

## Determination

### **Aon New Zealand / Fire Protection Inspection Services Limited [2017] NZCC 3**

<b>The Commission:</b>	Dr Mark Berry Elisabeth Welson Dr Jill Walker
<b>Summary of application:</b>	Aon New Zealand seeks clearance to acquire the book of business, assets and certain liabilities of Fire Protection Inspection Services Limited.
<b>Determination:</b>	Under s 66(3)(b) of the Commerce Act 1986, the Commerce Commission determines to decline clearance to the proposed acquisition.
<b>Date of determination:</b>	2 March 2017

Confidential material in this report has been removed. Its location in the document is denoted by [ ].

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## The proposed acquisition

1. On 8 November 2016, the Commerce Commission (the Commission) registered an application from Aon New Zealand (Aon) under s 66(1) of the Commerce Act 1986 (the Act) seeking clearance to acquire the book of business, assets and certain liabilities of Fire Protection Inspection Services Limited (FPIS).
2. Excluded from the proposed acquisition are leases for FPIS's premises in Wellington, Christchurch and Dunedin, as well as FPIS's shares in its wholly owned subsidiaries (Firetech Training Limited and Verifire Limited) and certain liabilities. The excluded liabilities include, but are not limited to, [ ].

## The decision – clearance declined

3. The Commission declines to give clearance to the proposed acquisition as it is not satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand.
4. Aon and FPIS are the largest suppliers of fire inspection services in New Zealand, and are each other's closest competitors in most markets. Other competitors operate on a much smaller scale and [ ]. We are not satisfied that the remaining competitors would be sufficient to constrain a potential substantial lessening of competition.
5. Neither are we satisfied that the possibility of entry or expansion would be likely, of sufficient extent, and timely-enough to constrain a potential substantial lessening of competition. There are practical barriers to entry and expansion for inspection companies and their inspectors. In our assessment, the expected profitability is unlikely to incentivise entry or expansion. There are also contractual limitations on inspectors leaving Aon and FPIS to join competitors or to set up their own businesses. We consider that the merged entity is also likely to have the ability and incentive to deter inspectors from leaving to join competitors or set up their own businesses.

## Our framework

6. Our approach to analysing the competition effects of the proposed acquisition is based on the principles set out in our Mergers and Acquisitions Guidelines.<sup>1</sup>

## The substantial lessening of competition test

7. As required by the Act, we assess acquisitions using the substantial lessening of competition test.
8. We determine whether an acquisition is likely to substantially lessen competition in a market by comparing the likely state of competition if the merger proceeds (the scenario with the merger, often referred to as the factual), with the likely state of

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<sup>1</sup> Commerce Commission *Mergers and Acquisitions Guidelines* (July 2013)  
<http://www.comcom.govt.nz/business-competition/guidelines-2/mergers-and-acquisitions-guidelines/>

competition if the acquisition does not proceed (the scenario without the merger, often referred to as the counterfactual).<sup>2</sup>

9. We make a pragmatic and commercial assessment of what is likely to occur in the future, with and without the acquisition, based on the information we obtain through our investigation and taking into account factors such as market growth and technological changes.
10. A lessening of competition is generally the same as an increase in market power. Market power is the ability to raise price above the price that would exist in a competitive market (the 'competitive price'),<sup>3</sup> or reduce non-price factors such as quality or service below competitive levels.
11. Determining the scope of the relevant market or markets can be an important tool in determining whether a substantial lessening of competition is likely.
12. We define markets in the way that we consider best isolates the key competition issues that arise from the acquisition. In many cases this may not require us to precisely define the boundaries of a market. A relevant market is ultimately determined, in the words of the Act, as a matter of fact and commercial common sense.<sup>4</sup>

#### **When a lessening of competition is substantial**

13. Only a lessening of competition that is substantial is prohibited. A lessening of competition will be substantial if it is real, of substance, or more than nominal.<sup>5</sup> Some courts have used the word 'material' to describe a lessening of competition that is substantial.<sup>6</sup>
14. Consequently, there is no bright line that separates a lessening of competition that is substantial from one that is not. What is substantial is a matter of judgement and depends on the facts of each case. Ultimately, we assess whether competition will be substantially lessened by asking whether consumers in the relevant market(s) are likely to be adversely affected in a material way.

#### **When a substantial lessening of competition is likely**

15. A substantial lessening of competition is 'likely' if there is a real and substantial risk, or a real chance, that it will occur. This requires that a substantial lessening of competition is more than a possibility, but does not mean that the effect needs to be more likely than not to occur.<sup>7</sup>

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<sup>2</sup> *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [63].

<sup>3</sup> Or below competitive levels in a merger between buyers.

<sup>4</sup> Section 3(1A). See also *Brambles v Commerce Commission* (2003) 10 TCLR 868 at [81].

<sup>5</sup> *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 (HC) at [127].

<sup>6</sup> *Ibid* at [129].

<sup>7</sup> *Woolworths & Ors v Commerce Commission* (HC) above n 5 at [111].

### The clearance test

16. We must clear an acquisition if we are satisfied that the merger would not be likely to substantially lessen competition in any market.<sup>8</sup> If we are not satisfied – including if we are left in doubt – we must decline to clear the acquisition.<sup>9</sup>
17. The burden of proof lies with Aon, as the applicant, to satisfy us on the balance of probabilities that the acquisition is not likely to have the effect of substantially lessening competition.<sup>10</sup> The decision to grant or refuse a clearance is necessarily to be made on the basis of all the evidence.<sup>11</sup> We will sometimes have before us conflicting evidence from different market participants and must determine what weight to give the evidence of each party.<sup>12</sup>

### Industry background

18. The proposed acquisition relates to the provision of fire inspection services. Fire protection companies design<sup>13</sup> and install fire protection systems, including alarms and sprinklers, predominantly for use in commercial buildings and large residential buildings (e.g., rest homes). These systems must then be inspected and certified at the time of installation, and in respect of sprinklers, re-inspected periodically thereafter, to ensure that they meet the relevant standards.
19. Independent inspections also provide a way for local councils to sign off that sprinklers and fire alarms comply with the Building Code requirements, and are used by insurance companies (such as Aon), when considering what insurance cover to provide to building owners.
20. The parties' services overlap in the provision of inspection services for newly installed sprinklers, re-inspection services for existing sprinklers, as well as inspection and certification services for new fire alarms.

