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Public version

Metal Roof Flashings

Investigation Report

Date: 5 October 2015

CONTENTS

Purpose

1. This report summarises the outcome of the Commerce Commission's (Commission) investigation into whether particular clauses of a settlement agreement entered into between Consolidated Alloys (N.Z.) Limited (CA), Edging Systems (NZ) Limited (ESL) and Robert Max Brough to settle a patent dispute on 14 June 2013 are likely to breach section 27 or section 27 via 30 of the Commerce Act 1986 (the Act).

2. In our view, the evidence supports a conclusion that clause 8 of the Settlement Agreement breached section 27 of the Act, as it had the purpose and likely effect of substantially lessening competition in the metal roof edge products market and the market for soft-edge flashing products, during a post-patent period.

3. The Commission has issued a warning to CA for its conduct. ESL applied for and was granted immunity under the Commission's Leniency Policy.

4. This summary report has been prepared to provide a public record of our views, the reasons for these views and the enforcement action taken against CA. The report is intended to assist participants in the industry and the general public (including businesses) to understand the investigation and its outcomes.

5. The Commission makes this report publicly available in accordance with its statutory functions and powers, including under section 25 of the Act, which allows the Commission to make information available with respect to the carrying out of its functions and the exercise of its powers.

6. The Commission emphasises that the views we have formed, as contained in this report, have not been tested in court. Where we have made assessments, we have proceeded by asking whether a substantial lessening of competition could ultimately be proven in court. However, only a court can make findings of fact or law, and this report does not purport to do either. Rather, it records the Commission's view on this investigation and the reasons for its decision to issue a lower level enforcement response to CA.

Summary

7. We have been investigating a settlement agreement entered into between CA and ESL to resolve a patent dispute.

8. Around October 2011, CA commenced proceedings in the High Court against ESL and ESL's Managing Director and owner, Mr Brough. The proceedings concerned an alleged breach of the registered patent (the patent)[1] CA holds over soft-edge flashing products for use on residential metal roofs.

9. CA alleged that ESL breached its patent by selling a soft-edge flashing product under the brand name EZ-Edge. CA sells a soft-edge flashing product under the brand name Flashguard-Z.

[1] Patent number 290485: title "Building construction material".

10. A trial was scheduled for 17 June 2013; however, the parties entered into the settlement agreement to discontinue the proceedings on 14 June 2013.[2]

11. ESL denied that EZ-Edge breached the patent[3] but agreed to:

 11.1 pay a settlement sum of $[ ] in three instalments between [ ] and [ ] (clause 3);

 11.2 pay a [ ]% royalty on the annual sales of its EZ-Edge product for a period of [ ] years until [ ] (with a minimum annual payment of $[ ]) (clause 5); and

 11.3 not sell any soft-edge flashing products other than EZ-Edge for 10 years from the date of settlement (ie, until 14 June 2023) (clause 8).[4]

12. On 22 September 2014, ESL applied for immunity for alleged cartel conduct affecting competition for the supply of soft-edge aluminium roof flashing products in New Zealand arising from the settlement agreement.[5] ESL's primary concern was the ten year restriction in clause 8 of the agreement.

13. The Commission granted conditional immunity to ESL and its past and present directors and employees, including Mr Brough, on 28 October 2014.

14. Since October 2013, ESL has been manufacturing and selling another soft-edge flashing product under the brand name Vent Edge. CA notified ESL on 9 October 2013 that this product breaches the patent and clause 8 of the settlement agreement, although it has not pursued this claim any further.

15. Without a court ruling, we cannot conclusively determine whether the patent validly applies to EZ-Edge, Vent Edge and any other soft-edge flashing product that CA may seek to restrict ESL from selling during the patent period. Therefore we have assumed the patent was validly in place up to 10 August 2015 for the purposes of our investigation.

16. However, clause 8 applies beyond the expiry of the patent. Consequently, the focus of our investigation relates to the impact of clause 8, and any associated impact of clause 5, in the post-patent period.

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2 The settlement agreement was strictly confidential and was not to be disclosed to any other person except for the purpose of legal or financial advice, or as required by law.

3 In the "Background D" section of the settlement agreement. [ ].

4 The definition of soft-edge flashing in the settlement agreement is the soft-edge aluminium flashing product of the type covered by and referred to in the Patent.

5 The application from ESL had its origins in a presentation by an executive officer of the EMA and Metal Roof Manufacturers Association. This presentation covered upcoming changes to commercial legislation, including the Commerce Act.
[ ].

17. CA subsequently advised the Commission that it had sent a letter to ESL on 10 August 2015 advising that it will not enforce clause 8 of the 14 June 2013 settlement agreement from the date of expiry of the patent, ie, from 10 August 2015.[6] [7]

18. Even though we consider a breach of the Commerce Act has occurred, applying our Enforcement Response Criteria, we are not recommending seeking a pecuniary penalty or issuing proceedings in the first instance as a result of this investigation. This is primarily because:

    18.1 whether the patent is valid or not, CA has not prevented ESL from selling its new Vent Edge product;

    18.2 CA advised ESL that it will not enforce clause 8 of the settlement agreement after the expiry of the patent;

    18.3 there has been no apparent harm to date and there is unlikely to be harm in the future; and

    18.4 CA has been cooperative.

19. As a result, the public interest is not in favour of the Commission commencing court action, given the costs, risks and uncertain future benefits involved.

Background

20. This section sets out the relevant background and facts. In particular, the key parties to this investigation, the patent and metal roof flashings.

Key parties

Edging Systems (NZ) Limited (ESL) ¬– the immunity applicant

21. ESL is a New Zealand-owned and registered company located in New Plymouth. ESL was founded by Mr Brough in September 2008. ESL is only involved in the manufacture/importation and distribution of edge products.

22. ESL is one of two manufacturers/importers and distributors of soft-edge flashing products in New Zealand. The other being CA.

23. As discussed, ESL manufactures and distributes a soft-edge flashing product under the brand name EZ-Edge.

24. Since October 2013, ESL has been manufacturing and selling another soft-edge flashing product under the brand name Vent Edge. Vent Edge is discussed in further detail below.

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[6] [ ].

