Pedersen Group of Companies ('Pedersens')	3
Lakesawn Lumber Limited ('Lakesawn')	3
Red Stag Timber Limited ('Red Stag')	3
Tachikawa Forest Products ('Tachikawa').....	3
Tenon Limited ('Tenon')	4
McAlpines Limited ('McAlpines')	4
Winstones Pulp International ('WPI')	4
Pukepine Sawmills (1998) Limited	4
Kiwi Lumber Holdings Limited ('Kiwi Lumber')	4
Pan Pac Limited ('Pan Pac')	4
Hancock Natural Resource Group Inc ('Hancock')	4
Kaingaroa Timberlands ('KT').....	4
PF Olsen and Company Limited ('PF Olsen').....	5
Fletcher Distribution Limited ('PlaceMakers').....	5
Bunnings Limited ('Bunnings').....	5
Independent Timber Merchants Co-operative Limited ('ITM').....	5
INDUSTRY BACKGROUND	5
The Supply of Logs.....	5
The Production of Sawn Timber.....	7
PREVIOUS DECISIONS	8
MARKET DEFINITION	8
Functional Market	9
Product Market	9
<i>Structural Timber</i>	10
Demand-side Substitutability	10
Supply-side Substitutability	11
Conclusion.....	13
<i>Structural Logs</i>	13
Demand-side Substitutability	14
Supply-side Substitutability	16
Conclusion.....	18
Geographic Market	18
<i>Production of Structural Timber</i>	18
Degree of Geographic Differentiation in the Market	20
Variations in Regional Pricing	21
Transport Costs	24
Synthesis.....	25
<i>Purchase of Structural Logs</i>	27
Summary of Relevant Markets	27
COUNTERFACTUAL AND FACTUAL	27
Factual	28

Counterfactual.....	28
COMPETITION ANALYSIS	30
The Purchase of Structural Logs in the CNI.....	30
<i>Existing Competition.....</i>	<i>30</i>
North Island Structural Timber Market	33
<i>Existing Competition.....</i>	<i>34</i>
<u>The Impact of Economies of Scale</u>	<u>35</u>
<u>Merger Simulation in a Geographically Differentiated Product Market.....</u>	<u>37</u>
<u>Conclusion on Existing Competition</u>	<u>40</u>
<i>Potential Entry</i>	<i>40</i>
<u>Entry by Non-Structural Sawmills</u>	<u>40</u>
<u>De Novo Entry</u>	<u>42</u>
<u>Conclusion.....</u>	<u>42</u>
<i>Countervailing Power</i>	<i>42</i>
<i>Conclusion.....</i>	<i>44</i>
OVERALL CONCLUSION.....	44
DETERMINATION OF NOTICE OF CLEARANCE.....	46

EXECUTIVE SUMMARY

1. On 17 January 2007 the Commerce Commission ('the Commission') received an application from Carter Holt Harvey ('CHH') for clearance to acquire the structural and industrial sawmilling business and certain assets of Lakesawn Lumber Limited ('Lakesawn') ('the Application').
2. After agreeing to an initial extension with a decision date of 22 March 2007, the Commission and the Applicant later agreed on two subsequent extensions. As a result, a decision on the Application was required by 9 May 2007.
3. The Commission considers that the relevant markets for consideration are:
 - A geographically differentiated market for the production and supply of structural timber in the North Island; and
 - The market for the purchase of structural logs in the Central North Island (CNI).
4. If the acquisition was completed, the combined entity would have []% of the market for the production of structural timber in the North Island, and []% of the market for the acquisition of structural logs in the CNI.

CNI Structural Log Market

5. The Commission considers that the additional structural log demand generated by the planned expansion of Red Stag Timber Limited ('Red Stag'), combined with the potential for other existing competitors to expand, would act to mitigate the competitive impact of the proposed acquisition on the structural log market.
6. Lakesawn is a relatively small operation compared to Red Stag and CHH, and is located in proximity to a number of sawmills of similar scale that purchase structural logs. Thus the difference in competition between the factual and the counterfactual is unlikely to be significant.
7. The Commission is satisfied that the proposed acquisition is unlikely to result in a substantial lessening of competition in the market for the purchase of structural logs in the CNI.

Geographically Differentiated North Island Structural Timber Market

8. As suggested by the delivered pricing model of competition, the impact of the proposed acquisition is likely to be the strongest in the geographic area surrounding the Lakesawn sawmill. However, Lakesawn is a relatively small [] operation compared to Red Stag and CHH, and is located in a region where a number of competing suppliers are concentrated, including Red Stag.
9. The Commission considers that the planned expansion of Red Stag, along with the potential for the expansion of other existing competitors would be likely to generate sufficient additional structural timber supply to offset any reduction in competition that may result from the loss of Lakesawn as an independent structural timber supplier. Thus the difference in competition between the factual and the counterfactual is unlikely to be significant.
10. The Commission considers that potential entrants would be unlikely to constrain the combined entity in the factual scenario, within the relevant timeframe.

11. The Commission considers that the countervailing power of large customers would be weakened in the factual compared with the counterfactual, such that countervailing power would be unlikely to constrain the combined entity.
12. The Commission is satisfied that the proposed acquisition would be unlikely to result in a substantial lessening of competition in the geographically differentiated market for the production and supply of structural timber in the North Island.

GLOSSARY

Terms

Bigfoot	A large scale sawmill that CHH had planned to build in Northland, prior to its decision to acquire TDC Sawmills Limited.
CNI	Central North Island.
MSG	Machine stress grader; machine used to test the stiffness of timber.
Pith	The low density, inner core of a log.
Pruned Sawlog	Used in the production of furniture, mouldings and other appearance grade timber.
Pulplog	Pulplog is sourced from the top section of the tree, including branches, and is used in the production of pulp and paper.
Sawmill	A facility where logs are cut into timber.
SSNIP	A small but significant non-transitory increase in price.
SLC	Substantial Lessening of Competition.
TIMO	Timber Investment Management Organisation, an organisation that develops and manages international timberland portfolios on behalf of investment groups.
Unpruned Sawlog	Used in the production of packaging timber (industrial grades) and construction timber (structural grades).

Parties

Ahead Lumber	Ahead Lumber Limited; sawmill
CHH	Carter Holt Harvey Limited; sawmill
CBM	CBM Sawmills Limited; sawmill.
Crown Forestry	Crown Forestry Group; land/forest owner
Eurocell	Eurocell Sawmilling Limited; sawmill
GMO	Grantham Mayo and Otterloo Renewable Resources; TIMO, forest owner
GFP	Global Forest Partners LP; TIMO, forest owner
Hancock	Hancock Natural Resource Group Inc; TIMO, forest owner
Independent Frame and Truss	Independent Frame and Truss; frame and truss manufacturers
Kaihu Valley Sawmills	Kaihu Valley Sawmills Limited; sawmill
KT	Kaungaroa Timberlands; TIMO, forest owner

Lakesawn	Lakesawn Lumber Limited; sawmill
MAF	Ministry of Agriculture and Forestry
McAlpines	McAlpines Limited; sawmill
Northland Forest Managers	Northland Forest Managers Limited; forest and harvest manager
Pan Pac	Pan Pac Forest Products Limited; sawmill and forest owner
PF Olsen	PF Olsen and Company Limited; forest and harvest manager
PinePac	PinePac Group; sawmill, forest owner and building material merchant
Pukepine	Pukepine Sawmills Limited; sawmill
Rayonier	Rayonier Asia Pacific Forest Resources; forest owner
Red Stag	Red Stag Timber Limited; sawmill
Rosvalls	Rosvalls Sawmill Limited; sawmill
Tachikawa	Tachikawa Forest Products (NZ) Limited; sawmill
Taranaki Sawmills	Taranaki Sawmills Limited; sawmill
TDC	TDC Sawmill Limited; sawmill
Tenon	Tenon Limited; sawmill
WPI	Winstone Pulp International Limited; integrated pulpmill, sawmill and forest owner

THE PROPOSAL

1. A notice pursuant to section 66(1) of the Commerce Act ('the Act') was received on 17 January 2007 seeking clearance for CHH to acquire the structural and industrial sawmilling business and certain assets of Lakesawn. The acquisition would result in horizontal aggregation between CHH's and Lakesawn's existing North Island structural and industrial wood products businesses.

PROCEDURE

2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear the acquisition referred to in a s 66(1) notice within 10 working days, unless the Commission and the person who gave notice agree to a longer period.
3. After agreeing to an initial extension with a decision date of 22 March 2007, the Commission and CHH later agreed on two subsequent extensions. As a result, a decision on the Application was required by 9 May 2007.
4. The Commission's approach to analysing the proposed acquisition is based on principles set out in the Commission's *Mergers and Acquisitions Guidelines*.¹

STATUTORY FRAMEWORK

5. Under s 66 of the Act, the Commission is required to consider whether the proposal would have, or would be likely to have the effect of substantially lessening competition in a market. If the Commission is satisfied that the proposal is not likely to substantially lessen competition then it is required to grant clearance to the application. Conversely, if the Commission is not satisfied it must decline. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.²
6. The substantial lessening of competition test was considered in *Air New Zealand & Qantas v Commerce Commission*, where the Court held;

We accept that an absence of market power would suggest there had been no substantial lessening of competition in a market but do not see this as a reason to forsake an analysis of the counterfactual as well as the factual. A comparative judgement is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, i.e. dominance has been attained. We consider, therefore, that a study of likely outcomes, with and without the proposed Alliance, provides a more rigorous framework for the comparative analysis required and is likely to lead to a more informed assessment of competitive conditions than would be permitted if the inquiry were limited to the existence or otherwise of market power in the factual.³

7. It was also considered in *New Zealand Bus Limited v Commerce Commission*, where the Court held:

Substantial lessening of competition is a relative rather than an absolute standard; it examines the state of competition with and without the transaction to determine whether, and to what extent, market

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

² *Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission* (1992) 4 TCLR 713-722.

³ *Air New Zealand & Qantas Airways Ltd v Commerce Commission*, (No.6) (2004) II TCLR 347 at 366.

power will move along the spectrum from perfect competition to monopoly... it must be assessed in the particular circumstances of the case.⁴

8. In determining whether there is a change along the spectrum that is significant the Commission must identify a real lessening of competition that is not minimal.⁵ Competition must be lessened in a considerable and sustainable way. For the purposes of its analysis the Commission is of the view that a lessening of competition and creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.
9. When the impact of market power is expected to be predominantly upon price, for the lessening, or likely lessening, of competition to be regarded as substantial, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and ordinarily able to be sustained for a period of at least two years, or such other time frame as may be appropriate in any given case.
10. Similarly, when the impact of market power is felt in terms of the non-price dimensions of competition such as reduced services, quality or innovation, for there to be a substantial lessening, or likely substantial lessening of competition, these also have to be both material and ordinarily sustainable for at least two years, or such other time frame as may be appropriate.

ANALYTICAL FRAMEWORK

11. The Commission applies a consistent analytical framework to all its clearance decisions. 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).
12. 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, in terms of:
 - existing competition;
 - potential competition; and
 - other competition factors, such as the countervailing market power of buyers or suppliers.
13. The Commission then assesses the overall impact of the acquisition in each of the relevant markets, to determine whether the acquisition would be likely to have the effect of substantially lessening competition in a market.

⁴ *Commerce Commission v New Zealand Bus Limited & Ors* CIV 2006-485-585 Judgment of Miller J, 29 June 2006.

⁵ *Fisher & Paykel Limited v Commerce Commission* (1996) 2 NZLR 731, 758 and also *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554.

PARTIES

Carter Holt Harvey Limited ('CHH')

14. CHH is a New Zealand incorporated company. It is a wholly-owned subsidiary of Rank Group Investments Limited.
15. CHH is a wood fibre products company and carries on business activities in wood products, pulp and paper, packaging and building supplies. CHH produces wood products for supply to New Zealand, Australia, America, Asia, and Europe. CHH produces structural and industrial timber for the New Zealand domestic market.
16. CHH Wood Products' business includes sawmills at Whangarei⁶, Kawerau, Putaruru, Kopu, and Nelson. CHH is the largest producer of structural timber in New Zealand.
17. CHH owns Carters Buildings Supplies ('Carters'), which is a nationwide building supplies retailing chain.

The Pedersen Group of Companies ('Pedersens')

18. The Pedersen group of companies is made up of Pedersen Industries Limited, Pedersen Holdings Limited, and Lakesawn. Pedersens is owned and controlled by Paul Pedersen and the Pedersen Commercial Trust.
19. Pedersen Industries Limited is a supplier of wood yard services in the CNI. This involves providing chipping and debarking services on contract for companies, such as CHH, New Zealand Forest Products (owned by CHH), and in the past Fletcher Challenge Forests.
20. Pedersen Holdings is a sawmilling business with three divisions: a roundwood operation at Kinleith where all product is on-sold to CHH, a chip mill where all product is currently on-sold to CHH, and a forestry division. Pedersens has a long-standing supply relationship with CHH [].