### Inspections and certification for newly installed sprinklers

21. In the diagram below we show the process for the inspection of new sprinklers.

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<sup>8</sup> Section 66(3)(a).

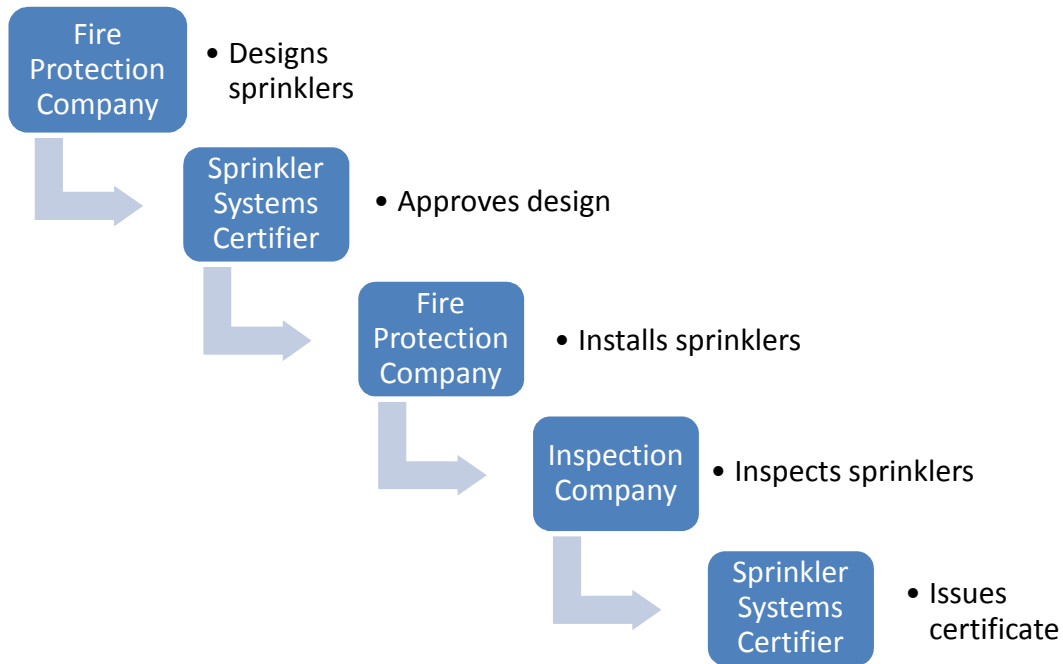
<sup>9</sup> In *Commerce Commission v Woolworths Limited* (CA), above n 2 at [98], the Court held that “the existence of a ‘doubt’ corresponds to a failure to exclude a real chance of a substantial lessening of competition”.

<sup>10</sup> *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at [7]. *Commerce Commission v Woolworths Ltd* (CA) above n 2 at [97].

<sup>11</sup> *Commerce Commission v Woolworths Ltd* (CA) above n 2 at [101].

<sup>12</sup> *Brambles New Zealand Ltd v Commerce Commission* above n4 at [64].

<sup>13</sup> In most instances, a fire engineer will be commissioned to design a sprinkler or alarm system (see telephone call with Fire Protection Inspection Services Limited (24 November 2016).



22. Industry participants generally view new sprinkler inspections as more demanding than re-inspections, both in terms of the required technical skill and the time needed to inspect them. However, the time, expense, and complexity of a sprinkler inspection can vary greatly depending on the premises. Certain commercial operations, such as warehouses, can present more complicated challenges for inspectors.
23. Fire protection companies, such as Wormald or Chubb, generally manage the installation process as well as ongoing maintenance and routine testing. First, their sprinkler designers prepare designs for new sprinkler systems. The fire protection company then submits these designs to the Sprinkler Systems Certifier (SSC), which is the body that ultimately approves whether sprinklers conform to the specified standards.<sup>14</sup> After approval of the design, the fire protection company can install the sprinklers.
24. The fire protection company<sup>15</sup> then engages an accredited inspection company, such as Aon or FPIS, to check that the sprinkler systems have been installed in accordance with the specified design and standards. After inspecting the premises, the inspector prepares and sends a report to the SSC. If the SSC is satisfied with the report, it will issue a certificate of compliance.
25. Sprinkler system certification is the only practical means accepted by Councils to demonstrate compliance with the Building Act.<sup>16</sup> Once a sprinkler system is certified, and all other Building Code requirements are met, the relevant Council will issue a Code Compliance Certificate, confirming compliance with the Building Code.

<sup>14</sup> Usually NZS 4541 for commercial buildings and NZS 4515 for large residential buildings.

<sup>15</sup> We note that on some occasions the sprinkler inspectors are engaged directly by the project manager of the construction company.

<sup>16</sup> In theory, it is possible to directly seek ministerial ratification for an overseas standard. However, we are not aware of any instances where this has occurred. See telephone call with IANZ (21 December 2016).



### Re-inspections for existing sprinklers

26. Inspectors also carry out re-inspections of buildings, to ensure that sprinkler systems continue to satisfy all of the building's warrant of fitness requirements. Sprinklers must be re-inspected by accredited fire inspectors either annually, for residential buildings (such as rest homes and apartment blocks), or biennially for other commercial and industrial buildings.
27. The complexity of sprinkler re-inspections can vary, depending on the type of property and any changes or renovations that have occurred since the last inspection.

### Inspections and certification for newly installed fire alarms

28. Like sprinklers, newly installed fire alarms in buildings must be inspected by an accredited inspection company, which certifies that the installation was completed in accordance with the specified standard (usually NZS 4512). Unlike sprinkler systems, however, there is no requirement for the re-inspection of fire alarms by accredited inspectors.