[7] [ ].

Consolidated Alloys (N.Z.) Limited (CA) – the investigated party

25. CA is a wholly-owned subsidiary of Amalgamated Metal (Australia) Limited.[8] CA is the largest manufacturer/importer and distributor of soft-edge flashing products in New Zealand.

26. As discussed, CA manufactures and distributes a soft-edge flashing product under the brand name Flashguard-Z.

Third-party roll formers

27. As part of the investigation, we held voluntary interviews with four third-party roll formers (roll formers produce finished metal roofs):

    27.1 [ ];

    27.2 [ ];

    27.3 [ ]; and

    27.4 [ ].

The patent

28. The patent was filed on 10 August 1995 and expires on 10 August 2015.

29. The patent in broad terms covers soft-edge flashing products that comprise of:[9]

    29.1 a metal sheet, such as aluminium, containing deformations or perforations that enable the metal sheet to be expanded longitudinally to conform to the corrugations in long run metal roofing (perforated metal); and

    29.2 an expandable waterproofing layer of a material, such as polyisobutylene, that is provided beneath the planar sheet (rubber backing).

Metal roof flashings

30. The purpose of a metal roof flashing (flashing) is to provide a weather seal to stop water coming into the roof cavity or cladding at certain points where roofing, and roofing-cladding planes meet.

31. To complete the seal between the flashing and the main metal roof, two techniques are commonly used:

    31.1 applying an edge product; and

    31.2 notching the flashing.

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8 CA trades under the name of DLM Wallace in New Zealand. Its operations include the sale of metal products, roofing and flashing solutions, solder and flux products and waterproofing solutions.

9 Patent number 290485 (for documentation see Filesite reference 2148848). Also refer to page four of letter received from CA on 19 November 2014 (Filesite reference 1998957).

32. Our investigation concerns edge products; in particular, soft-edge flashing products.

Edge products

33. For the purpose of this investigation report, edge product refers to any product that is attached to the edge of the flashing to create a weather seal.

34. Generally, edge products are only suitable on residential roofs. This is because notching is generally required on commercial roofs as they have a higher profile.[10]

35. As is explained in further detail in Attachment A, there are two types of edge products commonly used in New Zealand:

    35.1 strip products (these products comprise of a strip of soft aluminium); and

    35.2 soft-edge flashing products (these products comprise of a piece of perforated aluminium with a rubber backing).[11]

36. As well as being the only manufacturers and distributors of soft-edge flashing products in New Zealand, CA and ESL are also the only distributors of strip products in New Zealand (all strip products are imported).

37. For 2014 the total sales revenue for the edge products market was approximately $[ ].[12] Soft-edge flashing product sales amounted to approximately 80% of the edge products market by value and 65% by volume.[13]

Soft-edge flashing products

38. CA has sold Flashguard-Z from around 1995 in accordance with the patent. ESL has sold EZ-Edge since August 2009. Both products are made from similar materials; they have a reasonably similar appearance and they perform exactly the same function. Their essential feature is they are an easy to install solution for providing a water proof seal at the edge of a flashing.

39. In October 2013, four months after the settlement agreement was entered into, ESL introduced a new soft-edge flashing product Vent Edge.

40. Vent Edge is said by ESL to be the most significant design development since soft-edge flashings were introduced in the mid-1990s. Unlike EZ-Edge and Flashguard-Z, Vent Edge does not have a full rubber backing across the width of the perforated aluminium. Mr Brough says this feature enhances ventilation.

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10 The Metal Roofing Manufacturers’ code of practice states that notching is the preferred option for roofs with a profile over 30mm in height.

11 Soft-edge aluminium flashings are essentially unique to New Zealand; they are only manufactured here. New Zealand metal roofs are manufactured primarily from zinc-aluminium coated steel which is compatible with soft-edge aluminium flashing in terms of avoiding bi-metallic (dissimilar metals) corrosion.

12 Using CA’s and ESL’s respective financial years for 2014/15.

13 See Filesite reference 2025145 and edge products are sold by lineal metre.

41. Soon after ESL first started selling Vent Edge, CA sent a letter to ESL asking it to immediately cease selling or offering Vent Edge for sale.[14] CA said to us that Vent Edge was "a deliberate and calculated breach of clause 8 of the settlement agreement since these flashings continued to breach our patent and were other than EZ-Edge (and therefore outside of the royalty payment)".[15]

42. ESL contends [ ].

43. [ ].[16]

44. [ ] ESL has continued to manufacture and sell Vent Edge.
[ ].[17]
[ ].

Legal framework

Agreements that substantially lessen competition

45. Section 27 prohibits a firm from entering into or giving effect to a provision of an agreement that has the purpose, effect or likely effect of substantially lessening competition in a market.

46. To determine whether a provision is in breach of section 27, we look at how competitive the market is with the provision compared to how competitive the market would be without the provision.

47. The hallmark of the competitiveness of a market is the extent to which participants within it possess "market power". Market power is the ability to profitably and sustainably raise prices above, or reduce quality below, competitive levels. If an increase in a party's market power is substantial,[18] relative to what it would be without the agreement, an agreement is likely to breach section 27.

48. Section 27 also considers the "net" effect on competition, ie, it is necessary to balance the pro-competitive effects against the anti-competitive effects when

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[14] This letter was attached as "Appendix 4" in an email sent by CA's lawyers to the Commission on 19 November 2013 (Filesite reference 1907966).

[15] In a letter from CA to the Commission on 19 November 2014 at 5 (Filesite reference 1998957).

[16] [ ].

[17] [ ].

[18] "Substantial" is defined in the Act to mean real or of substance - section 1A of the Act.

testing whether the provision had the effect or likely effect of substantially lessening competition.

Price fixing agreements

49. Any provision of an agreement between competitors which has the purpose, effect or likely effect of fixing, controlling or maintaining prices (or any discount, allowance, rebate or credit) is deemed to breach section 27 via 30 of the Act. Therefore, analysis of whether the provision substantially lessens competition is not required.