Lakesawn Lumber Limited ('Lakesawn')

21. Lakesawn is a member of the Pedersen Group. Lakesawn owns and operates a sawmill in Taupo, which produces structural timber, industrial timber, outdoor timber, and appearance grade timber for supply to domestic and export markets.

Red Stag Timber Limited ('Red Stag')

22. Red Stag is a privately-owned timber company located in Rotorua. Red Stag was established in 2003 to own and operate an existing sawmill. Red Stag is the second largest structural timber producer in New Zealand, and also produces various types of outdoor and industrial timber products.

Tachikawa Forest Products ('Tachikawa')

23. Tachikawa is a joint venture between Japanese companies Tachikawa Forest Products Limited, a major sawmilling business specialising in Radiata pine processing, and Sojitz Corporation. Tachikawa owns and operates a large sawmill in Rotorua.

⁶ On 1 December 2006, CHH acquired TDC Sawmills Ltd (TDC) without having sought clearance or authorisation from the Commission under section 66 or section 67 of the Act. The Commission is continuing to investigate whether the acquisition of TDC by CHH contravened s47 of the Act. For the purpose of the present analysis, the Commission has considered TDC to be part of CHH.

24. Tachikawa's sawmill is set up to produce industrial and appearance grade timber products. Tachikawa does not produce structural timber.

Tenon Limited ('Tenon')

25. Tenon, which was formerly titled Fletcher Challenge Forests Limited, is a publicly listed timber company that owns and operates a sawmill in Taupo.
26. Tenon produces appearance grade and industrial grade timber, predominantly for export markets. Tenon does not produce structural timber.

McAlpines Limited ('McAlpines')

27. McAlpines is a privately owned timber and building materials group with a sawmill located in Rotorua, as well as two sawmills in the South Island.
28. McAlpines produces structural timber, decking timber, outdoor timber, and industrial grade packaging timber.

Winstones Pulp International ('WPI')

29. WPI is a vertically integrated pulpmill, sawmill and forestry company located on the southern fringe of the CNI region, in Tangiwai.
30. WPI produces appearance and industrial grade timber as well as some structural timber. WPI has [] of forest in Waimarino and Karioi.

Pukepine Sawmills (1998) Limited

31. Pukepine is a sawmill located in Te Puke. Pukepine produces structural timber, appearance grade timber, outdoor timber, and industrial grade timber.

Kiwi Lumber Holdings Limited ('Kiwi Lumber')

32. Kiwi Lumber is a timber production company with sawmills located in Putaruru, Dannevirke, and Masterton. Kiwi Lumber produces structural grade timber, industrial grade timber, and appearance grade timber.

Pan Pac Limited ('Pan Pac')

33. Pan Pac is a vertically integrated pulpmill, sawmill and forestry company based in Hawkes Bay. Pan Pac is a large producer of appearance grade and industrial grade timber. Pan Pac owns 32,500 ha of forest in Hawkes Bay.

Hancock Natural Resource Group Inc ('Hancock')

34. Hancock is a US-based Timber Investment Management Organisation ('TIMO'). Hancock manages the production and supply of pruned sawlogs, unpruned sawlogs and pulplogs, in the CNI, Northland and Nelson. Hancock manages approximately 90,000 ha of forest in the CNI.

Kaingaroa Timberlands ('KT')

35. KT is a joint venture between the endowment fund of Harvard University and NZ Superannuation Fund. Timberlands Limited manages the forest estate 180,000 ha in the CNI on behalf of the owners. The estate, which produces pruned sawlogs, unpruned sawlogs and pulplogs, was purchased from Fletcher Challenge Forests in 2003.
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PF Olsen and Company Limited ('PF Olsen')

36. PF Olsen is a forestry management company, which administers and manages 130,000 ha of plantation forest for individual and corporate clients throughout New Zealand.

Fletcher Distribution Limited ('PlaceMakers')

37. PlaceMakers is the trading name of Fletcher Distribution Limited, the retail trading arm of Fletcher Building Limited. PlaceMakers is the largest building material supply company, and is the largest wholesale purchaser of structural timber.
38. PlaceMakers has more than 50 stores throughout the country. Each store is a joint venture between a local business partner and Fletcher Distribution Limited.

Bunnings Limited ('Bunnings')

39. Bunnings is a building material retailing company with 38 stores located throughout the country. Bunnings is a part of the Wesfarmers Group of Australia.

Independent Timber Merchants Co-operative Limited ('ITM')

40. ITM is a building material supply cooperative with 92 stores located throughout New Zealand.

INDUSTRY BACKGROUND**The Supply of Logs**

41. Logs are the primary input in the production of sawn timber.⁷ The type and quality of logs required by a sawmill will depend on the type of timber that a mill intends to produce. Logs vary in size (diameter and length), shape (straightness, roundness and taper), and in strength and stiffness.
42. The species of tree predominantly used to produce sawn timber in New Zealand is *Pinus radiata*.⁸
43. When a tree is felled it is cut into several logs. If the tree has been pruned, the pruned part of the trunk (typically the bottom 6 metres) is cut and sold as a pruned log (high value). The next 12 – 15 metres of the trunk is cut into structural or industrial grade logs, depending on the characteristics of the wood. These logs are called unpruned logs. If the tree is not pruned the bottom 6 metres of the trunk is also sold as unpruned logs.
44. The top part of the tree, along with the production thinnings, are generally sold as pulp logs. Pulp logs are relatively low value, and are smaller diameter and/or not straight enough for sawlogs. Pulp logs are used, along with wood chips, in the manufacture of MDF and particleboard, and in the manufacture of pulp and paper.
45. Log grade specifications are used by buyers and sellers to categorise logs according to their characteristics. Harvesting crews will typically grade logs based on a number of measures during the harvesting process. When purchasing logs, sawmills specify the grade of log that they wish to purchase, depending on what they want to use it for.
46. The Ministry of Agriculture and Forestry ('MAF') website provides generic product specifications and prices for domestic and export grade logs.⁹

⁷ According to CHH, logs represent [] of the production cost of structural timber.

⁸ In excess of 90% of the area of the New Zealand plantation estate is *Pinus radiata*.

⁹ <http://www.maf.govt.nz/statistics/primaryindustries/forestry/index.htm>

47. **Table 1** shows the product specifications for domestic unpruned log grades as identified by MAF.

Table 1: Domestic Unpruned Log Grades (Forest Research Specification)

Log Grade	Log status	Small end Diameter (mm)	Maximum Knot (mm)	Sweep class
S1	Unpruned	400+	60	1
S2	Unpruned	300-399	60	1
S3	Pruned or unpruned	200-299	60	1
L1	Unpruned	400+	140	1
L2	Unpruned	300-399	140	1
L3	Unpruned	200-299	140	1

Source: MAF website

48. The letter used in the grading signals the quality of the log, which is measured by the characteristics specified in Table 1, as well as the density of the wood fibre.
49. Table 1, MAF categorises structural logs (or ‘S grade logs’) into three standard log grades, those being S1, S2, and S3 (which are differentiated according to the size of the log). Similarly, industrial logs are separated into three grades, those being L1, L2, and L3. Log sellers sometimes label structural logs according to their small end diameter (‘SED’). For example S 30 is equivalent to S2 (30 denoting a small end diameter of 30cm), and S40 is equivalent to S1.
50. Table 2 shows the product specifications for export log grades as identified by MAF.

Table 2: Export Unpruned Log Grade Specification¹⁰

Log Grade	Small end Diameter (mm)	Maximum Large end Diameter (mm)	Maximum Knot size (mm)	Length (m)	Percentage allowed	Sweep
Japan A	200-340	800	d/3 up to 150 mm max Excessive number of large knots not permitted	4.0 8.0 12.0	10% max balance 50% min	d/4 d/2 d
Japan J	200-260	No limit	d/3 up to 150 mm max Excessive number of large knots not permitted	4.0 8.0 12.0	10% max balance 50% min	d/4 d/2 d
Korea K	200-260	No limit	d/3 up to 150 mm max Excessive number of large knots not permitted	3.6 5.4 7.3 11.0	balance 10% max balance 40% min	d/4 d/4 d/2 d

Source: MAF website

51. As is evident from Tables 1 and 2, logs are graded based on a number of characteristics. For example, MAF considers that export grade logs can have knots of up to 150¹¹ mm in

¹⁰ Significant volumes of industrial sawlogs (KI grade) are also exported. The small end diameter of these logs is greater than 280mm with maximum knot size of up to 250mm.

¹¹ In practice this is actually 120mm.

diameter, whereas domestic structural logs cannot have knots greater than 60 mm in diameter.¹²

52. Within New Zealand, the Auckland, Northland and Nelson regions produce forests that are characterised by higher density wood; the Central North Island (CNI) produces forests that contain medium density wood; and other regions produce forests characterised by lower density wood.¹³
53. Logs in New Zealand (including structural logs) typically have a low density core. Higher density logs, of the sort found in Northland, typically yield a greater proportion of structural timber than in other regions because the pith (low density inner core) of the log is generally smaller in Northland logs.

The Production of Sawn Timber

54. The type of timber that can be cut from a log will depend to a large extent on the characteristics of the log. Timber is often categorised into appearance grades, industrial grades, and structural grades.
55. Appearance grade timber is used for joinery, furniture and mouldings. Appearance grade timber needs to be free of knots and other blemishes, and so has to be produced using pruned logs (no branches), or unpruned logs that have long clear lengths between branch whorls, so as to yield clear lengths of timber.
56. Structural timber is typically used in a load-bearing capacity as structural framing for buildings. Structural timber is produced using logs with higher density, small branches (up to 7cm in diameter), and of medium length (i.e. 4.9m – 6.1 m).
57. The production process for structural timber involves cutting the logs into green timber, drying the timber in a kiln, and further processing the timber in a planer mill (to give the timber a smooth surface). The timber is then graded in accordance with industry standards relating to strength, straightness, and knot size. This grading is carried out either visually, or using a machine grader.
58. Visual stress grading is the traditional method for grading timber, and involves each piece of sawn timber being graded according to its visual characteristics (for example, the size of the knots in the timber).
59. Newly introduced industry standards have resulted in an industry-wide move towards machine grading as an alternative to visual grading. Machine grading is a process whereby a machine is used to measure the density or stiffness of each piece of timber. Machine grading can be carried out before the timber has been dried (using an ‘A Grader’), or once the timber has been dried and processed (using a machine stress grader). Timber that meets the machine grading standards is graded and sold as machine stress graded timber (‘MSG’). Timber that fails to meet the structural timber standards is typically graded and sold as outdoor timber or industrial timber.
60. Industrial grade timber is used in packaging for different products such as pallets, and concrete formwork. Industrial grade timber is a by-product of the structural timber production process, because the pith of the structural log is not suitable for structural timber, and is therefore used to produce industrial timber.

¹² Industry participants such as [] advised the Commission that structural logs can have knots up to 70 mm in diameter.

¹³ <http://www.insights.co.nz/products_processes_tc.asp>

61. Some sawmills gear their production specifically towards the industrial timber market. Industrial timber is usually produced using logs of lesser stiffness with larger branches (up to 15cm in diameter) and varying lengths between 3.6m and 12m. These are often referred to by industry participants as industrial grade logs.
62. Sawmills are typically located close to or within forested regions, in order to reduce the high cost of transporting logs. A large proportion of the wood processing industry is concentrated in the CNI, where most mature forest plantations are currently located.

PREVIOUS DECISIONS

63. The Commission has previously considered a number of markets relating to the forestry and forest processing sectors.
64. In Decision 543, the Commission gave clearance for CHH to acquire the structural and wood processing business and assets of Tenon. This included structural sawmills located at Kawerau and Rotorua (Rainbow Mountain). In this decision, the Commission defined a market for the production of structural timber in the North Island.
65. In Decision 588, the Commission examined the proposed acquisition by Hancock of the majority of CHH's New Zealand forestry estate. The region in which aggregation occurred as a result of that acquisition was the CNI. The Commission defined a market for the production and supply of unpruned sawlogs in the CNI, for the periods 2006-2010, 2011-2015 and 2016-2020, as well as separate markets for pulp logs and pruned logs. The Commission was satisfied that the proposed acquisition would not have, or would not be likely to have, the effect of substantially lessening competition in any market.
66. In Decision 589, the Commission looked at the proposed acquisition of the CHH forests by a second acquirer CRBF Limited, where aggregation of forests would have occurred in the Northland region and the Nelson region. The Commission defined separate markets for the production and supply of unpruned sawlogs in each region for the periods 2006-2008, 2009-2013, and 2014-2018. The Commission was satisfied that the proposed acquisition would not have, or would not be likely to have, the effect of substantially lessening competition in any market.
67. In its previous Decisions, the Commission defined narrower geographic markets for the production and supply of unpruned logs¹⁴ than for the production and wholesale supply of structural timber.

MARKET DEFINITION

68. The Act defines a market as:¹⁵

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.
69. For the purpose of competition analysis, the internationally accepted approach is to assume the 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 would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest

¹⁴ The Commission did not differentiate between the production and supply of industrial-grade and structural-grade unpruned logs.