### Inspectors/inspection companies

29. Inspectors, as well as the inspection companies that employ them, must be accredited by International Accreditation New Zealand (IANZ) to an international standard (ISO/IEC 17020:2012 as a Type A inspection company). Accreditation represents a formal statement that an inspection company or inspector is competent to perform specified inspection tasks. The accreditation process includes assessments by independent technical experts of 'live' inspections conducted by prospective inspectors.<sup>17</sup>
30. For inspectors, the time necessary to obtain IANZ accreditation will vary, depending on among other things, the background of the inspector. For example, an individual with sprinkler design expertise is likely to require a relatively short period to achieve accreditation. One inspection company ([ ]) told us that it takes approximately twelve months for inspectors to obtain accreditation.<sup>18</sup> Other parties advised that the process can take between 18 and 24 months.<sup>19</sup>
31. To receive IANZ accreditation, fire inspection companies must demonstrate that they:<sup>20</sup>
  - 31.1 have sufficient impartiality and independence from the fire protection companies that install and carry out routine maintenance of fire systems;
  - 31.2 have adequate quality systems in place; and

<sup>17</sup> These technical experts currently include Messrs Robert Peart and Jason Dyer, both of whom are self-employed consultant engineers.

<sup>18</sup> [ ].

<sup>19</sup> [ ]

<sup>20</sup> Letter from Aon to the Commerce Commission at [15] (15 December 2016).

- 31.3 meet IANZ's standards of competence.
32. Fire inspectors form close working relationships with their customers. For new installations, these customers are usually the fire protection companies. Fire protection companies often prefer to work with the same inspectors, not only because of personal relationships, but also because they have built up a mutual understanding of the relevant standards. Fire protection companies require inspection services for all their installations, so inspection companies can receive considerable repeat work from them.
33. The inspection markets are essentially service markets. The main assets or inputs to this business are inspection staff. Unlike product inputs (such as widgets), labour inputs have their own challenges, such as quality differentiation, training, experience, supervision and labour mobility. In these reasons, and for the purpose our analysis, we have grouped inspection staff depending on experience and accreditation as follows:
- 33.1 **accredited inspectors** are inspectors who have IANZ accreditation and sufficient experience to have developed customer loyalty (in that they would be able to bring a customer book with them to another business).<sup>21</sup>
- 33.2 **trainee inspectors** are apprentice inspectors who are not accredited, but are employed by an inspection company, training to be accredited inspectors.
- 33.3 **unaccredited individuals** are staff who have neither accreditation nor inspection experience. They may have significant experience in the fire protection industry as an installer, maintainer or designer of sprinkler systems.
34. For most re-inspections, the fire inspectors are also contracted by the fire protection companies. However, inspectors can be contracted directly by building owners and building facility managers to undertake inspections. Similarly to new inspections, these customers tend to prefer consistency in their inspectors. However, we understand that long-term contracts are rare.<sup>22</sup>
35. Because many customers are loyal to their particular inspector, when inspectors move firms or set up their own businesses, it is common for them to take a book of business with them.<sup>23</sup> Due to these customer books, experienced inspectors can add considerably more value to a new employer than can typically be achieved by training a new inspector.

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<sup>21</sup> We include here the small number of experienced inspectors who are unaccredited but are employed as inspectors by an accredited inspection company. These inspectors conduct their own inspections on behalf of the inspection company but the final inspection report is signed by a managing inspector at that company. In our analysis we consider them with accredited inspectors because they are experienced inspectors and are likely to bring a customer book with them.

<sup>22</sup> Aon's Fire Protection Inspection Services Limited Due Diligence Report (17 November 2016) at 43; and [ ].

<sup>23</sup> Meeting with Aon (7 December 2016).

36. We understand that pricing for inspection work is typically based on a pricing formula that takes into account the size and type of the building, as well as the complexity of the system being inspected. In addition, customers may incur travel costs when the inspector is required to travel to locations outside of their immediate area.<sup>24</sup>
37. The prices for inspection work can vary markedly, with charges for re-inspection ranging from several hundred dollars for a rest home, to several thousand dollars for a large warehouse. New inspection charges are often significantly higher, [ ].<sup>25</sup>
38. Based on our enquiries, inspection companies obtain work based on a mixture of factors, including customer relationships, the quality of the inspector's service, and the inspector's pricing. We have been told some customers will generally tolerate modest price increases so long as service levels are maintained. Others negotiate and obtain quotes from different inspection companies.<sup>26</sup> Some end customers would require a cost-based justification for any price increases,<sup>27</sup> but others will merely rely on the recommendation of the fire protection company. For example, Aon [ ].<sup>28</sup>

#### *Sprinkler System Certifier (SSC)*

39. The role of an SSC is defined in the installation standard for sprinklers (NZS4541). An SSC must be accredited by IANZ to the same international standard as an inspection body (i.e., IEC/ISO 17020: 2012 as a Type A inspection body).<sup>29</sup> In particular, IANZ assesses an SSC to ensure that they have adequate quality systems in place and are competent to carry out the role of SSC.
40. To operate as an SSC, an organisation must employ a chartered professional engineer (CPEng), who is preferably also a member of the fire practice college of the Institute of Professional Engineers.<sup>30</sup> Aon is currently the only entity operating in New Zealand as an SSC.
41. As the SSC, Aon is responsible for the following activities:<sup>31</sup>

<sup>24</sup> Aon generally charges \$[ ] per hour of travel. See meeting with Aon (7 December 2016).

<sup>25</sup> [ ]

<sup>26</sup> Telephone call with FPIS (24 November 2016).

<sup>27</sup> For example, telephone calls with [ ] and [ ].

<sup>28</sup> Meeting with Aon (7 December 2016).

<sup>29</sup> The regulatory framework assumes that an inspector will also act as an SSC. A practical specialisation has developed, however, due to the more strenuous requirements to operate as an SSC.

<sup>30</sup> Letter from Aon to the Commission (15 December 2016) at [38].

<sup>31</sup> Application at [5.19].

- 41.1 certifying that newly installed sprinkler systems meet the requirements of the relevant standards;
  - 41.2 listing approved equipment for sprinkler systems; and
  - 41.3 listing approved contractors to work on sprinkler systems, including listing accredited inspection companies.
42. Aon, in its capacity as SSC, advised us that an organisation or individual will be listed by Aon as an approved inspector if they have been accredited by IANZ as competent to carry out inspections.<sup>32</sup>
43. Aon advised us that it undertakes no further competency assessment before listing inspectors, but requires that inspectors have appropriate levels of professional indemnity and public liability insurance, and pay a biennial accreditation service fee of \$1,630.<sup>33</sup> The evidence we obtained from other market participants accords with Aon's position.<sup>34</sup>

## Key parties

### Aon

44. Aon is a leading provider in New Zealand of insurance broking, risk management and associated services (e.g., human resources consulting). The Aon division relevant to the proposed acquisition is Aon Group Risk Consulting.
45. Aon originally entered the fire inspection business as an SSC in 2007. Since its acquisition of Central Inspections Limited (CIS) in 2010, Aon has also provided inspection and re-inspection services for sprinklers, as well as inspection and certification services of fire alarms. Aon's operations have grown rapidly, and it is now the second largest provider of sprinkler inspection services in New Zealand.<sup>35</sup>
46. Aon's inspection business is headquartered in Auckland, but inspectors are also co-located in Aon offices around the country. Apart from Auckland, Aon has inspectors based in Hamilton, Wellington, Christchurch and Dunedin.