Possible breaches of the Commerce Act

50. Our investigation considered whether clauses 5 and 8 likely breach section 27 and/or section 27 via 30 of the Act.

Clause 5: royalty payment

51. Clause 5 requires ESL to pay an annual [ ]% royalty to CA on each year's total sales of EZ-Edge until [ ]. The minimum annual payment that ESL must make is $[ ] and the royalty payment must be supported by a sales report prepared by an independent accountant.[19] The payments under clause 5 are in addition to the $[ ] ESL is required to pay CA under clause 3.

52. Clause 5 was inserted into the settlement agreement to enable ESL to pay its consideration to CA for the resolution of the patent proceedings over time. [ ].[20]

53. Clause 5 requires ESL to pay the royalty both during the remaining period of the patent and for [ ] years after the patent expires.

Clause 8: restriction on the sale of soft-edge flashing products

54. Clause 8 restricts ESL and Mr Brough from selling (directly or indirectly) any "Softedge Flashing other than EZ-Edge" until 14 June 2023. The patent expires on 10 August 2015.[21]

55. The consequence of clause 8 is that ESL is restricted from introducing any new soft-edge flashing products covered by the patent until 14 June 2023. Effectively, the question is whether this restriction substantially lessens competition.

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[19] Clause 6 of the settlement agreement states that if a sales report is not provided, then the royalty for that settlement year shall be $[ ].

[20] File note of telephone with Max Brough on 2 October 2014 (Filesite 1877257).

[21] Clause 1 of the settlement agreement defines "Soft edge Flashing" as being any aluminium soft-edge flashing product of the type covered by the patent, and "EZ-Edge " as being EZ-Edge versions I, II and III (in practice this is all current and existing versions of EZ-Edge).

56. CA told us that clause 8 was included because CA was concerned that:[22]

> Edging Systems would try to avoid the agreed royalty by creating another soft-edge flashing which was subtly different to EZ-Edge and therefore circumvent the agreed royalty payment, making the royalty valueless and the whole settlement of significantly reduced value to us.

57. These concerns were stated by CA as being "the key reason why clause 8 was inserted into the agreement."[23] Therefore, suggesting that clauses 5 and 8 are interrelated.

Market definition

58. Attachment A contains our detailed assessment of market definition.

59. In summary, we focussed on the preferences of roll formers because an end-homeowner's choice of roof is based on the roof as a whole, rather than what edge product is used.

60. We determined that the conditions in New Zealand are such that a roll former's choice of edge products is limited to soft-edge flashing products and strip products.

61. However, we were unable to conclusively define whether strip products and soft-edge flashing products were in the same or separate markets. This was because of conflicting evidence that we gathered during the investigation.

62. Some evidence relating to average selling prices and volumes suggested some roll formers had switched from strip to soft-edge products when the price of soft-edge reduced. However, other evidence such as from a strip-only customer indicated that the price of soft-edge would essentially have to be the same as strip for that roll former to switch.[24]

63. Accordingly, we identified the following two possible markets:

    63.1 the national market for the sale of soft-edge flashing products and strip products for use on residential metal roofs (the edge products market); and

    63.2 the national market for the sale of soft-edge flashing products for use on residential metal roofs (the soft-edge flashing products market).

64. We first considered the competition effects of the settlement agreement on the wider edge products market before considering the narrower soft-edge flashing products market. We did this because if there was a competition concern in the edge products market, then there would also be a concern in the soft-edge flashing products market.

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22 Letter from CA sent to the Commission 19 November 2014. (Filesite reference 1998957).

23 Ibid.

24 Commission interview with [ ] (paragraphs 60-61, Filesite reference 1968804).

Does clause 5 breach section 27 and/or section 27 via 30?

65. Clause 5 was inserted into the settlement agreement to enable ESL to pay its consideration to CA for the resolution of the patent proceedings over time. [ ].

66. Under clause 5 ESL is required to pay a [ ]% royalty to CA on all future sales of EZ-Edge. These royalty payments are payable for [ ] years after the patent expires.

Whether clause 5 has the purpose, effect or likely effect of substantially lessening competition

67. We do not consider that the purpose, effect or likely effect of clause 5 is to substantially lessen competition in the edge products and soft-edge flashing products markets before or after the patent expiry date in breach of section 27.

68. Rather than being anti-competitive, we consider that the objective purpose of clause 5 was to allow CA to recoup losses from ESL's alleged infringement of the patent and/or licence it to settle this dispute. On its face, we do not consider this purpose, if achieved, would likely substantially lessen competition. This licencing may have even enhanced competition during the patent period as otherwise CA may have been entitled to enforce its statutory monopoly and injunct the use of the patented technology by ESL until expiry of the patent on 10 August 2015.

69. Clause 5 does not affect ESL's ability to independently determine its own selling price of EZ-Edge, nor does it affect ESL's ability to manufacture and sell (absent clause 8) other soft-edge flashing products or edge products.

70. On one hand, because clause 5 is structured as a payment per unit of sale, it could potentially influence marginal cost and price competition between the suppliers. Therefore, a clause like this could have the effect of substantially lessening competition in the market if, for example, the costs of the royalty payments were higher than the development costs of bringing the product to market without the royalty payments.

71. However, as can be seen in the table below, ESL has not increased its EZ-Edge prices since it signed the settlement agreement, and CA has not increased its Flashguard-Z prices. In fact, there has been some apparent recent price reduction by CA. We therefore consider on the basis of our investigation, that clause 5 is unlikely to have had the effect to date, or be likely to have the effect in the future, of substantially lessening competition in the edge products and soft-edge flashing product market.

Whether clause 5 fixes, controls or maintains the price of soft-edge flashing products

72. We do not consider that clause 5 breaches section 27 via 30 of the Act, as it does not fix, control or maintain the prices (or a component of those prices) of the soft-edge flashing products sold by CA or ESL.

73. ESL has the ability to independently determine its own selling prices for EZ-Edge, and neither ESL nor CA has raised its prices as a result of the agreement.

74. [ ],[25] [ ].

Does clause 8 breach section 27 and/or section 27 via 30?

75. Clause 8 restricts ESL and Mr Brough from selling any soft-edge flashing other than EZ-Edge until 14 June 2023. The settlement agreement defines "Soft edge Flashing" as being any aluminium soft-edge flashing product of the type covered by the patent, and potentially also covers Vent Edge.