¹⁵ Section 3(1) of the Act.

space in which such market power may be exercised is defined in terms of the dimensions of the market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

70. This section considers the relevant markets for assessing the impact on competition of the proposed acquisition of Lakesawn by CHH.
71. In the Application, CHH refers to the markets defined by the Commission in previous clearances relating to the production of sawn timber. CHH considers that the relevant market is the North Island structural timber market. CHH notes that while the acquisition will result in aggregation in the structural and industrial sawmilling businesses of CHH and Lakesawn, the Commission has previously determined that the competition analysis would be the same for both markets, because industrial timber is a by-product of structural timber production. The Application therefore focuses on the structural timber market.

Functional Market

72. As noted above, CHH submitted in the Application that the acquisition would result in the aggregation of sawmilling businesses, and that the relevant market is the market for the manufacture and wholesale supply of structural timber. CHH did not identify an upstream functional market as being relevant for the purpose of assessing the acquisition.
73. However, the Commission considers that two functional levels appear to be relevant in assessing CHH's proposed acquisition of Lakesawn. At the downstream level, the acquisition would result in an aggregation in the market for the production and supply of sawn timber.
74. In addition, sawmills purchase logs, which are then processed to produce sawn timber. Accordingly, the acquisition would also result in an aggregation of demand in the market for the supply and acquisition of logs.
75. The Commission therefore considers it appropriate to define a downstream functional level for the production and supply of sawn timber, and an upstream functional level for the purchase of logs.
76. The specific product dimensions of each of these functional levels are considered below.

Product Market

77. Initially, markets are defined for each product supplied by (or purchased by) the parties to an acquisition. For each initial product grouping, the Commission considers 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 should be incorporated in the market.
78. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market. The degree of demand-side substitutability is influenced by the extent of product differentiation.
79. 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.

80. 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 to their relative prices.

Structural Timber

81. CHH and Lakesawn each produce various types of timber products, including structural timber products, industrial timber products, outdoor timber products, and appearance grade timber products. The Commission has previously found that the three main categories of sawn timber are appearance grade timber, structural grade timber, and industrial grade timber.¹⁶
82. In Decision 543, the Commission considered that there were likely to be distinct markets for each type of timber, as there was likely to be a lack of substitution on the demand- and supply-sides between these grades of timber.
83. The Commission noted that as all sawmills producing structural timber would also necessarily produce industrial timber as a by-product, the competition analysis with respect to both timber grades would be identical.¹⁷
84. While sawmills targeting structural timber production necessarily produce industrial timber, the Commission is now aware that some sawmills specialise in industrial timber production. For example, [] and [] produce industrial and appearance grades of timber, but do not produce structural timber.
85. This would indicate that the level of aggregation resulting from the proposed acquisition would be greater in respect of the production of structural timber.

Demand-side Substitutability

86. The grades of timber referred to above have distinct end-use applications.
87. As discussed in the industry background section, structural grade timber is used primarily in the construction industry for products such as framing timber. Structural timber is subject to grading standards (either MSG or visual grading standards) that do not apply to industrial or appearance grade timber, and is typically sold to building supply retail merchants (who sell the timber to builders or DIY customers) or to frame and truss manufacturers.
88. Industrial grade timber is typically used for products such as crates, pallets, and concrete formwork. Industrial grade timber is not subject to structural timber grading standards, and is not required to have a good level of density or stiffness. Therefore, industrial timber is of a lower cost and of low quality compared to structural timber. Industrial grade timber is not of sufficient quality to be used in a structural capacity. For example, a builder could not use industrial timber to build the frame of a house.
89. Structural timber can, in a technical sense, be used as a substitute for industrial timber. However, a crate or pallet manufacturer would not gain value from the additional quality of the structural timber, and so would not be willing to pay the premium demanded for structural timber. Therefore, structural grade timber is unlikely to be regarded as being substitutable for industrial timber in an economic sense, on the demand-side.
90. Appearance grade timber is high value timber that needs to be free of knots and other blemishes, and is used in the manufacture of furniture, mouldings and other decorative

¹⁶ Commerce Commission, Decision 543, paragraph 51.

¹⁷ Commerce Commission, Decision 543, paragraph 54.

fittings. Appearance grade timber is not subject to structural timber grading standards, and is therefore not required to have a good level of density or stiffness. Accordingly, appearance grade timber is unlikely to be considered a close substitute for industrial or structural grade timbers on the demand-side.

91. Each type of timber has different characteristics, is produced for different purposes, and is priced differently. Consequently, purchasers of structural timber would be unlikely to switch to other non-structural timber products in response to a small but significant non-transitory increase in the price of structural timber. The Commission considers that there is limited; if any, demand-side substitutability between structural timber and non-structural timber.

Supply-side Substitutability

92. CHH submits that the production processes for structural, appearance grade and industrial grade timber are all similar, and use much of the same equipment. CHH notes that the only difference is in the way the equipment is set up and calibrated to cut the required product range. CHH submits that sawmills are able to switch quickly and easily between the production of different timber types.
93. The Commission has considered the extent to which producers of industrial or appearance grade timber could easily switch into the production of structural products.
94. Sawmills purchase and process different types of logs, depending on the type of timber they intend to produce. For example, an appearance grade mill will usually purchase pruned logs, whereas sawmills that intend to produce structural grade timber purchase logs with structural characteristics (as discussed previously).
95. CHH has argued that appearance grade producers could be converted to the production of structural timber with relative ease. According to the Applicant, the main capital costs would be in the vicinity of [], and this would relate to the installation of timber stress-grading machinery.
96. Industry participants advised the Commission that the ability of appearance grade mills to switch easily into the production of structural timber depends on the configuration of the particular mill. A number of appearance grade sawmills have informed the Commission that they are not capable of producing significant volumes of structural timber.¹⁸ According to some industry participants, appearance grade mills are typically designed to maximize the recovery of timber from pruned logs, and are often based on relatively slow, precision cutting of relatively low volumes of logs.
97. For example, [] operates an appearance grade mill in []. [] produces small amounts of structural timber as a by-product, which is either sold through [].
98. [] purchases significant volumes of structural timber from CHH. [], indicated that the prices [] pays CHH for structural timber have recently increased by up to [] for certain grades. Despite this increase in price (which is considerably in excess of a SSNIP), [] would not convert its sawmill to a structural operation. [] noted that a significant investment would be required before [] could reach a scale that would be cost competitive with CHH.

¹⁸ For example, [].

99. The cost disadvantage faced by [] in switching to structural timber (on a significant scale) indicates that there exists a limited degree of supply-side substitutability between smaller appearance grade sawmills and structural sawmills.
100. [] advised the Commission that from an operational point of view it would be relatively easy for [] to switch to the production of structural timber []
101. However, [] would be very unlikely to move into structural production, because doing so would require it to divert its operational capacity away from appearance grade timber products. Any structural production would therefore involve sacrificing its existing appearance grade production, in which it has invested significantly in developing overseas markets. []
102. The Commission has also spoken to a number of industrial sawmills. One such example is [] which operates a [] industrial mill in [] said that it would not be able to switch to structural timber production without a major overhaul of its processing facilities. According to [] sawmill is not able to cut timber of a suitable length for the structural market. [] advised the Commission that [] would have to rebuild its sawmill in order to produce structural timber, which would involve significant capital investment.
103. [] primary focus is the supply of industrial grade timber []
- [] would not switch to producing structural timber in response to a 5% – 10% increase in the price of structural timber products.
104. Conversely, sawmills that produce structural timber do not appear to face barriers to switching to the production of industrial timber (since, as discussed previously, industrial timber is a necessary by-product of structural timber). For example, []
105. In summary, the ability of producers of industrial or appearance grade timber to switch into the production of structural products varies. For some sawmills, switching into structural production would be technically difficult, and would require substantial new investment and reconfiguration of their existing mills.
106. For other sawmills, the technical barriers to switching to structural timber production appear to be low. However, even where the technical cost of switching is low, in the case of [] there still appears to be significant opportunity costs associated with foregoing existing products and investment that has been sunk into specific markets.
107. On balance, the Commission considers that producers of appearance grade and industrial grade timber would, for the most part, be unlikely to switch to structural timber products in response to a small but significant non-transitory increase in the price of structural timber. Therefore, the Commission considers that there is limited supply-side substitutability between structural timber and other types of timber.

108. The Commission considers that the level of aggregation resulting from the proposed acquisition would be greater in respect of the production of structural timber. Accordingly, the Commission considers that if there are no competition concerns identified with respect to structural timber, there would be no concerns with respect to industrial timber.

Conclusion

109. Given that there is limited demand-side and supply-side substitutability between structural timber and non-structural timber, for the purposes of examining the proposed acquisition, the Commission considers it appropriate to define a product market for the production and supply of structural timber.

Structural Logs

110. In previous decisions relating to the acquisition of forestry assets, the Commission defined product markets for unpruned logs.¹⁹ However, for the purpose of the proposed acquisition the Commission has considered whether it is appropriate to define distinct markets for structural and industrial logs.

111. CHH has submitted that the relevant market is for unpruned logs.

... there is no distinct product market for the supply and acquisition of structural logs as opposed to industrial logs. All logs produce both structural timber and industrial timber. Some logs can be converted to produce more structural timber than other logs and these logs have a higher value. This creates a chain of substitution and there is no bright line that marks the boundary of the product market. The relevant boundary is between unpruned, pruned and pulp logs.²⁰

112. CHH provided an example of the timber recovery it might achieve from a hypothetical unpruned log. This is summarised in Table 3.

Table 3: Timber Recovery from an Unpruned Log

Final Product	Recovery
Structural timber (MSG8/12)	[]%
Industrial timber	[]%
Appearance/outdoor timber	[]%
Waste (sawdust, chip)	[]%
Total	100.0%

Source: CHH

113. CHH notes that the percentage of a log that is recoverable as structural timber will depend on the density of the log, with high density logs yielding a higher percentage of structural timber. According to CHH, this creates a spectrum of log grades, from the least dense logs to the most dense logs:

As a result, while the least dense log might not constrain the price of the densest log, via the chain of substitution, there is a price continuum such that all unpruned logs fall within the same market.²¹

114. Most parties spoken to in the course of the Commission's inquiries have referred to structural and industrial logs, which suggests that buyers and sellers make a distinction between logs that are suitable for structural timber production, and those that are not.

¹⁹ Decision 578: Hancock/CHH, Decision 579: CRBF/CHH

²⁰ CHH submission, 20 April 2007, paragraph 1.3

²¹ *ibid*, paragraph 2.12.

For example, information has been provided by [] refers to the [] negotiation of prices and volumes of structural logs between itself and CHH.²² Frequent reference is made by both parties to several structural log grades and associated price offers, including S15, S20, and S30 logs.

115. Another example is [] showing price trends (based on actual sales transacted by []) for what [] refer to as the major structural log grades (S20, S30, and S40). [] advised the Commission that it is well understood by the industry that structural logs are logs with lesser sweep, good density, and knot sizes of less than 70 mm. [] indicated that while there is a range of intermediate structural log sizes (such as S25, S28) within the conventional grades, the knot characteristics in particular is the key distinguishing feature between structural and non-structural logs.

116. Similarly, the CHH Information Memorandum relating to the sale of the CHH forestry estate includes [] that refer to specific grades of logs.²³ []

[] all specifically refer to S30 and S20 grade saw logs of particular lengths. Additionally, CHH refer extensively to structural log demand in internal strategic documents relating to the configuration of its sawmills throughout the North Island.

117. Industry participants advised the Commission that individual log sellers tend to have their own unique log labelling system, but that these systems typically distinguish between logs that have structural qualities and those that do not.

Demand-side Substitutability

118. CHH and Lakesawn are producers of structural timber, and therefore require logs that are suited to that purpose. Structural timber requires logs that have the following characteristics:

- a lesser degree of sweep (curve).
- higher density, which is used as a proxy for strength (this is measured using specialised machinery).
- branches that are less than 70 mm in diameter (because logs with a knot size greater than 70mm cannot be used by domestic mills to produce structural timber); and
- medium length (i.e. 4.9m – 6.1 m).

119. Several sawmills advised the Commission that they purchase only structural logs, from which they produce structural and industrial timber.²⁴ Other mills, such as [] purchase a combination of structural and industrial logs.

120. [] advised the Commission that approximately [] of [] log purchases are export A grade logs, which is a lower quality log than a structural log (lower fibre density and with knots up to 120 mm in size). []

²² Fax from [] to Commission staff, 20 March 2007.

²³ []

²⁴ []

] achieves a lower structural timber recovery out of these logs, because the proportion of the log with good density is smaller (the Pith is larger).