### FPIS

47. FPIS is the largest provider of fire inspection services throughout New Zealand. These include the inspection and re-inspection of fire sprinkler systems as well as the inspection and certification of fire alarm systems. FPIS mainly provides these services to its shareholder-customers. Those shareholders include, among others, fire protection companies such as Tyco New Zealand Limited (trading as Wormald), Chubb New Zealand and Argus Fire Protection Limited. FPIS has offices in Auckland,

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<sup>32</sup> Letter from Aon to the Commission (15 December 2016) at [14].

<sup>33</sup> Ibid at [5](c).

<sup>34</sup> See, for example, interview with IANZ (21 December 2016).

<sup>35</sup> Aon is the largest provider of new sprinkler inspections and the second largest provider of sprinkler re-inspection services. However it is a minor player in fire alarm inspections.

Wellington, Christchurch and Dunedin. It also has inspectors based in Hamilton and Tauranga.

48. Historically, FPIS operated as the New Zealand monopoly, or near monopoly, provider of inspection services for fire sprinkler systems and fire alarms. FPIS was also the only SSC in New Zealand, after taking over the role from the Insurance Council of New Zealand. This persisted until Aon's entry as an SSC in 2007, whereupon Aon and FPIS competed with each other as SSCs for about two years, until FPIS withdrew completely from providing those services.<sup>36</sup>
49. While FPIS retains a strong presence in sprinkler and alarm inspections, we understand that its market share (including with respect to its own shareholder-customers) has declined significantly following the entry of new competitors, including Aon in 2010.<sup>37</sup>

### **Other inspection parties**

#### *Argest Technical Services Limited*

50. Argest, a division of Stephenson & Turner Architects & Engineers, provides building compliance management, fire system management, and facilities management services throughout New Zealand. This includes the inspection of new sprinklers, the re-inspection of existing sprinklers, and the inspection and certification of new fire alarm systems. Argest has offices in Auckland, Wellington and Christchurch. Argest employs three inspectors based in Wellington and one [ ] in Christchurch.<sup>38</sup>
51. Argest is the third largest inspection firm operating in New Zealand, and currently holds national contracts to provide sprinkler re-inspection services for the Ministry of Education and the New Zealand Police. Outside of these contracts, however, we understand that Argest's new sprinkler and alarm inspections are confined largely to the lower North Island.

#### *Fire System Inspections Limited*

52. FSI, which is based in Auckland, provides sprinkler inspection and re-inspection services for customers located mainly in the upper North Island. It employs two inspectors. As FSI does not offer alarm inspections, we understand that FSI frequently refers clients to Building and Fire Safety Limited, and vice versa.

#### *Building and Fire Safety Limited*

53. BFS, which is also based in Auckland, provides inspection and certification services for newly-installed fire alarms, mainly in the upper North Island. It employs two inspectors.

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<sup>36</sup> Telephone conversation with FPIS (24 November 2016).

<sup>37</sup> After holding a national supply of 100%, or close to 100%, from its inception in 1989 to the mid-2000s, we estimate that based on its national turnover, FPIS currently accounts for about [ ]% of new sprinkler inspections, approximately [ ]% of sprinkler re-inspections, and [ ]% of fire alarm inspections.

<sup>38</sup> Email from Argest to the Commission (27 January 2017).

[ ]

*Hudson Fire Inspections Limited*

54. Hudson is a Dunedin-based company which currently provides sprinkler re-inspection services and fire alarm inspection services throughout the South Island. It currently has two inspectors. However, the current owner of Hudson is proposing to sell the business later this year to his Christchurch-based employee,

[ ]<sup>39</sup> [ ].

55. Hudson does not currently offer new sprinkler inspections,

[ ].

**Customers**

56. The customers of sprinkler and fire alarm inspection services comprise:

56.1 fire protection companies, such as Wormald and Chubb;

56.2 building owners/facilities managers; and

56.3 developers and project managers.

57. The largest and most influential of these customer groups are the fire protection companies. As noted above, fire protection companies generally manage the installation process and source the required inspections for new sprinkler systems. They also take a leading role in re-inspections, as they often hold contracts for the maintenance of fire protection systems in buildings.

58. For new inspections and re-inspections, fire protection companies are typically responsible for choosing inspectors, or at least presenting a range of choices to clients.

59. However, it is the end customer that ultimately requires proof that their sprinklers and alarms have been inspected and certified in compliance with the Building Code. As such, developers and project managers sometimes source their own inspectors for new inspections. Building owners and facilities managers may do the same for re-inspections. For example, some national customers may negotiate directly with an inspection company to secure sprinkler re-inspections at multiple sites. As discussed

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<sup>39</sup> Telephone call with Hudson (22 December 2016).

above, Argest has two such contracts, with the Ministry of Education and the New Zealand Police. Other examples exist with major retail chains.<sup>40</sup>

**Restraints of trade**

60. Of relevance to our assessment of this acquisition are the restraint of trade provisions in each of Aon’s and FPIS’s standard employment agreements. To provide context for our consideration of this matter, we include a summary of the relevant provisions.

*Aon’s restraint of trade provisions*

61. Aon’s standard employment agreements include a restraint of trade which:

61.1 [ ]

61.1.1 [ ]

61.1.2 [ ]

61.2 [ ]<sup>41</sup>

62. In December 2016, Aon made conditional offers of employment, [ ]<sup>42</sup>.  
[ ]  
] Aon waived the restraint provisions in the conditional employment contracts.

*FPIS’s restraint of trade provisions*

63. The majority of FPIS’s inspection staff are also subject to restraint of trade provisions in their employment contracts.<sup>43</sup>

[ ]:

[ ]

64. [ ]<sup>44</sup>

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<sup>40</sup> [ ]

<sup>41</sup> Letter from Aon to the Commission (15 December 2016) at [25].