76. The focus of our assessment is whether the purpose and likely effect of clause 8 is to substantially lessen competition during the post-patent period (the period between 10 August 2015 and 14 June 2023).

Whether the purpose of clause 8 in the post patent period is to substantially lessen competition

77. The purpose inquiry in s 27(1) cases is focused on an objective[26] assessment of a substantial purpose of the provision[27] in the agreement (which may be one of several purposes).[28] However, evidence of subjective purpose may inform the analysis in circumstances where it is "borderline as to whether there might be an anticompetitive effect."[29]

Purpose viewed objectively

78. On its face clause 8 is designed to restrict ESL from selling any soft-edge flashing covered by the patent other than EZ-Edge until 14 June 2023. As already discussed, clause 8 is included in the settlement agreement to support CA's "royalty" payments provided for in clause 5 of the settlement agreement. Of the options available and being discussed, ESL agreed to the royalty mechanism instead of a one-off lump sum

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25 [ ].

26 While the New Zealand authorities diverge on the approach to the analysis of anti-competitive purpose, to date the courts favour an objective assessment, taking into account any subjective evidence of the rationale for the agreement, *ANZCO Foods Waitara Ltd* v *AFFCO New Zealand Ltd* [2006] 3 NZLR 351 (CA) at [255].

27 "I also adopt the point made by McGrath J in *Giltrap City* that anything other than an objective ascertainment of purpose does not fit in with the per se provisions, such as sections 29 and 30, which also refer to the concept of purpose. It would be contrary to the intended mischief to which those provisions are aimed if a party were able to escape liability for conduct that is prohibited absolutely on the basis of a subjective ascertainment of purpose." *ANZCO* at [260].

28 Section 2(5) Commerce Act 1986.

29 "In my view the test, at least for ss27 and 28, is an objective one but evidence of subjective purpose can be adduced and taken into account in assessing objective purpose." *ANZCO* at [255]; and "I recognise that it is possible that, under Cooke P's formulation in *Tui Foods*, there may, at the margin, be a role for subjective evidence of purpose... however this is only where such evidence exists and it is restricted to cases where it is borderline as to whether there might be an anticompetitive effect", *ANZCO* at [261].

payment.[30] This was a pragmatic solution that suited and allowed ESL to pay over time out of its cash flow.

79. The settlement agreement does not state the amount of damages claimed by CA; however, CA told us that ESL's alleged breach of the patent had a "[ ] effect on the financial performance" of its business.[31] [ ].[32] [ ] is likely to have influenced the adoption of clause 8 which prevents ESL working around clause 5 by selling other soft-edge flashing products.

80. CA was also concerned about ESL producing "another look-alike product", which would raise concerns of "passing off/misleading and deceptive conduct, and, if inferior, damage to the goodwill built up in Flashguard-Z".[33]

81. However, viewed objectively, one purpose of clause 8 was to restrict ESL from selling any soft-edge flashing products other than EZ-Edge to support the royalties provision in clause 5. An intended consequence of that clause was to exclude CA's only likely competitor from entering the market with another competing product.

82. From that perspective, an objective purpose of clause 8 was to substantially lessen competition by excluding other competition. This is true even though clause 8 is related to clause 5, and ESL requested the royalty payment mechanism in clause 5. Clause 5 can only be fully protected if clause 8 successfully prevents ESL from selling soft edge flashing other than EZ-Edge.

83. Even if we were incorrect on that, clause 8 lasts [ ] years' longer than clause 5. CA could not explain why the restriction was in place for [ ] years past the required royalty period in clause 5 ie, from [ ] to 2023. So, even if no objective purpose of lessening competition while clause 5 was in place could be shown, we consider that the sole purpose of clause 8 was to substantially lessen competition in the [ ] to 2023 period.

Whether clause 8 has the likely effect of substantially lessening competition?

84. Given that CA and ESL have agreed that clause 8 will not be enforced and has effectively expired, clause 8 has not had the effect of substantially lessening competition. However, we consider that clause 8 had the likely effect of doing so.

85. To assess whether clause 8 of the agreement has the likely effect of substantially lessening competition in the edge products and soft-edge flashing products markets during the post-patent period, we considered the current state of competition

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30 File note of telephone with Max Brough on 2 October 2014 (Filesite 1877257).

31 Letter from CA sent to the Commission, 19 November 2014 (Filesite reference 1998957).

33 [ ].

33 Letter from CA sent to the Commission 19 November 2014 (Filesite reference 1998957).

between soft-edge flashing products and other edge products. This was to help us establish what the counterfactual in the post-patent period may look like.

The current state of competition between soft-edge flashing products[34]

Table 1: Soft-edge and strip pricing history 2009-2015

		Average price per metre ($)				
		Vent Edge	EZ-Edge (63mm)	Flashguard-Z (63mm)	Strip (ESL)	Strip (CA)
Average price by CA's financial year (ESL)[35]	2008 (09)			[ ]	[ ]	[ ]
	2009 (10)		[ ]	[ ]	[ ]	[ ]
	2010 (11)		[ ]	[ ]	[ ]	[ ]
	2011 (12)		[ ]	[ ]	[ ]	[ ]
	2012 (13)		[ ]	[ ]	[ ]	[ ]
	2013 (14)	[ ]	[ ]	[ ]	[ ]	[ ]
	2014 (15)	[ ]	[ ]	[ ]	[ ]	[ ]

86. [ ].

87. The introduction of EZ-Edge by ESL in August 2009 resulted in [ ] in the price of Flashguard-Z. For some time after this, and from what ESL has reported, up to very recently, the relative prices of Flashguard-Z and EZ-Edge have been constant. It was also the case that while CA lost some market share, Flashguard-Z maintained a consistent price premium over EZ-Edge.

88. [ ].

89. Furthermore, after the introduction of EZ-Edge, there was a decrease in the percentage of roll formers that used strip products (see Graph 1 below).[36] This decrease suggests that there were some roll formers that were prepared to switch

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[34] For a full commentary on competition and prices see Filesite 2119287.