121. [] said that [] sometimes purchased non-structural logs, because they were cheaper than structural logs. [] advised the Commission that [] was able to cut some structural timber out of these logs, but not as much as out of a structural log. This would result in [] producing increased volumes of non-structural timber, such as outdoor timber and packaging timber, which could be sold to domestic and export customers.
122. [] advised the Commission that [] sometimes purchases non-structural logs, but uses those logs to produce non-structural outdoor timber and industrial timber.
123. Accordingly, the buying behaviour of some sawmills indicates that they are, to a limited extent, willing to switch to lesser quality logs sold at a lower price, and in doing so reduce their structural timber recovery. For example, sometimes sawmills are 'forced' to switch to non-structural logs by an inability to source structural logs. However, generally structural sawmills prefer to process logs that enable them to achieve higher structural recovery, and are willing to pay a premium for such logs.²⁵
124. Switching to lower quality logs will result in a sawmill producing a greater amount of non-structural timber and a lesser amount of structural timber, thus altering the sawmill's product mix. As a result, the sawmill might no longer be able to produce adequate volumes of structural timber to meet customer demand, or might produce excess volumes of industrial timber compared with customer demand.
125. Structural sawmills often have plant and equipment that is used for processing sawn green timber into structural timber. This equipment includes the kilns, planers, and the MSG equipment. Having invested in capacity at the downstream end of the timber processing operation that matches structural timber production, structural sawmills have an interest in operating that processing equipment to its capacity. If a structural sawmill with downstream processing capacity switches to logs that achieve lower structural timber recovery, its structural timber production will decrease, therefore leaving its downstream structural timber processing equipment under-utilised, and its overall production costs higher.
126. For example, [] has recently invested in a machine stress grader, so now will be targeting higher quality logs, as part of a plan to produce structural timber.
127. The additional value associated with log quality may become even more noticeable in the future, given that new standards have recently been introduced that require sawmills to have their structural timber grading independently verified. According to Tim Rigter of Red Stag, the new standards require tighter monitoring to ensure that structural timber grading is verified according to industry standards. Mr Rigter advised the Commission that this will require some sawmills to tighten their existing grading standards, and that as a result, log quality will become more important for achieving good structural timber recovery.

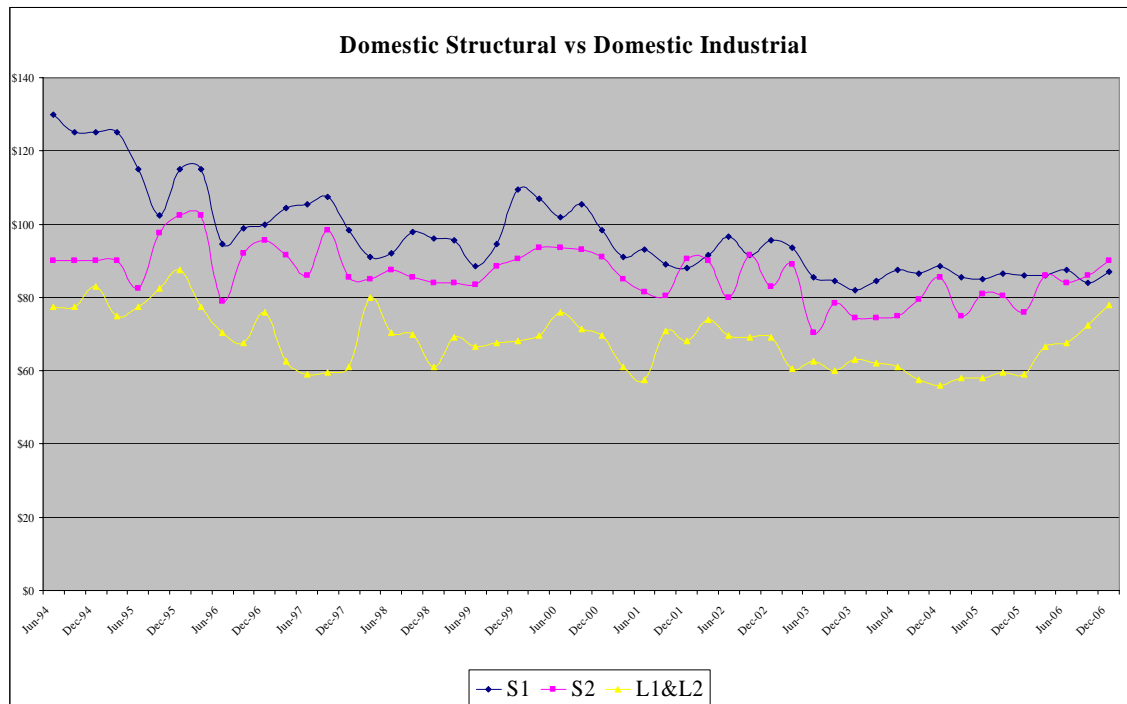
²⁵ An analysis conducted by MAF on domestic structural and industrial log prices, which indicates that a significant premium is paid for structural logs. This data is discussed further in the following section of this report.

128. This was supported by [], a log pricing determination expert from the University of Canterbury's School of Forestry, whom advised the Commission that the structural log market is becoming more discrete because of tougher structural timber grading requirements.
129. In summary, the Commission considers that there is some scope for sawmills to switch from structural grade logs to non-structural logs. However, sawmills that are set up to produce structural timber, and are targeting structural timber markets, typically prefer to purchase logs that meet structural specifications (particularly in relation to the minimum knot size). This indicates that on the demand-side, the degree of substitutability between structural logs and non-structural logs is likely to be limited.

Supply-side Substitutability

130. The Commission has considered whether suppliers of structural logs would divert logs with structural qualities into non-structural log markets in response to a small but significant non-transitory decrease in the price of structural logs, relative to the price of non-structural logs.
131. The Commission has spoken to a number of arbitrators that are involved in determining log prices in the event that dispute resolution mechanisms are triggered within log supply contracts between processors and forest owners. [] industrial grade logs are generally sorted separately from structural grade logs and the bulk of them are exported, since export markets do not require high quality logs.
132. [] noted that if log sorting is done well, logs with structural qualities will typically be labelled as structural logs and sold domestically. However, [] noted that at the moment logs with structural qualities are being exported because the export prices are unusually high.
133. [] advised the Commission that while structural logs can be sold into the export market, export grade logs typically do not meet the specifications for a structural log, particularly in respect of knot size and sweep. [] noted that a significant premium is usually paid by domestic sawmills for structural logs.
134. Log data collected by MAF is separated into various grades, based on the physical characteristics of logs. The log grades used by MAF are summarised in Table 1 and Table 2. In using these grades, MAF acknowledges that there is variation in the way logs are graded within the industry, and notes that the log grades it has used have not been universally adopted by the industry.²⁶
- To help overcome the situation, the Ministry relies on industry sources to provide log prices to the nearest log grade equivalent, and to identify any significant changes to log specifications.
135. Quarterly data of domestic structural and industrial log prices collected by MAF for the period from June 1994 to March 2007 is presented in Figure 1. On average, domestic industrial logs have typically traded at prices around 20%-30% below those for domestic structural log prices throughout this period.

²⁶ <http://www.maf.govt.nz/statistics/primaryindustries/forestry/index.htm>

Figure 1: Domestic Structural Log Prices versus Domestic Industrial Log Prices

Source: MAF

136. As noted previously, this premium suggests that the qualities inherent in structural logs are valued by log buyers, and as a result structural logs attract a premium price.
137. Structural logs can, in a technical sense, be used instead of industrial logs to produce low grade timber products. However, industrial logs cannot typically be used to produce structural timber. Sawmills that specialise in industrial timber production do not gain additional value from using logs with structural qualities. Therefore, industrial sawmills would not be willing to pay the premium that is typically paid for logs with structural qualities.
138. Given that the market places a significantly higher value on structural logs, forest owners would be unlikely to divert structural logs to the industrial market in the event of a SSNIP. Accordingly, the degree of supply-side substitutability between structural logs and industrial logs is likely to be limited.
139. In the first quarter of 2007 global industrial log prices rose significantly due to strong international demand, as well as to a fall in global supply. This price spike has led to a convergence of global log prices and domestic structural log prices. This has, in some cases, resulted in logs with structural qualities being diverted to export markets.
140. [] advised the Commission that export log markets have not been this strong since 1995. [] noted that, at the moment, some forest owners are sending logs straight to the wharf for export rather than grading logs as part of the harvesting process.
141. Industry participants advised the Commission that this phenomenon is unusual, and is unlikely to be sustained.²⁷ [] noted that global price increases of this nature

²⁷ [

]

usually amount to a short term price spike, and considered it likely that the recent increase in price would also be short-term. [] expected that the premium paid for domestic structural logs (over export and industrial grade logs) would soon be restored.

142. Dr Bruce Manley advised the Commission that there is traditionally a premium paid for structural logs (over export and industrial grade logs), and that the premium will most likely be restored.
143. The Commission considers that the premium that has traditionally been paid for logs with structural qualities will likely be restored.
144. The Commission considers that under normal market conditions domestic structural log prices would have to fall by a considerable amount before forest owners would divert logs with structural qualities into the industrial log market (or the export market). This is because the end uses of structural logs in the domestic market require qualities such as density and stiffness that are valued, and hence tend to attract a price premium, while in the export and industrial markets such qualities are not required.
145. Therefore, the Commission considers that on the supply-side, the degree of substitutability between structural logs and non-structural logs is likely to be limited.

Conclusion

146. The Commission considers that forest owners would, under normal market conditions, be unlikely to divert logs with structural qualities to the domestic industrial log market, or to export markets, in response to a small but significant non-transitory decrease in the price of structural logs. And sawmills set up to produce structural timber have a strong preference to purchase structural logs. Consequently, the Commission considers that there is limited scope for supply-side and demand-side substitutability between structural logs and industrial logs.
147. The diversion of logs with structural qualities to export markets during the first quarter of 2007 suggests that the relevant product market may be defined more broadly, so as to include all unpruned logs. However, the Commission considers that this phenomenon took place under exceptional circumstances, and would be unlikely to sustain itself throughout the relevant timeframe for considering this acquisition.
148. The Commission considers that for the purposes of the present Application, the competition effects are best analysed within a product market for structural logs. The competition effects arising the limited degree of substitutability between structural and non-structural logs can be taken into account within the competition analysis.

Geographic Market

Production of Structural Timber

149. The Commission defines the geographic dimension of a market to include all of the relevant, spatially dispersed sources of supply to which buyers would turn should the prices of local sources of supply be raised.
150. In a previous decision relating to the acquisition by CHH of the sawmilling assets of Tenon Limited, the Commission defined a market for the production of structural timber in the North Island.²⁸

²⁸ Decision 543: CHH/Tenon.

151. The current Application involves CHH acquiring structural sawmilling assets that are located in Taupo. CHH currently has structural sawmills in Whangarei, Kawerau, Putaruru, Kopu, and Nelson. The immediate area of aggregation is therefore in the Taupo and Rotorua districts.
152. CHH submitted that the structural timber market is wider than the North Island market adopted by the Commission in its previous Decision, but nonetheless adopted a North Island structural timber market in its Application.
153. CHH supplies timber throughout New Zealand from its major sawmills in Northland, the CNI, and in Nelson. Lakesawn supplies customers throughout a large part of the North Island (between Wellington and Auckland). Lakesawn also has a [] customer in Christchurch.
154. Sawmills tend to be located in close proximity to sources of logs, rather than to timber customers, due to the relatively high costs of transporting bulky logs compared with the cost of delivering sawn timber. Processing capacity is concentrated around the large exotic forests, which are located in the CNI and Northland. Smaller sawmills are scattered throughout other forested regions.
155. Sawmills typically sell structural timber products to customers on a “delivered” basis. The costs associated with transporting the timber to the customer’s premises is incurred by the sawmill, and charged to the customer.
156. Large volume sawmills such as [] tend to have a larger pool of customers than smaller mills, and spread over a bigger geographic region. [] supplies up to [] of its domestic structural production to South Island customers, with its largest customer located in Christchurch. []²⁹.
157. The Commission notes that there is some structural timber produced in the North Island that is shipped down to the South Island. However, there is less timber flowing in the opposite direction, because logs harvested in the southern regions are typically less suited to producing structural timber. A number of parties have told the Commission that the only region in the South Island producing relatively good structural timber is the Nelson region, where CHH has a structural sawmill.
158. Smaller volume sawmills often concentrate their timber sales within a smaller geographic area. The size of the geographic region supplied by a given sawmill tends to correspond with the size of the sawmill itself. For example, medium size sawmills such as [] tend to supply local customers, along with some customers that are located at a distance. The geographic spread of their customers indicates that while their sales are concentrated regionally, they are able to compete for more distant customers. [] supplies customers throughout much of the North Island (between Auckland and Wellington). [] supplies a majority of its timber to customers in Auckland and Waikato, but also supplies customers in the lower North Island.
159. Small sawmills tend to have a smaller catchment area for sales. For example:

²⁹ [

- [] - supplies customers throughout Northland, Auckland, and the Bay of Plenty.
- [] – supplies most of its timber to customers in Auckland.
- [] - supplies customers throughout the lower North Island
- [] - supplies customers in the lower North Island and the Hawkes Bay from its sawmills in the central and lower North Island.
- []

160. The Commission has seen other evidence of localised competition in information supplied by structural sawmills located throughout the North Island. A number of them referred to locally-based sawmills as being their main competitors.