<sup>42</sup> Email from Aon to the Commission (22 December 2016).

<sup>43</sup> Aon’s response to the Commission’s Letter of Issues (24 January 2017) at [20].

<sup>44</sup> Email from FPIS to the Commission (15 February 2017).

## How the acquisition could substantially lessen competition

65. We have considered three possible ways in which the proposed acquisition could result in a substantial lessening of competition:
- 65.1 the merged entity could raise prices, or reduce the quality of, inspection services above the prevailing levels (unilateral effects);<sup>45</sup>
  - 65.2 the acquisition could increase the merged entity's ability and/or incentive to foreclose competitors, by making it difficult for fire inspection companies to obtain SSC services such as the listing of new inspectors (vertical effects); and
  - 65.3 the acquisition could increase the merged entity's ability and/or incentive to foreclose competitors, by expanding bundled discounts or by tying together a range of inspection services (conglomerate effects).

## With and without scenarios

### With the acquisition

66. Aon is proposing to acquire the book of business, assets and certain liabilities of FPIS.
67. Aon does not intend to purchase FPIS's subsidiary, Firetech Training Limited, which is the only New Zealand Qualifications Authority (NZQA) accredited private training organisation offering NZQA unit standards in fire safety and protection.<sup>46</sup> We have accordingly not considered any competition issues that may arise from a transfer in ownership of this subsidiary.

### Without the acquisition

68. In its application, Aon submitted that if it does not acquire FPIS, the shareholders of FPIS will seek an alternative purchaser (for either FPIS's assets or its shares).<sup>47</sup> Aon considered that any alternative purchaser would likely acquire FPIS on similar terms to what Aon is offering.
69. Aon submitted in its application that a sale to a third party was likely, and was the most competitive counterfactual.<sup>48</sup> In its response to the Letter of Unresolved Issues on 23 February, Aon submitted that this was no longer likely [ ].<sup>49</sup>  
[ ]

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<sup>45</sup> Most customers of fire inspection companies appear more sensitive to quality decreases than to price increases.

<sup>46</sup> NZQA accredited standards in fire protection and safety are used for the training of individuals involved in the installation and maintenance of fire equipment, but does not qualify those individuals to carry out sprinkler or fire alarm inspection work.

<sup>47</sup> Application at [8.2].

<sup>48</sup> Ibid at [8.7].

<sup>49</sup> Aon's response to the Commission's Letter of Unresolved Issues (23 February 2017) at [4] and [5].



].<sup>50 51</sup>

70. [ ]<sup>52</sup>  
[ ]<sup>53</sup>  
[ ]<sup>54</sup> Accordingly, we consider that, without the merger, a sale to a third party is likely.

71. We consider the most competitive counterfactual to be a sale to a third party.<sup>55</sup> We have therefore adopted this as our counterfactual. Our analysis does not, however, turn on the specific identity of the alternate purchaser.

### Market definition

#### Our approach to market definition

72. Market definition is a tool that helps identify and assess the close competitive constraints that the merged entity would face. Determining the relevant market requires us to judge whether, for example, two products are sufficiently close substitutes, as a matter of fact and commercial common sense, to fall within the same market.

73. We define markets in the way that best isolates the key competition issues that arise from a merger. In many cases this may not require us to precisely define the boundaries of a market. What matters is that we consider all relevant competitive constraints, and the extent of those constraints. For that reason, we also consider products which fall outside the market, but which still impose some degree of competitive constraint on the merged entity.

74. In general, the more closely substitutable two products are, the closer the competition and the greater the competitive constraint between the products.

#### The applicant’s view on the relevant markets

75. Aon submitted that the key market that would be affected by the proposed acquisition would be the national market for the inspection of sprinkler and fire alarm

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<sup>50</sup> Ibid at [5].

<sup>51</sup>

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<sup>52</sup>

[ ]

<sup>53</sup>

Ibid.

<sup>54</sup>

[ ]

<sup>55</sup>

Commerce Commission *Mergers and Acquisitions Guidelines* (July 2013) at [2.33].

systems. Given Aon's role as the only existing SSC, it submitted that the national market for sprinkler system certification services may also be relevant to the consideration of this acquisition.

### **Our view of the relevant markets**

#### *Product/service dimension*

76. Contrary to Aon's submission, and for the purpose of this competitive analysis, we have considered the supply of:
- 76.1 inspection services for newly installed sprinkler systems (new sprinkler inspections);
  - 76.2 re-inspection services for existing sprinkler systems (sprinkler re-inspections); and
  - 76.3 inspection and certification services for new fire alarm systems (fire alarm inspections).
77. In reaching this view, we have considered the following evidence:
- 77.1 fire alarm, sprinkler re-inspections and new sprinkler inspections are not substitutable, from a demand-side perspective;
  - 77.2 inspectors and inspection companies cannot seamlessly move between providing these different types of inspections, without significant time and investment;
  - 77.3 the aggregation from the proposed acquisition differs by type of inspection, due to differences in the number and strength of existing competitors; and
  - 77.4 each type of inspection is typically priced and offered independently of the others, and to distinct customer bases.

#### *Geographic dimension*

78. Contrary to Aon's submissions, we consider that there are geographically differentiated markets within New Zealand. This is largely due to our understanding of the practical difficulties faced by inspectors when it comes to offering competitive services from out-of-region.