[35] CA's financial year ends 31 December, so it is currently in its 2015 financial year. Whereas ESL's financial year ends 31 March, so it is currently in its 2016 financial year. As a result, ESL's figures reflected in the table are 3 months ahead of CAs.

[36] Approximately two years after the introduction of EZ-Edge, the percentage of total strip users reduced from [ ]% to [ ]%. This reduction in the use of strip products has since been maintained. (Filesite reference 2025145).

from strip products to soft-edge flashing products when the price of soft-edge flashing products was reduced.[37]

90. The introduction of Vent Edge in late 2013 was also significant as its list price was $[ ] and $[ ] per metre below the list prices for EZ-Edge and Flashguard-Z, respectively [ ]. As a result, the cheapest soft-edge product available, Vent Edge, was closer to the price of strip.

91. In addition to the price impact that the introduction of EZ-Edge and Vent Edge had, the introduction of these products also impacted the sales dynamics in the market (see Graph 1). Upon EZ-Edge's introduction, Flashguard-Z sales [ ]% up until 2012, after which they [ ].

Graph 1: Total metres sold of edge products since 2008

[

]

92. The introduction of Vent Edge on CA is more difficult to discern since it was only introduced in October 2013, and we only have yearly sales data for CA. Monthly sales data of ESL's product, however, suggests that Vent-Edge has had an impact on ESL's own sales (see Graph 2 below).

Graph 2: ESL monthly sales of edge products since the introduction of Vent Edge

[

]

93. ESL's sales of Vent Edge averaged around [ ] per month between October 2013 (when it was first introduced) and January 2015. In February 2015 the sales

[37] While this was not directly identified in an interview, everything else in the market appears to have remained the same. Therefore, we consider that it could only have been EZ-Edge and its price reductions that were significant changes to the market.

increased significantly compared to ESL's other products and while its sales declined in subsequent months, they were still about twice as much as previous sales levels.

94. [ ].

95. Nonetheless, it is clear that sales of Vent Edge are continuing to increase and overall there has been a consistent upward trend since December 2014 into mid-2015.

96. [ ].[38] [ ].[39]

Does clause 8 have the likely effect of substantially lessening competition in the edge products or soft-edge flashing products markets during the post-patent period?

97. To determine whether clause 8 has the likely effect of substantially lessening competition in the market during the post-patent period, we examined:

    97.1 the likely state of competition during the post-patent period in the edge products and soft-edge flashing products markets with clause 8 (the factual); and

    97.2 the likely state of competition during the post-patent period in the edge products and soft-edge flashing products markets without clause 8 (the counterfactual).

98. We then considered whether there would be any reduction in competition during the post-patent period between the factual and counterfactual situations in the edge products and soft-edge flashing products markets.

99. We undertook this analysis on the basis that in the factual situation CA could decide to enforce clause 8 and prevent ESL from selling Vent Edge during the post-patent period (if Vent Edge was covered by the patent).

<u>Likely market structure in the post-patent period</u>

100. As discussed above, CA and ESL are the only manufacturers and distributors of soft-edge flashing products and strip products in New Zealand. We do not consider that entry by a third competitor into the edge products or soft-edge flashing products market is sufficiently likely during the post-patent period.[40]

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[38] [ ].

[39] [ ].

[40] See Filesite 2085647 for our full version of the reasons.

101. In summary, the reasons for our view are:

101.1 the amount of investment required to become a third competitor in a relatively small sized market that has some entry risks;

101.2 roll formers favour trusted New Zealand-based suppliers. This is because these purchasers need certainty that warranties will be honoured under local laws if an issue in the product were to arise. For an overseas new entrant to overcome these concerns we consider they would need to either:

101.2.1 offer prices significantly below existing prices to try and convince these roll formers to switch their supply in an inelastic market; and/or

101.2.2 set up an office in New Zealand and operate a New Zealand registered company.

101.3 even if there was an entrant, expansion would be difficult given the above factors and it is likely that there would be no effective constraint on existing competitors for some time.

102. Additionally, the roll formers that we spoke to were satisfied with their respective suppliers and there was no observation of a potential new supplier or any desire to invite one into the market. [ ].

103. The patent held by CA is very wide and encompasses almost any soft-edge flashing made of metal with a waterproof rubber-type backing. Due to the prevalence of zinc-aluminium coated steel metal roofs in New Zealand and the requirement for similar materials to prevent bi-metallic corrosion and to provide even-appearance paint fade over time, strip and soft-edge flashing products are the only viable edge products.[41] [ ]. These factors and the lack of viable alternatives were also highlighted by the roll formers we interviewed.[42]

104. Therefore, for the purpose of considering the likely effect of clause 8, we have considered both the edge products and soft-edge flashing products markets as having two participants.

41 See Attachment A Market Definition.

42 Ibid.

The likely state of competition in the edge products and soft-edge flashing products markets during the post-patent period without clause 8

105. As discussed in the previous section, Vent Edge provides significant and increasing competition in the current state of the market.

106. Without clause 8, ESL could manufacture and sell any new soft-edge flashing product in the post-patent period, including Vent Edge, without the risk of its sale being restricted or hindered by CA contending that the new soft-edge flashing product falls within clause 8. It is not clear, however, exactly how competitive Vent Edge would have been immediately upon the patent expiry date, if it has not been introduced in 2013 (this is discussed further below).

107. Nevertheless, we consider that the state of competition would be or become similar to, or greater than, the current state of competition between the two suppliers in both the soft-edge flashing and edge products markets.

Does clause 8 have the likely effect of substantially lessening competition during the post-patent period?

108. Clause 8 prevents ESL from selling soft-edge flashing products (as covered by the patent), other than the current versions of EZ-Edge, for approximately eight years after the patent expires and [ ] years after the royalty period.

109. We consider that ESL's ability to sell Vent Edge alone increases the competition faced by competing soft-edge flashing products.[43] Given the large volume of soft-edge flashing products sold within the edge products market,[44] the reduction in competition faced by competing soft-edge flashing products as a result of clause 8 restricting ESL's sale of Vent Edge is likely to substantially lessen competition in the edge products market overall.