161. CHH noted that smaller mills can have an advantage in supplying local customers, based on being closer to customers as well as being closer to log supplies:

More generally, CHH will remain materially constrained by smaller sawmills. CHH has relatively few but larger sawmills. As a result, CHH is more distant from many of its customers and suppliers than smaller sawmills. From a cost perspective, while CHH gains production economies from scale, it does face higher overall transport costs (both to and from its sawmills) on average than smaller sawmills. ...

This is particularly important given that forest owners and customers in New Zealand are relatively widely dispersed and, as noted in the Commission’s previous decisions, customers tend to purchase from a range of suppliers including local sawmills and larger producers such as CHH. The benefit of proximity also works to small sawmills advantage in terms of establishing strong customer relationships based on more specialised local knowledge and presence/community loyalty.³⁰

162. Whilst the behaviour of some sawmills suggests that competition takes place on a local or regional basis, other evidence suggests that a broader geographic market may be appropriate for the purpose of assessing the competitive impact of the proposed acquisition. The process of defining the geographic scope of the relevant market is further complicated by the concentration of structural timber demand in Auckland, which attracts timber from throughout the North Island. Only small volumes of timber are transported through Auckland.

Degree of Geographic Differentiation in the Market

163. The behaviour of buyers and sellers of structural timber in the North Island, particularly the policy of delivered pricing, suggests that the timber supplied by a given sawmill is differentiated by location. This means that no two structural sawmills are likely to be perfect substitutes for a given customer.

164. Each customer is likely to have a preference to buy from one sawmill over another, because of the locations of the sawmills relative to its own location. This suggests that a given sawmill may possess a degree of market power – it can raise the price above marginal cost and still retain a substantial proportion of its customers – although its ability to do so would be limited by the presence of other sawmills offering close substitutes (which will depend on the proximity of competing sawmills and the extent of transport costs).

165. As a result, the most distant sawmill might not, in a practical sense, be considered a suitable substitute for the local sawmill. However, market boundaries can be difficult to

³⁰ CHH “Response to Commerce Commission Questions dated 12 February 2007”, February 19 2007, paragraphs 18.2, 18.3.

delineate in a differentiated market: an overly narrowly defined market may exclude significant substitutes; on the other hand, an overly broad market may overlook the differing degrees of constraint offered by close and less close substitutes.

166. Some information provided to the Commission suggests that geographic differentiation may be relevant in defining a structural timber market. The Commission has therefore tested the geographic boundaries for the structural timber market, and the extent to which it might be subject to geographic differentiation.

Variations in Regional Pricing

167. According to price lists provided to the Commission, CHH's structural timber prices vary between regions. In addition, CHH have recently increased structural timber prices throughout the country, and the increases in invoiced prices have varied between regions. This pricing behaviour suggests that there is a geographic differentiation dimension to the market in which structural timber is supplied.

168. Under CHH's recent price changes, effective from March 2007, prices have generally increased. CHH has provided reasons for these increases, including increases in the costs of logs, energy, and freight. According to CHH, log prices, which account for []% of the cost of structural timber, increased by []% in the year to June 2006, [].

169. Although these cost increases may help to explain some of the increases in structural timber prices in general, the Commission is particularly interested in regional variations in prices, in order to gauge the significance of any regional differentiation. The following section considers the evidence presented to the Commission in respect of regional pricing of structural timber products.

170. A number of large buyers of structural timber informed the Commission that CHH's new pricing regime resulted in significant price increases in some regions. The Commission has analysed this information, both in terms of regional price increases over time, and variations in prices between regions.

171. For example, []³¹[] .

].

172. []

]

173. The price increases vary between products, and between regions. The most significant price increase occurred for the []

].³²

174. The price increases [] .

³¹ The CHH price lists are on a 'free-in-store' basis, which includes transport to customer.

³² The structural timber pricing information provided by [] relates to actual sizes (90x45) rather than nominal sizes (100x50).

Table 4 summarises the old and new prices for that product by region, and indicates that significant regional variation in prices remain.

Table 4: Structural Prices by Region (MSG8 90x45)

	Old CHH price list*	Old invoiced price	New list price / Invoiced price (1 March 2007)	Change
H1				
Northland	[\$]	[\$]	[\$]	[]%
Auckland	[\$]	[\$]	[\$]	[]%
Waikato	[\$]	[\$]	[\$]	[]%
BOP	[\$]	[\$]	[\$]	[]%
Gisborne	[\$]	[\$]	[\$]	[]%
Napier	[\$]	[\$]	[\$]	[]%
Palmerston N	[\$]	[\$]	[\$]	[]%
Wellington	[\$]	[\$]	[\$]	[]%
VARIATION	[]%	[]%	[]%	
H3				
Northland	[\$]	[\$]	[\$]	[]%
Auckland	[\$]	[\$]	[\$]	[]%
Waikato	[\$]	[\$]	[\$]	[]%
BOP	[\$]	[\$]	[\$]	[]%
Gisborne	[\$]	[\$]	[\$]	[]%
Napier	[\$]	[\$]	[\$]	[]%
Palmerston N	[\$]	[\$]	[\$]	[]%
VARIATION	[]%	[]%	[]%	

Prices are \$ per lineal metre.

* []

]]

175. Under the previous CHH price lists, the posted prices were close to being uniform across the North Island. However, according to a number of large structural customers, discounts could be negotiated at a regional or even store level. [] submitted that:³³

[]

].

176. Table 4 shows that there has traditionally been significant variation in the actual structural timber prices throughout the North Island. Such variation continues under the new prices charged by CHH, albeit to a lesser extent.

177. [] noted that CHH has now removed all discounting at a regional level, and that once the removal of these discounts is taken into account, the effect of CHH's recent price changes is to significantly increase structural timber prices in the Northland region. According to [], the relatively low prices that previously prevailed in the Northland region were due to the presence of TDC Sawmills Limited, which was a large

³³ []

scale independent sawmill that was acquired by CHH in December 2006. [] noted that:³⁴

... with the recent purchase of TDC, CHH now dominate the supply to the Northland region, providing them with the ability to lift prices substantially due to less competition.

178. Prior to the recent price changes, the price of MSG8 90x45 varied by up to [] prices vary by [].³⁵ Under the new pricing, structural timber

179. As noted earlier, [] operates an appearance grade sawmill in [], and [].³⁶ The majority of the structural products sold through [] are sourced from CHH. []

180. [] notes that the increases in Northland structural timber prices exceed price increases in other regions, and argues that these targeted regional price increases are a result of CHH acquiring the TDC structural mill in Whangarei.

181. [] has provided similar pricing material showing the old and new CHH price lists. [] has also noted that whereas previously it was able to negotiate reductions with CHH, such “special branch pricing” is being withdrawn by CHH.

182. CHH submitted that its new delivered timber prices []³⁷ [],³⁸ []

[]

]³⁹

183. While there may be some cost-based justification for some of the differences in pricing between regions, such justification appears at odds at least in Northland, to the extent that CHH can now supply Northland from the former TDC mill, rather than as formerly, supplying the region from its structural mills that are located well to the south of Auckland.

184. The above information indicates that CHH has introduced relatively significant price increases in some regions. In addition, there has been (and remains) variations in

³⁴ Ibid.

³⁵ Similar results are obtained in respect of the other structural product prices provided by []. For example, for the 70x45 prices, the range in regional prices was previously around [], and is currently around [].

³⁶ []

³⁷ CHH “Response to Commerce Commission questions date 12 February 2007”, February 19 2007, paragraph 13.1.

³⁸ Bell Gully letter to Commission, 27 February 2007, page 6.

³⁹ Ibid, page 7.

structural price levels across regions. While some of the price change may reflect increased costs, it also appears that changes in the level of competitive pressure in some regions may explain recent changes in structural timber prices. If such price increases (and price variation between regions) can be sustained, this would suggest that there are regional geographic markets for, or regional differentiation in, for the production and supply of structural timber.

Transport Costs

185. The geographic boundaries of the structural timber market will depend on the significance of the cost of delivering timber to customers, relative to the value of the structural timber. If transport costs (and hence differentiation) within the North Island were zero, that would suggest that prices throughout the North Island would be uniform, and all suppliers of structural timber would be competing on the same basis. In other words, more distant mills would not be disadvantaged in terms of delivering their product over greater distances.
186. If, on the other hand, the costs of transporting structural timber were high relative to the value of the structural timber, the effective boundaries of the geographic dimension of the market would be narrow. As a result, sawmills competing from a distance would be at a significant disadvantage.
187. The Commission sought information from sawmills throughout the North Island on the costs incurred by those sawmills in transporting structural timber to customers, as well as information on the distance over which they transported structural timber. Table 5 summarises information supplied by structural sawmills relating to the cost of transporting timber to their customers.

Table 5: North Island Freight Costs and Distances

Mill	From	To	Freight cost (\$/m ³)	Distance (approx kms)
[]	[]	[]	\$15	160 km
	[]	[]	\$21	290 km
	[]	[]	\$28-50	400 km
	[]	[]	\$60	700 km
	[]	[]	\$9-12	140 km
	[]	[]	\$22-33	300 km
	[]	[]	\$40-53	500 km
[]	[]	[]	\$10	200 km
	[]	[]	\$20	450 km
[]	[]	[]	\$15	60 km
	[]	[]	\$25	180 km
[]	[]		\$20	
[]	[]	[]	\$5	10 km
	[]	[]	\$18	160 km
	[]	[]	\$30	440 km
[]	[]		\$8	15 km
	[]		\$15	40 km
[]	[]	[]	\$20	100 km

Mill	From	To	Freight cost (\$/m ³)	Distance (approx kms)
[]	[]	[]	\$25	130 km
	[]	[]	\$32	350 km
[]	[]	[]	\$7	40 km
	[]	[]	\$22	270 km
[]	[]	[]	\$24 ⁴⁰	450 km
[]	[]	[]	\$58	650 km
[]	[]	[]	\$31	350 km

Source: Industry Participants

188. The cost of transporting structural timber appears to be low relative to the value of structural timber, and transport costs (expressed as \$/m³) typically increase with distance, although often at a diminishing rate.⁴¹ This supports the use of a delivered pricing model of competition, as discussed in the competition analysis section.
189. A SSNIP-based approach could provide a guide to the geographic market boundaries. The acquisition of Lakesawn by CHH would result in an aggregation in the Taupo/Rotorua region. Current CHH price lists define the Bay of Plenty region as encompassing Taupo and Rotorua, as well as Whakatane and Tauranga. According to the CHH price list for [] currently pays CHH [] per m³ for MSG8 90x45 H1 structural product, and [] per m³ for the H3 product.
190. As these are delivered prices, freight costs need to be removed in order to derive a product price at the mill. Given an average freight cost within the Bay of Plenty region of [] per m³ (estimated based on the transport cost information presented in Table 5) the ex-mill prices faced by [] would be [] and [] per m³ respectively.
191. A 5%-10% SSNIP applied to the prevailing [] H1 price would result in a price increase of between \$[] and \$[] per m³. Such an increase is generally within the range of the intra-North Island freight costs listed in Table 5 above, suggesting that the geographic boundary of the structural timber market could be a North Island market.⁴² However, despite being able to profitably compete for distant customers, sawmills may prefer to sell structural timber to customers that are close by (particularly when capacity constrained).

Synthesis

192. The incidence of cases where sawmills transport structural timber throughout a large part of the North Island suggests that a North Island market could be appropriate. This behaviour is consistent with transport cost information provided by sawmills, which also

⁴⁰ This cost represents a backloading freight cost.

⁴¹ In other words, the freight cost per kilometre is often higher for shorter distances, suggesting some economies of scale in transport. This could be due to the loading and unloading of trucks representing a fixed cost (that is, not being sensitive to distance).

⁴² [] informed the Commission that it has not recently supplied into Northland, as TDC has been particularly aggressive in that region. However, [] has said that they would start supplying timber into Northland, if prices increased by \$10 (approximately 2%) relative to the prices in other regions.

suggests that transporting structural timber throughout the North Island is commercially viable.

193. However, the pricing information presented in Table 4 suggests that there is significant variation in prices between regions in the North Island. The pricing data also suggests that recent price increases have varied between regions in the North Island. As noted previously, the extent of this variation suggests that there is an element of geographic differentiation within the North Island structural timber market, with the level of differentiation being a function of the costs of transporting timber.

194. In addition to being a function of transport costs, the varying degree of recent price increases may also reflect differing levels of competitive activity across regions.

195. []⁴³
[

].