[ ]<sup>56</sup>

79. In addition to the costs of an inspection, inspectors typically bill customers per-hour of travel outside their headquarters in major centres, usually Auckland, Wellington and Christchurch. It becomes uneconomic, in time and cost, for inspectors to travel too far from a centre when compared to a competitor in another centre. For example, Hudson advised that it is not prepared to travel to the North Island because it is not

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<sup>56</sup> [ ]

economic for it to do so. Even within these regions, inspection companies will attempt to service multiple customers at a time to make travel costs economic.<sup>57</sup>

80. Our evidence suggests that inspectors occasionally travel out-of-region, if there is a sufficient volume of inspections over a sufficiently discrete period to justify the expense,<sup>58</sup> or if requested to do so by a particularly valued customer, located in its region.<sup>59</sup>
81. When inspectors travel out-of-region, customers are generally billed for the travel expenses. We understand that this explains, in part, why out-of-region inspectors cannot typically compete effectively with local firms. Fire protection companies also appear to prefer to deal with familiar, locally-based inspection companies, with whom they have developed close relationships.<sup>60</sup>
82. In our view, the existing competitive situation is characterised by the nationwide coverage of the merging parties, supplemented by regional rivals that are each focused on a particular geographic area. For the purpose of considering the acquisition, we have identified three broad regional markets:
- 82.1 upper North Island (Taupo north);
- 82.2 lower North Island (south of Taupo); and
- 82.3 South Island.
83. Not all service providers or customers are active across all regions, resulting in differing competitive dynamics between each of these geographic markets.
84. We also note that the South Island, in particular, may experience some differentiated competition within different parts of the geographic market. In particular, we understand the main South Island competitor for Aon and FPIS for sprinkler re-inspections and fire alarm inspections is Hudson, which is based in Dunedin. As discussed above, Hudson is due to undergo a change of ownership later this year. [ ]<sup>61</sup>

#### *National sprinkler certification market*

85. For the purposes of our analysis of the vertical and conglomerate effects of the acquisition, we have defined a national market for sprinkler certification services. Currently, Aon in its role as SSC, is the only provider of these services.

<sup>57</sup> Meeting with Aon (7 December 2016).

<sup>58</sup> Meeting with Aon (7 December 2016); Application at [5.10]; and [ ]

<sup>59</sup> [ ]

<sup>60</sup> [ ]

<sup>61</sup> [ ]

## Competition assessment

### Competition assessment overview

86. The merging parties overlap in the provision of sprinkler and alarm inspection services throughout New Zealand. As noted previously, FPIS mainly (but not exclusively) provides these services to its fire protection company shareholders. Aon provides sprinkler and alarm inspection services to those same shareholders, and also competes with FPIS for other customers.<sup>62</sup> Aon and FPIS are considered by the market to be each other's closest competitors, across most of the product and geographic markets in which they participate.
87. The proposed acquisition would remove FPIS as an alternative to Aon, leaving only a handful of smaller, primarily regional providers as the remaining competitors.
88. As shown in Table 1, the merged entity is likely to face competition from at least one other rival in each of the affected geographic markets for each of the relevant product markets, with the exception of new sprinkler inspections in the South Island.

**Table 1: Providers of inspection services for sprinklers and alarms as at December 2016**

	Upper North Island	Lower North Island	South Island
<b>New sprinkler inspections</b>	<ul style="list-style-type: none"> <li>• Aon</li> <li>• FPIS</li> <li>• FSI</li> </ul>	<ul style="list-style-type: none"> <li>• Aon</li> <li>• FPIS</li> <li>• Argest</li> </ul>	<ul style="list-style-type: none"> <li>• Aon</li> <li>• FPIS</li> </ul>
<b>Sprinkler re-inspections</b>	<ul style="list-style-type: none"> <li>• Aon</li> <li>• FPIS</li> <li>• FSI</li> </ul>	<ul style="list-style-type: none"> <li>• Aon</li> <li>• FPIS</li> <li>• Argest<sup>1</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Aon</li> <li>• FPIS</li> <li>• Hudson</li> </ul>
<b>New alarm inspections</b>	<ul style="list-style-type: none"> <li>• Aon</li> <li>• FPIS</li> <li>• BFS</li> </ul>	<ul style="list-style-type: none"> <li>• Aon</li> <li>• FPIS</li> <li>• Argest</li> </ul>	<ul style="list-style-type: none"> <li>• Aon</li> <li>• FPIS</li> <li>• Hudson</li> </ul>

Source: Industry participants

1. Argest also holds national contracts with the Ministry of Education and the New Zealand Police to provide sprinkler re-inspection services for these entities. While Argest does provide services for these clients in other geographic markets, we understand that its other out-of-region activities are limited.

89. However, with the exception of Argest in the lower North Island, these remaining competitors are much smaller than the merging parties. As shown in Table 2, the combined entity would account for around 80% of the inspectors employed by

<sup>62</sup> FPIS's shareholders account for around [ ]% of FPIS's revenue (Application at [9.3]) and around [ ]% of Aon's revenue (see Aon's Fire Protection Inspection Services Limited Due Diligence Report (17 November 2016) at 44.

inspection companies in the upper North Island; 60% of inspectors in the lower North Island; and 70% of inspectors in the South Island.<sup>63</sup>

**Table 2: Inspector numbers and shares by geographic region as at December 2016**

Company	Upper North Island		Lower North Island		South Island		Total NZ	
	Number	%	Number	%	Number	%	Number	%
Aon	6 <sup>1</sup>	32%	2	28.5%	2 <sup>2</sup>	20%	10	28%
FPIS	9	47%	2	28.5%	5	50%	16	44%
<b>Combined entity</b>	<b>15</b>	<b>79%</b>	<b>4</b>	<b>57%</b>	<b>7</b>	<b>70%</b>	<b>26</b>	<b>72%</b>
FSI	2	10.5%	-	-	-	-	2	6%
BFS	2 <sup>3</sup>	10.5%	-	-	-	-	2	6%
Argest	-	-	3 <sup>4</sup>	43%	1 <sup>5</sup>	10%	4	10%
Hudson	-	-	-	-	2	20%	2	6%
<b>Total</b>	<b>19</b>	<b>100%</b>	<b>7</b>	<b>100%</b>	<b>10</b>	<b>100%</b>	<b>36</b>	<b>100%</b>

Source: Industry participants.

<sup>1</sup> [ ]

<sup>2</sup> [ ]

<sup>3</sup> BFS's inspection staff work only on fire alarms.

<sup>4</sup> Approximately [ ]% of Argest's inspection capacity is utilised servicing its national contracts, predominantly outside the lower North Island.

<sup>5</sup>[ ]

90. As shown in Table 3, we estimate that, on a national basis, the combined entity would account for around [ ]% of new sprinkler inspection revenue, around [ ]% of sprinkler re-inspection revenue, and around [ ]% of new alarm inspection revenue.

<sup>63</sup> We note that, with the exception of BFS, the inspectors employed by each company conduct different inspections with some carrying out one type of inspection (e.g., sprinkler re-inspections), while some inspectors are cross-trained to carry out a mixture of different inspection work.