110. Additionally, the sale of Vent Edge also increases the competition faced by competing strip products, further supporting our view that the clause 8 restriction on ESL selling Vent Edge is likely to substantially lessen competition in the edge products market. As discussed above, there is evidence to suggest that some roll formers have a marginal preference for strip products, but would be prepared to switch to soft-edge flashing products if the price of soft-edge flashing products reduced. Given these price considerations, we would expect that some further roll formers would switch from strip products to soft-edge flashing products if the cheaper Vent Edge product continues to be sold unencumbered in the edge products market.

111. In fact, Mr Brough also recently told us that he knows of some South Island strip customers that have recently switched to Vent Edge. He said that these roll formers

43 As outlined above.

44 Approximately 65% of the total metres of edge product sold in the wide market are soft-edge flashing products.

are absorbing the extra cost and using Vent Edge to compete by offering an edge product that is quicker and easier to use than strip.[45]

112. Furthermore, Graph 2 above appears to show that some of ESL's strip product users switched to Vent Edge when it began selling a significantly increased amount of the product in February and March 2015.

113. It is arguable that clause 8 has the effect of substantially lessening competition as soon as the patent expires, as that is the time that any exclusionary effect could begin if CA restricted ESL from selling Vent Edge It is also arguable that competition is unlikely to be lessened until the point at which entry into the edge products market would otherwise have occurred absent ESL's original alleged breaches of the patent and subsequent licence of EZ Edge. However, we cannot determine exactly when new product entry would have occurred absent clause 8, because neither the patent nor clause 8 prevents ESL from developing and testing new soft edge products; clause 8 only prevents ESL from selling such products.

114. It is not necessary to form a definitive view on when during the post-patent period we consider clause 8 is likely to have the effect of substantially lessening competition. This is because on any view, and on the facts of this case, a restraint that is eight years beyond the expiry of the patent is likely to have the effect of substantially lessening competition in the market.

115. Therefore, we consider that competition in the wide edge products market is likely to be substantially lessened by clause 8 restricting ESL from selling other soft-edge flashing products (in particular Vent Edge) during the post-patent period.

116. As a result, we consider that there is also likely to be a substantial lessening of competition in the narrower soft-edge flashings product market during the post-patent period if CA enforced clause 8. However, it is not necessary for us to assess this in any detail due to our findings in the wide edge products market.

Whether clause 8 fixes, controls or maintains the price of soft-edge flashing products?

117. We do not consider that clause 8 likely breaches section 27 via 30 of the Act as it does not fix, control or maintain the selling prices of CA and ESL's soft-edge flashing products, or a component of those prices.

118. ESL and CA are still free to independently determine their selling prices for EZ-Edge and Flashguard-Z. Further, ESL has introduced Vent Edge, a significantly cheaper product, in defiance of clause 8.

Conclusion on clause 8

119. In conclusion, we consider that:

   119.1 the purpose of clause 8 is likely to substantially lessen competition in the edge products and soft-edge flashing products markets;

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[45] File note call with Max Brough on 6 July 2015 (Filesite reference 2125145).

119.2 clause 8 is likely to have the effect of substantially lessening competition in the edge products and soft-edge flashing products during the post-patent period, in breach of section 27 of the Act; and

119.3 clause 8 does not fix, control or maintain the price of any soft-edge flashing products.

Conclusion of assessment under sections 27 and section 27 via 30

120. We therefore consider, on the basis of our investigation, that:

120.1 clause 8 of the settlement agreement likely breaches section 27 of the Act;

120.2 clause 8 of the settlement agreement does not breach section 27 via 30 of the Act; and

120.3 clause 5 of the settlement agreement does not breach section 27 or section 27 via 30 of the Act.

Decision on what action to take

121. [ ].

122. [ ].[46] [ ].

123. [ ].

ESL's position

124. ESL is immunised from any action by the Commission in regard to the settlement agreement and now that CA has communicated that clause 8 has expired with acknowledgement from ESL, there is nothing further required of ESL.

125. We will write to ESL, informing it that the Commission is satisfied that ESL has fulfilled its obligations under the Conditional Immunity Agreement executed on 29 October 2014. We will also confirm with ESL that it is released from its ongoing obligations under the Immunity Agreement (pursuant to clause 24). Our letter will also highlight the fact that whatever the circumstances, ESL was party to what we

[46] [ ].

consider was an unlawful agreement. It derived some benefit from the agreement by avoiding an infringement action which could have forced it to stop selling any soft-edge products, and/or be liable for damages.

Enforcement action options for CA

126. We consider that issuing a warning to CA for a likely breach of section 27 is the most appropriate enforcement action in this case, rather than commencing court action.

127. As a result, the public interest is not in favour of the Commission commencing court action, given the costs, risks and uncertain future benefits involved.

Enforcement criteria

128. In reaching this decision, we have considered our Enforcement Criteria, which sets out how we decide whether to commence or continue enforcement action and the most appropriate response in each case.

129. Our enforcement Criteria are:

129.1 extent of detriment;

129.2 seriousness of conduct; and

129.3 public interest.

Extent of detriment

130. Given the length of time that clause 8 is operative after the expiration of the patent (approximately eight years), we consider that there is potential for long-term harm.

131. While we cannot conclude on whether the patent is valid or not, even assuming the patent was invalid, our view is that there has been no harm since Vent Edge has been introduced into the market.

Seriousness of conduct

132. While CA may not have breached a per se provision of the Act, a breach of this kind is serious as it would restrict the sale of competing products in a market. However, we consider that CA has not been reckless as it had a legitimate dispute over patent rights that it was attempting to settle. While CA's purposes may have been seeking to settle the dispute, an anti-competitive purpose (potentially among multiple purposes) viewed objectively is sufficient to breach the Act. Further, clause 8 restricted the sale of competing products in a market beyond any period legitimately required to protect the patent.

Public interest

133. While court action may deter future breaches of section 27 of the Commerce Act, issuing a warning to CA is more likely to be in the public interest.

133.1 Any court action could be costly and risky with uncertain future benefits.

133.2 A warning letter will put CA on notice of our concerns under the Act and illustrate to parties that they must be careful when settling disputes that the terms do not infringe the Commerce Act.