196. CHH suggests that the larger price increases have tended to be exceptional cases for smaller customers. However, [] raised concerns about the price increases introduced by CHH in early 2007, and in particular, the relatively significant price increases in the Northland region.⁴⁴ CHH has advised customers that prices will be increased further on 1 July 2007.⁴⁵

197. The Commission considers that regional price variations may be exacerbated by capacity constraints, which cause sawmills to focus on nearby customers rather than searching for customers that are further away. [] advised the Commission that [] is currently running its sawmill at full capacity, and therefore is focusing on meeting the needs of its existing customers. [] noted that [] prefers to supply customers that are close by, but that it will look at sending timber to Northland [].

198. If capacity constraints are addressed by competing sawmills, recent price increases in some regions, and the variation in prices between different regions, may not be sustainable.

199. Despite the variation in pricing behaviour between different regions, the Commission considers that defining separate regional markets within the North Island would not accurately reflect the way in which competition occurs for the production and supply of structural timber. In particular, there are likely to be significant areas of overlapping supply, especially in relation to the concentration of processing capacity in the CNI.

200. On balance, the Commission considers that the relevant competition effects are best identified by defining a North Island market that is characterised by geographic differentiation.

⁴³ Bell Gully letter to Commission, 27 February 2007, page 7.

⁴⁴ CHH estimates that excluding Carters, these [] merchants account for the following purchases of structural timber: []. Application, paragraph 102.

⁴⁵ []

201. The Commission has taken possible variations in competitive intensity throughout the North Island into account as part of the competition assessment, specifically in its consideration of the delivered pricing model of competition.

Purchase of Structural Logs

202. In Decision 588, the Commission considered the market in which unpruned logs are supplied. The Commission found that such logs can be transported economically over distances of up to approximately 150 kilometres, and concluded that the relevant geographic boundary in that case was the CNI.
203. The Commission considers that for the purposes of assessing the current Application by CHH to purchase Lakesawn, a CNI market is again likely to be appropriate. It is noted that the product market used in this case is for structural logs, which tend to be more valuable than other grades of unpruned logs, such as industrial logs. However, it is unlikely that this would make a significant difference in terms of the distance over which structural logs could be transported in response to a SSNIP.
204. For example, the Commission has previously referred to the range of unpruned log prices, and applied a SSNIP to the midpoint of that range to see what additional distance it would be economic to transport unpruned logs over in response to that SSNIP. Over the last two years, this range of S1, S2, L1, and L2 prices have been from \$65-\$86, and so a 10% SSNIP at the midpoint would represent a price increase of \$7.50 per m³, whereas a SSNIP applied to higher value structural logs would represent a price increase of \$8.50 per m³. At a transport cost of \$0.12 per m³ per kilometre, the resulting difference in the geographic boundary for structural logs compared with would be just under 10 kilometres (with the geographic boundary for structural logs being approximately 160 kilometres).
205. Therefore, the Commission has considered the impact of the proposed acquisition on the market for structural logs in the CNI.

Summary of Relevant Markets

206. The Commission concludes that the following markets are relevant for the purpose of considering the present Application:
- the geographically differentiated market for the production and wholesale supply of structural timber in the North Island; and
 - the market for the supply and acquisition of structural logs in the CNI.

COUNTERFACTUAL AND FACTUAL

207. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a comparison of the likely outcomes in two hypothetical situations, one with the acquisition (the factual) and one without (counterfactual).⁴⁶ The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

⁴⁶ *Air New Zealand & Qantas Airways Ltd v Commerce Commission* (No.6), unreported HC Auckland, CIV 2003 404 6590, Hansen J and KM Vautier, para 42.

Factual

208. In the factual, CHH would acquire Lakesawn’s stock, customer lists, files and records, supply contracts with customers and specific plant and machinery. [

].

209. The Lakesawn sawmill would be closed down, and the remainder of the plant and equipment (including the green mill) would be sold overseas.

210. [

].

211. CHH and Red Stag would remain the largest producers of structural timber in the North Island. There would continue to be a number of smaller sawmills in the North Island, including PinePac, Ahead Lumber, Northpine, and Pukepine.

Counterfactual

212. Lakesawn’s owner, Paul Pedersen, advised the Commission that [

]. Pedersens provides a number of these services to CHH, including a roundwood operation at CHH’s sawmill in Kinleith, and a chip mill where all product is currently on-sold to CHH. Pedersens has a long-standing relationship with CHH for the provision of these services.

213. CHH advised the Commission that [

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214. CHH considers that [

].

215. CHH said that there is potentially [

].

216. [

]:

[

].

217. Industry participants considered that the Lakesawn sawmill may close down regardless of whether the acquisition goes ahead.⁴⁷ Some noted that closing the Lakesawn sawmill

⁴⁷ [].

is in Pedersen's interest in order to preserve its long-standing commercial relationship with CHH as a provider of wood yard services and supplier of roundwood. Industry participants were of the view that CHH wants Pedersens to close the Lakesawn mill, and that this will happen one way or another.⁴⁸

218. [

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219. [

].

220. Lakesawn began to wind down its operations in January 2007, after Lakesawn staff were informed that Lakesawn was to be closed down, subject to Commission clearance being granted for the proposed acquisition. Lakesawn was forced to reduce its number of shifts per working day from two to one in February due to staff losses. Lakesawn closed its green mill in April after further staff losses. [

]

221. [

]

222. However, at no stage was it argued, either by the Applicant or the Vendor, that Lakesawn was a failing firm. [], Lakesawn [] contributor to the financial performance of Pedersens. For example, information provided by Lakesawn indicates that Lakesawn [] of the overall Pedersen Group profits in the 2006 financial year.⁴⁹

223. The Commission considers that Pedersens would have a strong incentive to restore the business under the counterfactual. The purchase price for Lakesawn is [

], and that under the counterfactual Pedersens would therefore be better off selling Lakesawn as a going concern rather than stripping the assets.

224. The sunk costs involved in establishing a sawmill also suggest that Lakesawn is worth more as a going concern. For example, Pedersens [

] Closure of the sawmill under the counterfactual would prevent Pedersens from realising the value of those investments. The Commission therefore considers that Pedersens would be unlikely to close Lakesawn under the counterfactual.

225. Accordingly, the Commission considers the likely counterfactual to be that Pedersens would either attempt to restore the Lakesawn business in preparation for sale, or it would sell to a third party, which would continue to operate the sawmill. In either case, the Commission considers that the sawmill would continue to operate, although on a smaller

48 []

49 [] submission to the Commerce Commission, 26 February 2007.

scale in the next twelve to twenty four months until the business is able to recover from its down-scaling in recent months.

COMPETITION ANALYSIS

The Purchase of Structural Logs in the CNI

226. CHH is the largest purchaser of structural logs in the CNI. CHH purchases structural logs from several suppliers in the []. CHH purchases a large portion of its logs [

] Prices are negotiated on a quarterly basis, and are based on market conditions in the previous quarter. [

].

227. Lakesawn purchases structural logs from suppliers such as []. Volumes and prices are negotiated on a [] basis.

228. In circumstances where buyers and sellers have contracts that specify quarterly supply volumes, and are unable to agree on the price for a given quarter, an independent arbitrator is appointed to determine the 'market price'. The 'market price' is determined through a benchmark study of industry-wide log supply transactions that have taken place over the previous quarter.

229. The Commission has considered whether the aggregation of purchasing power on the buyer's side of the market resulting from the proposed acquisition would allow the combined entity to artificially depress the price of structural logs in the CNI.

Existing Competition

230. CHH submitted that the combined entity would continue to face competition from other sawmills in purchasing logs. Additionally, CHH argued that it is constrained by the ability of forest owners to divert structural logs to export markets. CHH argues that, for these reasons, the acquisition of Lakesawn does not affect its ability to compete for logs.

231. The Commission has gathered information from the Applicant and other relevant parties, and has used this to estimate market shares for the purchase of structural logs in the CNI. These figures are set out in Table 6.

Table 6: Estimated Buyer Market Shares for the Purchase of Structural Logs in the CNI for 2006

	Location of mill	Volume	
		m ³	%
CHH	Kopu, Kawerau, Putaruru, Tokoroa	[]	[]%
Lakesawn	Taupo	[]	[]%
Merged entity		[]	[]%
Red Stag	Rotorua	[]	[]%
McAlpines	Rotorua	[]	[]%
Pukepine	Te Puke	[]	[]%
WPI	Ohakune	[]	[]%
Taranaki Sawmill	National Park	[]	[]%
Donelley	Reporoa	[]	[]%
Kiwi Lumber	Putaruru	[]	[]%
TOTAL		[]	100%

232. The acquisition of Lakesawn by CHH may result in CHH's share of structural logs purchased in the CNI increasing from []% to []%. This is outside the Commission's safe-harbour guidelines.
233. [] Lakesawn's log supply is not contracted, and would therefore be contestable and available on the open market post-acquisition. Therefore, in order for CHH to increase its share of the market from []% to []%, it would be required to compete with other sawmills for those logs that would have been purchased by Lakesawn in the counterfactual. Based on information provided by competing sawmills (discussed below), the Commission considers it likely that several of the existing competitors, such as Red Stag, McAlpines, Pukepine, WPI, and Taranaki Sawmills, would compete for those logs. As such, the proposed acquisition would not necessarily increase CHH's market share from []% to []%.
234. A number of forest owners have expressed concerns that, as a result of the acquisition, the merged entity might be able to exercise market power (as a large purchaser of structural logs in the CNI) by reducing the price it pays for structural logs.
235. [] was concerned that the acquisition of Lakesawn would leave only two significant log buyers in the CNI (CHH and Red Stag), and that, as a result, the price premium that has traditionally been placed on structural logs over and above industrial grade logs would be lost.
236. [] which manages forests around [], noted that [] of their structural log production is sold under contract to CHH, and that it presently uses Lakesawn [] to leverage bargaining power in price negotiations with CHH. [] is concerned that the acquisition of Lakesawn by CHH may hinder its ability to negotiate competitive log prices with CHH, and will eliminate the commercial benefits of having an independent customer located near its forests.
237. On the other hand, it is evident that there would remain several structural sawmills that either purchase, or have the capacity to process structural logs, of a volume similar to, or greater than, the amount processed by Lakesawn. For example, Red Stag currently processes []% of the structural logs harvested in the CNI, compared with Lakesawn's market share of []%.

238. Industry participants advised the Commission that their ability to purchase and process structural logs is limited by current shortages in the supply of structural logs, rather than by operational capacity constraints or a lack of demand for structural timber. Tim Rigter, General Manager of Red Stag, advised the Commission that Red Stag is not currently operating to capacity because it is currently unable to purchase sufficient volumes of high-density structural logs. However, Mr Rigter advised the Commission that CNI log harvest volumes are expected to increase significantly in the next two years and beyond, and that this will facilitate further expansion.
239. [] noted that one factor contributing to the current shortage of logs has been decisions by forest owners to delay the harvesting of their forests. While this has resulted in a relatively tight log market today, harvesting levels are expected to increase significantly, and [] considers that log availability in the CNI over the next couple of years will not constrain [].
240. [] view as to the expected increase in CNI harvest levels is consistent with information presented to the Commission during its investigation into Hancock's acquisition of the CHH forestry estate in late 2006. []
[].
241. Red Stag advised that it is planning to expand its structural log-in capacity from 327,000 m³ to 440,000 m³, but that it will seek additional contracted log supply before progressing these plans. Red Stag's expansion would be likely to take place in both the factual and the counterfactual.
242. There are several other structural sawmills that consume sizable volumes of structural logs. For example, [] consumes approximately [] of structural logs, compared with Lakesawn's structural log consumption of [] noted that structural logs are difficult to source because there is strong demand for structural logs in the CNI, []
[]
243. Information provided by industry participants⁵⁰ suggests that the cost of incremental expansion is not a significant barrier. For example, [] has the capacity to increase the volume of structural logs that it processes, but that []
[].
244. [] advised the Commission that [] plans to expand its production (and structural log consumption) by [] over the next two years, with minimal capital investment and no additional shifts.
245. The Commission considers that small to medium size sawmills would be likely to expand incrementally in response to an increase in the availability, or decrease in the

⁵⁰ []

price of structural logs, and would therefore be likely to compete for additional volumes of structural logs if the combined entity attempted to artificially reduce the price of structural logs under the counterfactual.

246. The Commission considers that the planned expansion of Red Stag, along with the potential for the expansion of other existing competitors, would be likely to generate sufficient additional structural log demand to offset any reduction in competition that may result from the loss of Lakesawn as an independent purchaser of structural logs in the CNI.
247. Lakesawn is a relatively small operation compared to Red Stag and CHH, and is located in proximity to a number of sawmills of similar scale that purchase structural logs. Thus the difference in competition between the factual and the counterfactual is unlikely to be significant.
248. In conclusion, the Commission is satisfied that the proposed acquisition is unlikely to result in a substantial lessening of competition in the market for the purchase of structural logs in the CNI. Accordingly, the Commission does not consider it necessary, for the purpose of assessing the current Application, to consider other constraints that may be present.