**Table 3: Estimated share of national turnover as at December 2016**

Company	New sprinkler inspections		Sprinkler re-inspections		New fire alarm inspections	
	Annual turnover	%	Annual turnover	%	Annual turnover	%
Aon	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
FPIS	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
<b>Combined entity</b>	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Argest	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
FSI	[ ]	[ ]%	[ ]	[ ]%	-	-
BFS	-		-	-	[ ]	[ ]%
Hudson	-		[ ]	[ ]%	[ ]	[ ]%
<b>Total</b>	[ ]	100%	[ ]	100%	[ ]	100%

Source: Industry participants.

91. Over time, Aon has grown its position in the inspection markets to become the second largest market participant. This has occurred through acquisition<sup>64</sup> and from taking business and inspectors from its competitors, [ ]<sup>65</sup> [ ]<sup>66</sup> [ ]<sup>67</sup>.
92. Similarly, Argest has expanded its presence in the inspection markets largely by acquiring two inspection companies in the lower North Island (Fire System Consultants Limited and Kensway Fire Limited), and securing two large national contracts. [ ]<sup>68</sup>
93. The smaller regional players (FSI, BFS and Hudson) have also expanded since their formation, although their revenues remain relatively small. At the same time as all of the companies have been expanding, FPIS's market shares have been declining, although it remains the largest inspection company in the country, across most metrics.

### Unilateral effects in sprinkler inspections

#### Overview

94. The acquisition would result in significant overlap for sprinkler inspections in each of the affected geographic markets. In particular, the merged entity would account for

<sup>64</sup> In 2010, Aon acquired CIS, an inspection company based in the lower North Island.

<sup>65</sup> Aon's Fire Protection Inspection Services Limited Due Diligence Report (17 November 2016) at 14; and [ ]<sup>65</sup>).

<sup>66</sup> Application at [6.5].

<sup>67</sup> Aon's Fire Protection Inspection Services Due Diligence Report (17 November 2016) at 44 .

<sup>68</sup> [ ]

between approximately 60% and 80% of the total number of inspectors working in each of the affected geographic markets.

95. We consider that, apart from new sprinkler inspections in the South Island, the merged entity would face some existing competition from a smaller rival in each of the upper North Island and South Island geographic markets: FSI in the upper North Island; and Hudson in the lower South Island (re-inspections only and [ ]). In the lower North Island, the merged entity would face a regional competitor: Argest.<sup>69</sup> However, we do not consider that the presence of these firms would be sufficient to constrain an exercise of market power by the merged entity, particularly as [ ].
96. For new sprinkler inspections in the South Island, the post-acquisition competitive situation would appear even more problematic. The proposed acquisition would result in the merged entity being the only provider of new inspections in the South Island.

*Aon's view on unilateral effects*

97. Aon has submitted that post-acquisition, the merged entity would face strong competition in each of the affected North Island geographic markets. Aon also submitted that there are low barriers to entry and expansion in the new sprinkler and re-inspection markets.
98. With respect to the South Island, in particular, Aon submitted that the proposed acquisition would not result in a substantial lessening of competition for new inspections.<sup>70</sup> Aon submitted that:
- 98.1 [ ];
- 98.2 [ ];
- 98.3 Hudson has chosen not to carry out new inspections in the South Island, but could choose to provide those services relatively easily and promptly; and
- 98.4 inspection companies offering new inspections in the North Island, such as Argest, could expand relatively easily into this market.

99. [ ]<sup>71</sup>  
[ ]

<sup>69</sup> Argest also provides some services in each of the upper North Island and South Island geographic markets as mentioned, but only to a subset of customers. Therefore, Argest does not appear to impose an effective competitive constraint on the merged entity outside of the lower North Island at present.

<sup>70</sup> Aon's response to the Commission's Letter of Issues (24 January 2017).

<sup>71</sup> [ ]

].<sup>72</sup>

*Evidence from competitors*

- 100. During our investigation, we spoke to all existing inspection companies. The key points that emerged from these interviews included the following:
  - 100.1 competing inspection companies have expanded somewhat over time, mostly at the expense of FPIS, but have not (except for Argest’s national contracts) expanded into different product or geographic markets;
  - 100.2 [ ];
  - 100.3 there is currently a limited pool of experienced inspectors available for competing inspection companies to hire; and
  - 100.4 training new inspectors is relatively time consuming and expensive for smaller firms.

Argest: sprinkler inspections and re-inspections in the lower North Island

- 101. Argest has expanded its sprinkler re-inspection and new inspection business in the last four years, after diversifying from its building management compliance activities and acquiring two existing inspection companies, both of which were based in the lower North Island: Fire System Consultants Limited and Kensway Fire Limited.<sup>73</sup>
- 102. Argest has also been successful in winning national contracts which include the provision of sprinkler re-inspection services. Nevertheless, our investigation has found that Argest has a negligible footprint in the upper North Island and South Island geographic markets, outside of these national contracts. These national contracts do not appear to have allowed Argest to expand into other geographic markets.

103. [

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104. [

].<sup>75</sup>

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<sup>72</sup> Ibid.  
<sup>73</sup> Meeting with Argest (29 November 2016).  
<sup>74</sup> Ibid.  
<sup>75</sup> Ibid.



Hudson: sprinkler re-inspections in the South Island

105. Hudson advised us that in respect of its re-inspection business it is operating its current structure at [ ]% of its capacity, [ ]

106. [ ]<sup>76</sup>

107. Hudson is not currently involved in providing new sprinkler inspections. [ ]<sup>77</sup>

FSI: sprinkler inspections and re-inspections in the upper North Island

108. FSI carries out new sprinkler inspections and re-inspections, mainly in Auckland, but also in the rest of the upper North Island (as far south as New Plymouth/Taupo).<sup>78</sup> FSI has [ ]<sup>79</sup>

109. [ ]<sup>80</sup>  
[ ]<sup>81</sup>

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<sup>76</sup> Telephone call with Hudson (22 December 2016).  
<sup>77</sup> Ibid.  
<sup>78</sup> Telephone call with FSI (30 November 2016).  
<sup>79</sup> Ibid.  
<sup>80</sup> Ibid.  
<sup>81</sup> Telephone call with FSI (28 November 2016).