ATTACHMENT A - Market definition

Our approach to market definition

1. A market is defined in the Act as a market in New Zealand for goods and services as well as other goods and services that are substitutable as a matter of fact and commercial common sense.[47]

2. To define the competitive market in this case, we focussed on which products customers regard as close substitutes to soft-edge flashing products, and whether they would switch sufficient purchases to those products to make a SSNIP – a small, but significant, non-transitory increase in price[48] – unprofitable.

Customers of edge products in New Zealand

3. We consider that residential homeowners are the end-consumers of edge products and roll formers are, in effect, wholesale purchasers of edge products.

4. A roll former will purchase an edge product from CA or ESL and will then use the product to create flashings that are then sold to the homeowner.

5. Generally, a homeowner buys the roof as a complete system from a roll former. This system is essentially a 'one-stop-shop' for a homeowner looking to buy a new roof. It includes the main roof and flashings, and includes all of the components required (eg, the fixing screws, and edge products).

6. Once the homeowner has purchased the roof of their choice, they then hire a roof installer (roofer) to install the roof. The roofer can be independent of the roll former, or an associated part of the roll former's business.

7. Alternatively, a homeowner may go directly to an independent roofer and ask for a new roof. In this case, the roofer essentially acts as an agent for the homeowner. The roofer will purchase a roof directly from a roll former and then install it for the homeowner.

8. As a result, it appears a homeowner's decision is based on the best offer of the roof as a whole. As long as the edge product used in the roof performs as expected, homeowners appear to be indifferent as to what edge product is used.[49]

9. Furthermore, the total value of edge products is very small when compared to the total value of the whole roof.[50] Therefore, an increase in the price of an edge product may go unnoticed by the homeowner, if passed on to them.[51]

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[47] Section 3(1A) of the Commerce Act.

[48] The test assumes that all other prices are held at current levels.

[49] None of the roll formers that we spoke to said that homeowners specify what edge product they want used on their roof.

[50] It was estimated that for a roof that has approximately 140 metres of edge product (see Commission interview with [ ], the total cost of the edge product would be between $112 and $265

10. Therefore, for the purpose of defining the relevant market, we focussed on the preference of roll formers.

Roll formers' choice of edge products

11. It is apparent from our investigation that roll formers only have a choice of aluminium soft-edge flashing products and strip products, as these are the only commercially realistic edge products suitable for New Zealand conditions.

12. None of the roll formers that we asked had heard of, or would entertain the thought of using, any of the edge products that were originally proposed as alternatives by CA.[52] The table below outlines the response to each of CA's proposed alternatives.

Table 2: Summary of roll formers' responses to proposed alternative edge products

Proposed edge product	Reason for rejection
Lead strip flashing	Lead is incompatible with Zincalume (the most prevalent type of metal roof in New Zealand) due to bi-metallic corrosion.[53]
A flashing based on expanded metal sandwiched between layers of polymer eg, "Wakaflex" brand	The roll formers had not heard of this product. In any case, we understand that it would be difficult to paint plastic, and for the paint to remain consistent with the colour of the roof overtime.[54]
Soft pure zinc	Too expensive.[55]
Bitumen-based flashing with aluminium mesh reinforcement	The one roll former we asked had not heard of the product, but explained that this product sounds like the soft-edge flashing product.[56] None of the other roll formers proactively recalled this product as being an alternative. ESL also said that bitumen is incompatible with Zincalume.[57]

(depending on what edge product is used). Whereas the total cost of the roof for the end homeowner is typically around $16,000 (see Commission interview with [ ]).

51 In the Commission interview with [ ].

52 Letter from CA to the Commission on 19 November 2014 (Filesite reference 1998957).

53 Commission interview with [ ] (paragraph 45, Filesite reference 1970291).

54 In the Commission interview with [ ], this was a problem that was identified with flashings made from plastic. We understand that the same problem would occur with edge products too.

55 All of the roll formers we asked expressed this view.

56 Commission interview with [ ] (paragraph 72, Filesite reference 1970291).

57 Letter from Mr Brough on 22 December 2014 (Filesite reference 1938309).

13. While it is not an edge product itself, a process called 'notching' is a method that can be, and is, used to create a weather-seal between the flashing and the main roof.

14. However, we do not consider that notching is a realistic substitute for soft-edge flashing products or strip products. As notching is considerably more time consuming than using an edge product (it was estimated that notching a flashing would take an experienced tradesperson up to a day longer than using an edge product).[58]

15. Therefore, for the reasons mentioned above and as a matter of commercial common sense, roll formers in New Zealand appear to have the following edge products to choose between:

    15.1 Soft-edge flashing products:

        15.1.1 Flashguard-Z (manufactured and distributed by CA);

        15.1.2 EZ-EDGE (manufactured and distributed by ESL); and

        15.1.3 Vent Edge (manufactured and distributed by ESL).

    15.2 Strip products:

        15.2.1 Aluminium strip (imported and distributed by CA); and

        15.2.2 Aluminium strip (imported and distributed by ESL).

Market by sizes

16. Both Flashguard-Z and EZ-EDGE come in two different sizes: 43mm width and 63mm width.[59] Vent Edge is only sold in the 63mm size. The materials used to manufacture both sizes are the same; just the widths and prices of the two products are different.[60]

17. The 43mm soft-edge flashing product is only suitable for use on corrugated iron roofing profiles. In comparison, the 63mm soft-edge flashing product is suitable for use on both corrugated iron and trapezoidal profiles.

18. The choice between 43mm and 63mm soft-edge flashing products comes down to the roll former's preference (unless a roof is trapezoidal profile). Some roll formers prefer to only use 63mm, so they can hold less stock, whereas other roll formers prefer to swap between 43mm and 63mm based on price considerations.

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[58] Commission interview with [ ] (paragraph 70, Filesite reference 1968804).

[59] Flashguard-Z also comes in a larger size, 75mm width; however, sales of this product are very limited [ ]. Therefore, for the purpose of this investigation, the 75mm width product has not been included.

[60] Both CA and ESL's 43mm soft-edge flashing product is cheaper than the 63mm width.