North Island Structural Timber Market

249. CHH is the largest supplier of structural grade timber in the North Island (and in New Zealand). CHH currently produces approximately [] m³ in the North Island, and has a market share of around []%. Lakesawn is the [] largest supplier of structural grade timber in the North Island, producing approximately [] m³ of structural timber per year, with a market share of approximately []%.
250. CHH and Lakesawn both supply structural timber to various building supply and farming supply stores, including Placemakers, Bunnings, ITM and Mitre 10. CHH and Lakesawn also supply structural timber to frame-and-truss manufacturers.
251. CHH supplies timber to its own subsidiary (Carters), which is the [] building supplies chain in New Zealand.
252. Sawmills typically have flexible supply agreements with customers that allow for the negotiation of timber sales on an ad hoc basis. These supply agreements often contain provisions for head office rebates and co-operative advertising. Head office rebates are a form of bulk discount, whereby customers are rewarded for meeting specified sales volumes.⁵¹
253. CHH submitted that the combined entity would continue to face competition from both North Island and South Island sawmills, sawmills in other sawn timber markets (appearance grade and industrial grade timber), and producers of other building materials (such as steel or concrete blocks). In the Application, CHH further noted that the threat of imports from Australia also impacts on its pricing decisions. According to CHH, its acquisition of Lakesawn would not give rise to a substantial lessening of competition because:
- the market is vigorously competitive;
 - the sawmilling market exhibits excess capacity;

⁵¹ [

- there are a number of participants in the market capable of expanding, and that do not face barriers to expansion (citing Red Stag as an example);
 - there are no barriers to new entry and there are a number of identifiable new entrants that would be likely to enter in response to a price increase above competitive levels; and
 - building supply chains can exert countervailing power.
254. However, concerns have been expressed by several building supply chains and frame-and-truss manufacturers in relation to the proposed acquisition of Lakesawn. For example, [] submitted that having recently purchased TDC sawmill, the subsequent acquisition of Lakesawn would allow CHH to exert control over the structural timber market.
255. [] submitted that “supply constraints in the timber industry are currently affecting all participants and the last and potential acquisitions are exacerbating the situation”.
256. In order to assess competition in this market, the Commission has considered the degree of constraint provided by existing competition, potential entrants, and the countervailing power of customers.

Existing Competition

257. The Commission has gathered information from the Applicant and other relevant parties, and has used this to estimate market shares for the North Island structural timber market. These figures are set out in Appendix 1.
258. The acquisition by CHH of Lakesawn would result in the estimated market share of CHH increasing from []% to []%. The capacity of the merged entity would amount to []% of the total structural timber production capacity in the North Island.⁵²
259. Red Stag would remain as a competing supplier of significant volumes of structural timber (currently []%). There are also a number of smaller mills, including Pukepine ([]%), Kiwi Lumber ([]%), and Anderson & O’Leary ([]%).
260. Following the proposed acquisition, the three-firm concentration ratio based on output would be []%.⁵³ Given the post-acquisition market share of CHH ([]%), the acquisition would lie outside of the Commission’s safe harbours.⁵⁴
261. [] noted that it has had difficulty sourcing structural timber since Lakesawn began reducing production volumes in January. [] argued that apart from CHH and Red Stag, the remaining competitors are too small to meet the requirements of large timber purchasers.
262. [] has also expressed concern that CHH’s acquisition path is leading to high concentration in the market. [] noted that there are limited options available to replace the timber supplied by Lakesawn, and that many of the competitors can supply only small quantities of structural timber.
263. CHH pointed out that Red Stag had recently expanded its structural timber production capacity significantly, and that this capacity expansion illustrates the lack of barriers to

⁵² Estimated capacity that could be achieved without undertaking major capital expenditure

⁵³ The three-firm concentration ratio for a particular market is calculated by combining the three largest businesses, and measuring that as a percentage of the total size of the market.

⁵⁴ Commerce Commission, *Mergers and Acquisitions Guidelines*, page 25.

expansion in the structural timber market. Further, CHH argued that there is material excess capacity in the North Island.

264. [

]

265. [

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266. [

].

267. By expanding capacity, Red Stag would be in a better position to respond to any post-acquisition increase in CHH's structural prices by increasing its own production, thus diminishing the extent to which competition would be lost through the exit of Lakesawn.

268. The Commission recognises that the geographically differentiated North Island structural timber market is a highly concentrated market characterised by a large number of small suppliers, and a small number of large suppliers. The Commission has spoken to several small structural sawmills to assess the degree of constraint that they would be likely to pose on the combined entity.

269. Several of the small to medium size sawmills advised the Commission that they are currently expanding their operations. Examples of these include [] all of whom are ramping up current production levels in response to expected increases in Northland log harvesting levels and recent price increases for various structural timber grades. [] the aggregate effect of several small mills expanding their production will provide some degree of constraint in both the factual and the counterfactual.

270. Not all sawmill owners expressed an interest in expanding. [] advised the Commission that [] produces small amounts of structural timber at its mill, but that it purchases most of its structural timber requirements from CHH. [] noted that it would not increase its structural timber production, even in the face of a significant increase in the price of structural timber, because it does not have the scale to produce structural timber efficiently.

The Impact of Economies of Scale

271. The Commission has seen some evidence suggesting that there are economies of scale in the production of structural timber, this could limit the degree of competitive constraint provided by small sawmills. The impact of scale on the cost of producing structural

timber is illustrated in **Figure 2**, which plots production costs⁵⁵ against log consumption for a range of actual and hypothetical sawmill operations. The hypothetical examples include the structural mill CHH was planning at Marsden Point, [] TDC Fortress mill at Whangarei (now owned by CHH).

Figure 2: Timber Production Costs and Log-in Volumes []

]

272. The trendline⁵⁶ in Figure 2, which provides a reasonable ‘fit’ to the data, indicates that the unit cost of a large scale sawmill (such as the Bigfoot sawmill) would be approximately \$[] per m³. Other relatively large sawmills have []: Red Stag (\$[] per m³), CHH’s Kawerau mill (\$[] per m³), and the former TDC Fortress mill (\$[]).
273. By comparison, Lakesawn (which is significantly smaller in scale) has an estimated unit production cost of \$[] per m³.⁵⁷ Other small mills represented in Figure 2 have production costs in excess of \$[] per m³.
274. CHH has argued that other factors will offset the scale disadvantage in production faced by smaller sawmills. For example, smaller sawmills source logs and supply customers within a smaller geographic area than large sawmills, and therefore incur lower transport costs. []

⁵⁵ Production costs include green mill costs (primary sawmill), kiln costs (associated with drying the timber), and dry mill costs (relating to planing and edging). Production costs do not include overhead costs.

⁵⁶ A logarithmic trend line is fitted.

⁵⁷ But as noted above, these costs are only part of the total cost of production.

] This suggests that large log buyers may be able to secure favourable log prices.

275. While smaller mills may on average be located in closer proximity to their customers, this may not necessarily result in significantly lower distribution costs. This is because only a portion of freight costs are distance-sensitive. There are also fixed costs associated with transporting timber, such as the costs of loading and unloading the truck, which are incurred irrespective of the transport distance.⁵⁸
276. Additionally, small sawmills may be more likely to transport smaller loads of timber, amounting to only partial truck loads. [] has provided the Commission with information showing that the cost of delivering timber per square metre is higher for partial loads, when compared with full loads. Taking this information into account, it is not clear that large sawmills will face materially higher freight costs than smaller mills.
277. Transport cost information provided by parties (illustrated in Table 5) suggests that larger mills may in some cases incur additional costs of transporting timber to customers. However, where differences exist between the transport cost incurred by [] and that incurred by smaller sawmills (such as []), those differences only partially offset the significant production cost disadvantage faced by the smaller mills.⁵⁹
278. Some industry participants advised the Commission that small sawmills are able to compete because they face lower overhead costs than CHH.⁶⁰ Other industry participants, such as [], consider that small sawmills are at a significant cost disadvantage to CHH in producing structural timber.
279. The Commission considers that the economies of scale achieved by large sawmills in the production process would be only partially offset by the factors discussed above. The Commission considers that the economies of scale achieved by large sawmills in producing structural timber is a relevant factor in considering the competitive impact of aggregation in the relevant market. However, the Commission considers that small sawmills do each pose some constraint within a relatively narrow geographic area.⁶¹
280. The cost disadvantage faced by Lakesawn, compared with large sawmills such as CHH and Red Stag, suggests that while the proposed acquisition would result in some aggregation of market share (from around []% to []%), this aggregation may to some extent overstate the overall loss of competition resulting from the acquisition. However, the impact of the acquisition may be more significant within the area immediately surrounding the Lakesawn sawmill.

Merger Simulation in a Geographically Differentiated Product Market

281. The Commission has undertaken some quantitative modelling to simulate the merger in the context of a geographically differentiated market. The modelling is intended to assist the Commission in assessing the likely impact of the proposed acquisition.
282. Behaviour in geographically differentiated markets is often analysed by economists using models of imperfect competition, in which consumers view each firm's product as

⁵⁸ For example, freight costs expressed as \$ per m³ per kilometre tend to be lower for greater distances.

⁵⁹ For example, in **Figure 2**, the smaller mills production costs are around \$[] per m³, while production costs at CHH Kawerau are [] per m³.

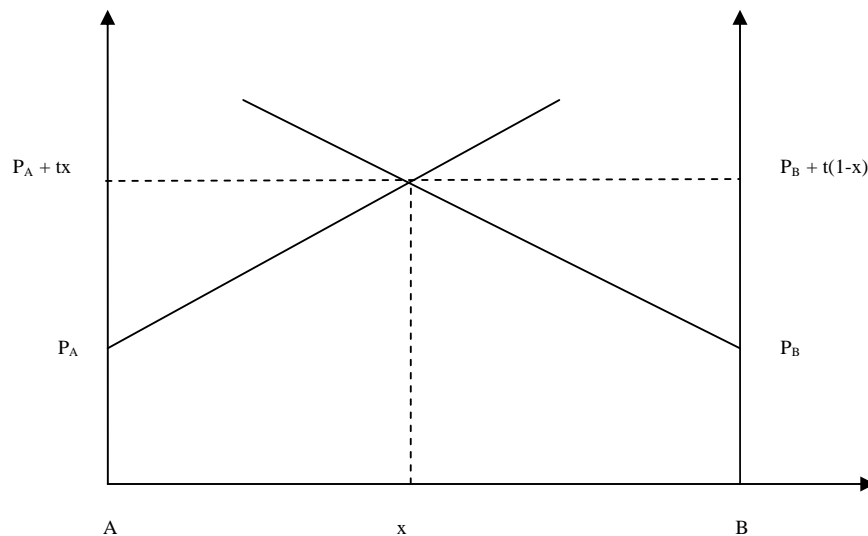
⁶⁰ [].

⁶¹ As shown in Appendix 1, the smaller mills collectively account for approximately [] of current North Island structural timber production.

occupying a particular location in geographic and/or product (characteristic) space.⁶² The closer two products in this space are, the more substitutable they are regarded by consumers; the less close, the less substitutable they are. Spatial models predict that competitors will seek to move away from each other in the spectrum, in order to create a degree of market power. The degree of market power a firm has will depend on the distance it is away from the next nearest product, and the extent to which supply-side substitution (product re-positioning to exploit ‘gaps’ between existing substitutes) can occur.

283. Given the discrete location of production, the geographic dispersion of buyers, and the presence of transport costs, it is reasonable to consider the merging of two sawmills within a framework of geographic differentiation. In principle, such an analysis would take into account the spatial nature of production and competition, with the result that aggregation of processing capacity in adjacent areas could have a different impact on competition than an aggregation involving more dispersed production sites.
284. A delivered pricing model of competition is depicted in Figure 3.