Approximately 87% of soft-edge flashing products sold in New Zealand are the 63mm size.[61]

19. Given that the performance of the different sizes is very similar and a roll former's preference of size appears to be based on price versus stockholding considerations, we consider that the different sizes of soft-edge flashing products are in the same market.

Soft-edge flashing products

20. We consider Flashguard-Z, EZ-EDGE and Vent Edge to be in the same product market.

21. The roll formers we have spoken to said that there is no discernible difference between Flashguard-Z and EZ-EDGE.[62] A roll formers' choice of soft-edge flashing product is based on personal preference of supplier, price considerations or compatibility with their machinery,[63] rather than performance.

22. Demand-side substitutability between the two brands was evident when EZ-EDGE was first introduced into the product market. Before EZ-EDGE was introduced, CA's Flashguard-Z had an average (and list) price of $[ ] and $[ ] per metre, for the 63mm and 43mm sizes respectively.[64]

23. When EZ-EDGE was introduced to the product market in August 2009 it was priced considerably cheaper at $[ ] and $[ ] per metre respectively.[65] As a result, on introduction of EZ-EDGE by ESL, the list price of CA's Flashguard-Z soon fell to $[ ] and $[ ] per metre.

24. [ ].[66]
[ ].

25. None of the roll formers we spoke to used Vent Edge. However, we consider that Vent Edge is in the same product market as Flashguard-Z and EZ-EDGE.
[ ].[67]

26. Finally, although we consider that it could be theoretically possible to manufacture a soft-edge flashing that non-contentiously falls outside of the settlement

61 Based on CA and ESL's 2014 financial year. Filesite reference 2083109.

62 Commission interview with [ ] (paragraph 97, Filesite reference 1970291).

63 Commission interview with [ ] (see paragraph 58, Filesite reference 1971178).

64 Letter from CA to the Commission on 16 March 2015. Attachment called Schedule 1 (NZCC Letter). (Filesite reference 2021754)

65 EZ-EDGE was introduced at $[ ]/m and $[ ]/m for the 63mm and 43mm sizes respectively. See letter from ESL to the Commission on 27 March 2015. (Filesite reference 1996157).

66 [ ].

67 File note call with [ ].

agreement (for example a soft-edge flashing made from lead), we do not consider that the current market conditions are such that any alternative designs exist.[68]

Soft-edge and/or strip

<u>Demand-side substitutability</u>

27. When installed correctly, soft-edge flashing products and strip products provide an equally effective weather-seal between the flashing and the main roof. [69] Both products are able to be used equally effectively on trapezoidal and corrugate profiles.

28. However, soft-edge flashing products and strip products are differentiated in price and speed of installation.

29. Soft-edge flashing products are quicker to install than strip products. The roll formers that we have spoken to said that soft-edge flashing products can be anywhere between minutes and two hours quicker to install.[70] This is because soft-edge flashing products can be moulded to the main roof by hand, whereas the strip products need to be moulded to the roof with a rubber-type mallet.

30. Although slower to install, strip products are considerably cheaper than soft-edge flashing products. Strip products have an average sale price of approximately $[ ] to $[ ] per metre.[71]

31. Roll formers we spoke to viewed the strip and soft-edge flashing products as being in separate markets.[72]
[
].

32. However, the data that we received as part of our investigation suggests that soft-edge flashing products and strip products are in the same market.[73] When EZ-EDGE was introduced into the market, the price of soft-edge flashing products reduced. Upon this price reduction, there was a decrease in the percentage of roll formers that used strip products.[74] This decrease suggests that there were some roll

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68 None of the roll formers identified any alternative design that would be suitable for New Zealand conditions.

69 Commission interview with [ ] (paragraph 62, Filesite reference 1970291).

70 In the Commission interview with [ ], it was estimated to be “minutes”. However, in the Commission interview with [ ], it was estimated to take two hours longer.

71 ESL’s list price for strip is $[ ]/m, and CA’s list price for strip is $[ ]/m.

72 Commission interview with [ ].

73 Based on a combined analysis of the sales data provided to the Commission by both ESL and CA. (Filesite reference 2025145).

74 Approximately two years after the introduction of EZ-EDGE, the percentage of total strip users reduced from [ ]% to [ ]%. This reduction in the use of strip products has since been maintained. (Filesite reference 2025145).

formers that were prepared to switch from strip products to soft-edge flashing products when the price of soft-edge flashing products was reduced.[75]

33. Furthermore, Mr Brough told the Commission that he has also noticed some of his previous strip users switching to Vent Edge.[76]

34. Based on this evidence, we are not convinced that all roll formers would not switch between edge products.

35. However, we do not consider that it is necessary to conclusively define the product market. If there are no concerns in a narrower product market (ie, a market that contains just soft-edge flashing products), then there will be no concerns in a wider edge product market.

36. Conversely, if there is a concern in the wider edge products market then there will also be a concern in the narrower soft-edge flashing products market.

37. Therefore, for the purpose of this investigation report, we will assess whether there are any concerns in the market for edge products. If there are no concerns in this market, then we will also assess whether there are any concerns in the narrower soft-edge flashing product market.

<u>Supply-side substitutability</u>

38. We do not consider that supply-side substitutability is a relevant consideration to the market definition in this case. Given that ESL and CA are the only suppliers in New Zealand, and both already sell both strip and soft-edge flashing products.

39. Further, we do not consider that other industry figures (such as roll formers) are in a position to more readily, easily and affordably manufacture/import and distribute soft-edge flashing products or strip products than another new entrant. This is because soft-edge flashing products and strip products involve the importation of materials from overseas, and in the case of soft-edge flashing products, also having specialised machinery available.

Conclusion on market definition

40. For the reasons discussed above, we have defined the relevant markets in which to consider the competition effects of the settlement agreement as:

    40.1 the national market for the sale of soft-edge flashing products and strip products for use on residential metal roofs (the edge products market); and

    40.2 the national market for the sale of soft-edge flashing products for use on residential metal roofs (the soft-edge flashing products market).

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[75] While this was not directly identified in an interview, everything else in the market appears to have remained the same. Therefore, we consider that it could only have been EZ-EDGE and its price reductions that were significant changes to the market.

[76] File note call with Max Brough on 6 July 2015 (Filesite reference 2125145).