Figure 3: A spatial competition model



285. The horizontal axis represents the two-dimensional geographic space along which customers are assumed to be evenly distributed. A and B represent the location of two firms, both selling the same product. Transport costs increase in proportion to the delivery distance from the mill to the customer. P_A represents the price of firm A’s product, before freight (the ‘ex-mill’ price). $P_A + tx$ represents the delivered price to the customer, where ‘ x ’ is the delivery distance in kilometres and ‘ t ’ is the transport cost per kilometre. The delivered price from B is likewise shown by the line sloping upwards to the left from P_B .
286. The above illustration shows that firm A has an advantage in supplying customers to the left of point x , as its delivered price is lower, while firm B has an advantage in supplying

⁶² Dennis W Carlton and Jeffrey M. Perloff, *Modern Industrial Organisation* (3rd ed.), Addison-Wesley, 2000, p. 215.

customers to the right of that point. Each has a natural market within which it is able to under-price its rivals.⁶³

287. Suppose that firms A and B are located close together, so that they compete with each other quite strongly, and that the next nearest firm is located much further away, so that it poses much less of a competitive constraint because of high transport costs. In this case, if firms A and B were to merge, the merged entity could increase the prices charged to their customers quite significantly, to a level just below that charged by the next closest competitor.
288. This merger simulation takes into account the cost of transporting timber products from the mill to the customer, and does this by modelling customers with localised preferences in respect of purchasing structural timber. In other words, a customer's demand for structural timber produced by a particular mill is assumed to decrease as the distance between the customer and the mill increases. This provides local sawmills with an inherent advantage in terms of supplying local demand, in line with the delivered pricing model discussed above.
289. The other key assumption in the simulation relates to the partitioning of the North Island into Upper, Central, and Lower regions. This partitioning reflects the main centres of demand for and supply of structural timber in the North Island.
290. There are a number of other assumptions built into the model, as follows: there are production cost differences between the mills, and these are reflected in market shares; there are no capacity constraints for existing firms (i.e. firms can expand or contract in response to the simulated demand/price shifts); there is no new entry; and the market elasticity is -1, while the firm price elasticity of demand (for CHH), based on critical loss analysis, is -2.
291. Merger simulation can provide a helpful guide in assessing the possible pricing impact of an acquisition. In the current case, the Commission has used a model that simulates the ability of mills to compete, once transport costs are taken into account. The Commission notes that such simulation is only one element of its analysis of the competition implications of the proposed acquisition. The merger simulation takes no account of qualitative factors that will typically be relevant, such as potential entry and the possible countervailing power of acquirers. The Commission has considered these issues separately as part of this decision.
292. The results of the Commission's simulation modelling suggest that, all else being equal, CHH's acquisition of Lakesawn could produce a 3.5% increase in structural timber prices sourced from the Upper North Island, 4.5% in the central North Island, and 1.5% for the Lower North Island.
293. These results reflect the aggregation of Lakesawn and CHH in the CNI, where both parties to the acquisition operate sawmills that produce structural timber. According to models of spatial competition, a sawmill supplying a local customer will tend to supply that customer at a delivered price that is just below the price of the next closest competitor. Where two mills that are relatively close are merged, the competition between them will be eliminated, and they will tend to raise prices and reduce output. More distant mills will tend to expand output and raise price to a lesser degree in response to their increase in demand.

⁶³ Firms with lower costs will tend to have larger natural markets than higher cost firms.

Conclusion on Existing Competition

294. Given the degree of geographic differentiation in the market, the impact of the proposed acquisition is likely to be strongest in the CNI region (surrounding the CHH and Lakesawn sawmills). However, Lakesawn is a relatively small [] operation compared to Red Stag and CHH, and is located in a region where a number of competing suppliers are concentrated, including Red Stag.
295. The Commission considers that the planned expansion of Red Stag, along with the potential for the expansion of other existing competitors, would be likely to generate sufficient additional structural timber supply to offset any reduction in competition that may result from the loss of Lakesawn as an independent structural timber supplier. Thus the difference in competition between the factual and the counterfactual is unlikely to be significant.⁶⁴
296. In addition, the results of the modelling undertaken by the Commission suggest that the merger could result in increases in local prices of approximately 4-5%, with lesser increases expected in more distant areas.
297. In conclusion, the Commission is satisfied that the proposed acquisition is unlikely to result in a substantial lessening of competition in the geographically differentiated North Island structural timber market.

Potential Entry

298. The Commission considers it useful in the context of assessing the current Application to consider the constraints imposed by potential entrants.

Entry by Non-Structural Sawmills

299. The Application includes a list of non-structural mills that, the applicant believes are potential entrants into the structural timber market.⁶⁵ [] are unlikely to be entrants into the structural market, for the reasons set out below.⁶⁶ A number of the smaller mills listed by CHH as being non-structural – [] – have already been included in the Commission’s analysis of existing competition in the structural timber market.
300. The remaining non-structural mills listed by CHH are generally smaller scale mills, and while some of these might consider converting into structural production, they are unlikely to be of a sufficient scale to pose a significant competitive constraint in the structural timber market within a two year timeframe.
301. As noted previously, [] would need to undertake a substantial reconstruction of its mill in order to produce structural timber.
302. [] is a large appearance grade mill located in []. In an operational sense, [] could switch to the production of structural timber relatively easily. []

⁶⁴ In *New Zealand Bus Limited v Commerce Commission*, the court noted that the SLC test is a “relative, rather than an absolute standard”, and “it examines the state of competition with and without the transaction to determine whether and to what extent market power will move along the spectrum from perfect competition to monopoly”. NZ Bus, paragraph 121.

⁶⁵ Application, Table 3. CHH refer to these mills as potential appearance grade producers (paragraph 91). However, it appears that the listed mills are non-structural mills (i.e. mills producing appearance grade and/or industrial grade timber), which according to CHH could switch into structural timber production.

⁶⁶ A number of these mills have been dismissed as ‘near entrants’ in the earlier discussion on the relevant product market dimension.

303. []
304. []
305. [] a large industrial timber mill located in [] also said that it cannot produce a full range of structural timber products, because it is unable to cut timber that exceeds 5 metres in length. [] focuses on producing industrial and appearance grade timber for export.
306. [] in [] is an example of an appearance grade sawmilling operation that has recently switched to the production of structural timber. []
307. [] advised the Commission that the initial switch was made easily, but that changes need to be made over time to increase the productivity of the mill. []
308. In order to set up its sawmill in a way that is more suited to structural timber production, []
309. In summary, the Commission does not consider that entry by conversion into the structural market by the larger non-structural mills is likely within a two year time frame.

While some smaller scale entry is likely, such entry would be unlikely to be of a sufficient scale to constrain the merged entity.

De Novo Entry

310. Another possible form of entry would be the development of a greenfield structural sawmill. CHH has submitted that de novo entry could occur within 18-24 months, but that such entry is less likely than other forms of entry.⁶⁷

311. [

]

[

].

312. This suggests that new entry on a significant scale is unlikely within the two year timeframe usually employed by the Commission. [

]

313. [

]

314. A number of parties have also referred to an Environment Court decision, to prevent a new \$30 million sawmill development proposed by Earnslaw One for the Coromandel region, as evidence of the difficulties in establishing a new greenfield sawmill in New Zealand. Earnslaw One's subsidiary, Blue Mountain Lumber, had gained the necessary resource consents for the proposed mill, although an appeal to the Environment Court led to the development being discontinued.⁶⁸

315. The Commission considers that while de novo entry is possible, the extent of such entry within two years is unlikely to provide a sufficient constraint on the merged entity.

Conclusion

316. Accordingly, the Commission considers that potential entry would be unlikely to constrain the combined entity in the factual scenario, within the relevant timeframe.

Countervailing Power

317. The Commission has considered whether the potential for the merged entity to wield market power in the North Island structural timber market might be constrained by countervailing power in the hands of its customers.

⁶⁷ Application, paragraphs 97, 98.

⁶⁸ http://www.nzfoa.org.nz/news/environment_court_decision_fells_blue_mountain_lumber_s_coromandel_mill

318. Under the factual, the merged entity would be likely to continue supplying Carters Building Supplies (with []% of the retail timber market). CHH would also supply PlaceMakers, [], ITM ([]%), Bunnings ([]%), and Mitre 10 ([]%).
319. CHH submitted that timber merchants exert significant countervailing power in the North Island structural timber market. CHH argued that store owners can meet their individual store requirements by trading with local sawmills. CHH submitted that there is excess capacity in the North Island structural timber market, and that as a result timber retail merchants are in a strong position to negotiate with sawmills. CHH argued that there are no costs faced by timber merchants in switching to alternative suppliers.
320. There are various reasons why customers might find it difficult or costly to switch to a competitor. The larger chains negotiate with suppliers at a head office level for customer rebates based on the volume of their purchases. The rebates schemes offer increasing incentives for meeting staggered 'share of purchase' thresholds. These rebates are negotiated with head office, but are typically shared with individual store owners in order to encourage them to purchase from the preferred supplier.
321. While these rebates are designed to attract as much volume as possible for the timber supplier, they do suggest that the larger retail chains have some degree of negotiating power (they are able to negotiate a bulk discount price that is favourable to the prices available to independent stores).
322. However, a customer who diverts part of its structural timber requirements to a smaller supplier will have to take into account the loss of rebate associated with such diversion. This may act as a disincentive for switching to alternative suppliers.
323. There are also costs associated with dealing with multiple suppliers. Timber merchants have noted that they prefer to have a single supplier for all their stores, so that they are able to offer their customers the same products and run the same promotions nationwide.
324. [] noted that smaller mills cannot offer the security of supply, nor the volume required by large timber merchants such as [], and that the recent acquisitions of TDC and Lakesawn by CHH increase [] reliance on CHH. [] also expressed concerns that it will be disadvantaged as a customer of CHH because it competes with Carters at the retail level.
325. The main buyers of structural timber have expressed concern at recent increases in structural timber prices, especially in certain regions, and have noted that their ability to negotiate discounts at a store or regional level has been reducing. For example, [], which according to CHH is the [] largest buyer of structural timber ([]%), has noted that in relation to the ability of customers to influence timber pricing:⁶⁹

[

]

⁶⁹[].

326. [

].

327. CHH has changed the way in which it sets timber prices, and this appears to have involved a move away from negotiating at a regional level, towards negotiating at a national level. While larger customers appear to have been able to negotiate national volume-based rebates, the withdrawal by CHH of its previous practice of offering regional discounts off its price lists does appear to reflect some reduction in the negotiating power held by its customers.
328. The Commission considers that the countervailing power of CHH's customers is limited by CHH's involvement in the timber distribution functional level of the market, which offers CHH a secure distribution channel, thus reducing CHH's reliance on other building supplies chains. In summary, the Commission considers that the countervailing power of large customers would be weakened in the factual compared with the counterfactual. Accordingly, countervailing power would pose limited constraint on the combined entity in the factual.

Conclusion

329. The Commission considers that the impact of the proposed acquisition is likely to be the strongest in the geographic area surrounding the Lakesawn sawmill.
330. However, Lakesawn is a relatively small [] operation compared to Red Stag and CHH, and is located in a region where a number of competing suppliers are concentrated, including Red Stag.
331. The Commission considers that the planned expansion of Red Stag, along with the potential for the expansion of other existing competitors, would be likely to generate sufficient additional structural timber supply to offset any reduction in competition that may result from the loss of Lakesawn as an independent structural timber supplier. Thus the difference in competition between the factual and the counterfactual is unlikely to be significant.
332. This is supported by the results of the modelling undertaken by the Commission, which suggests that the merger could result in increases in local prices of approximately 4-5%, with lesser increases expected in more distant areas.
333. The Commission considers that potential entrants would be unlikely to constrain the combined entity in the factual scenario, within the relevant timeframe.
334. The Commission considers that the countervailing power of large customers would be weakened in the factual compared with the counterfactual, such that countervailing power would be unlikely to constrain the combined entity.
335. The Commission is satisfied that the proposed acquisition is unlikely to result in a substantial lessening of competition in the geographically differentiated North Island structural timber market.

OVERALL CONCLUSION

336. Overall, the Commission is satisfied that the proposed acquisition would be unlikely to result in a substantial lessening of competition in either:

- the geographically differentiated market for the production and wholesale supply of structural timber in the North Island; and
- the market for the supply and acquisition of structural logs in the CNI.

DETERMINATION OF NOTICE OF CLEARANCE

337. Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by Carter Holt Harvey Ltd to acquire the structural and industrial sawmilling business and certain assets of Lakesawn Lumber Limited.

Dated this 9th day of May 2007

Paula Rebstock
Chair
Commerce Commission

Appendix 1: Structural Timber Production in the North Island

	location of mill	current production		current capacity		planned capacity	
		m ³	%	m ³	%	m ³	%
CHH	Kopu, Kawerau, Putaruru, Whangarei	[]	[]	[]	[]	[]	[]
Lakesawn	Taupo	[]	[]	[]	[]	[]	[]
Merged entity		[]	[]	[]	[]	[]	[]
Northpine	Waipu	[]	[]	[]	[]	[]	[]
Bay Lumber	Waipapa (Northland)	[]	[]	[]	[]	[]	[]
Kaihu Valley Sawmills	Dargaville	[]	[]	[]	[]	[]	[]
Rosvalls	Whangarei	[]	[]	[]	[]	[]	[]
Ahead	Auckland	12,000	[]	[]	[]	[]	[]
Anderson & O'Leary (Pinepac)	Whenuapai	[]	[]	[]	[]	[]	[]
Red Stag	Rotorua	[]	[]	[]	[]	[]	[]
McAlpines	Rotorua	[]	[]	[]	[]	[]	[]
Pukepine	Te Puke	[]	[]	[]	[]	[]	[]
WPI	Tangiwai	[]	[]	[]	[]	[]	[]
Donelley	Reporoa	[]	[]	[]	[]	[]	[]
Kiwi Lumber	Putaruru, Dannevirke, Masterton	[]	[]	[]	[]	[]	[]
Pan Pac	Hawkes Bay	[]	[]	[]	[]	[]	[]
Prime	Gisborne	[]	[]	[]	[]	[]	[]
Eurocell	Upper Hutt	[]	[]	[]	[]	[]	[]
Taranaki Sawmills	New Plymouth, National Park	[]	[]	[]	[]	[]	[]
Allied Pine	Whanganui	[]	[]	[]	[]	[]	[]
TOTAL		[]		[]		[]	