110. FSI advised that training a new inspector would take up to [ ] to undertake inspection work, but noted that this period may be reduced if the new inspector had previous experience such as in sprinkler design.<sup>82</sup>
111. FSI advised that prices for inspection services in the upper North Island have reduced by 15% over the last two to three years which it attributed in part to FPIS lowering its prices to try to regain market share.<sup>83</sup> It also noted that the rivalry between the three inspection companies in the upper North Island had stimulated competition.

BFS: fire alarm inspections in the upper North Island

112. As previously noted, BFS is currently involved in fire alarm inspections.  
[ ]<sup>84</sup>

113. [ ]<sup>85</sup>

*Evidence from customers*

114. During the investigation, we spoke to nine customers of inspection companies.<sup>86</sup> These comprised two nationwide firms and seven regional companies, and included FPIS shareholders as well as non-FPIS shareholders.
115. For new inspections, FSI was viewed by customers as a competitive option to the merging parties in the upper North Island, while Argest was viewed as an alternative in the lower North Island. However, South Island customers considered that Aon is currently the only alternative for new inspections.
116. For re-inspections, each of the regional companies was viewed as alternatives to the merging parties by customers. In particular, Hudson was viewed as a competitive option in the South Island;<sup>87</sup> Argest was seen as a competitor in the lower North Island;<sup>88</sup> and FSI was identified as a competitor in the upper North Island.<sup>89</sup>
117. A number of customers considered that price increases may have to be accepted following the proposed acquisition. Some also noted that these price increases may encourage entry or expansion, if experienced inspectors could be sourced.

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<sup>82</sup> Telephone call with FSI (3 February 2017).

<sup>83</sup> Ibid.

<sup>84</sup> Telephone call with BFS (23 November 2016).

<sup>85</sup> Telephone call with BFS (2 February 2017).

<sup>86</sup> There are approximately 50 fire protection companies currently operating in New Zealand (see Application at [4.10]). In addition, there are a number of other parties, including building and property owning companies, that purchase sprinkler inspection services.

<sup>87</sup> [ ]

<sup>88</sup> [ ]

<sup>89</sup> [ ]

117.1 [ ]<sup>90</sup>[ ]<sup>91</sup>  
 [ ]  
 ]  
 raised no particular concerns about the acquisition as it considered there were options in all the centres in which it operated.

117.2 [ ], a fire protection company operating in the South Island, told us that for new installations they would not have any other options.<sup>92</sup>  
 [ ]

117.3 [ ], which is another fire protection company with operations in the South Island, also told us that the merging parties are its only current options for new sprinkler inspections.<sup>93</sup>  
 [ ] considered that the acquisition may lead to an improved level of service [ ], and that in future some inspectors would probably break away.

117.4 [ ], considered that its options for sprinkler inspections would be reduced by the proposed acquisition.  
 [ ]. If the merged entity raised its prices significantly above the competitive level, it would have no choice but to accept the price increase.<sup>94</sup>

117.5 [ ]<sup>95</sup>  
 [ ] believes that pricing post-acquisition will increase 10 – 15% “which might be acceptable”. However, if prices went up 25% fire protection companies would be likely to sponsor entry.

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90 [ ]  
 91 [ ]  
 92 [ ]  
 93 [ ]  
 94 [ ]  
 95 [ ]

*The Commission's views on existing competition in sprinkler inspections*

118. The Commission's view is that, with the exception of the lower North Island where Argest operates, Aon and FPIS are each other's closest competitors across most of the geographic sprinkler markets. In recent times, FPIS appears to have led price decreases in the North Island geographic markets in a bid to arrest the decline in its market share.<sup>96</sup>
119. The acquisition would result in substantial aggregation in each of the regional sprinkler inspection markets.
120. In the upper North Island sprinkler markets, in which the acquisition would result in a three-to-two, we are not satisfied that the remaining regional competitor, FSI, would [ ] to constrain an exercise of market power by the merged firm.
121. In the lower North Island sprinkler markets, Argest would continue to provide some competitive constraint. However, the acquisition would reduce the number of competitive options in this geographic market from three to two, which would be expected to result in less competitive tension between the market participants. In this regard, we note that pricing competition has been a feature of the lower North Island market in recent years. For instance, [ ]<sup>97</sup>
122. In the South Island sprinkler markets, we consider that Hudson would continue to provide some limited competitive constraint on the merged entity in sprinkler re-inspections in the South Island. However, [ ]
123. The aggregation from the proposed acquisition would be particularly acute with respect to new sprinkler inspections in the South Island, which Hudson does not currently provide and is unlikely to provide in the near term.
124. For new inspections, Aon currently provides the only local competitive constraint in the South Island. As noted, Aon submitted [ ]<sup>98</sup>  
[ ] Aon has, for example, been successful in winning an estimated [ ]%<sup>99</sup> market share in Christchurch so we consider that the existence of Aon as a prospective option has provided a material constraint on FPIS. Our view is consistent with those expressed by South Island customers we

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<sup>96</sup> [ ]

<sup>97</sup> Meeting with Aon (7 December 2016).

<sup>98</sup> Aon's response to the Commission's Letter of Issues (24 January 2017) at [45](a) and (b).

<sup>99</sup> Ibid at [44].

interviewed, who were concerned they would be left with no significant alternatives to the merged entity.

125. For these reasons, we cannot be satisfied that existing competitors would be sufficient to constrain the merger from substantially lessening competition.

### **Potential competition**

126. Given our conclusions on existing competition, we have considered whether entry from competitors based in adjacent geographic or product markets, new entry, or expansion by existing competitors would meet the LET test.<sup>100</sup> That is, we have considered whether such entry or expansion is likely, of a sufficient extent and in a timely manner, to provide a competitive constraint on the merged entity such that a substantial lessening of competition would be defeated.
127. Our analysis of whether entry and expansion are likely includes consideration of whether the expected profitability of entry or expansion is positive. In order to be of sufficient extent, the potential for entry or expansion should effectively constrain the merged entity in each of the relevant markets. In order to be timely, the potential entry or expansion must be likely to occur in a reasonably short time period, and be of sufficient scale to render the lessening of competition not substantial.
128. We consider that accredited inspectors are the key asset for entry or expansion into the relevant markets.
129. The combined entity would control a large majority of the accredited sprinkler inspectors in New Zealand post-acquisition (see above at Table 2). We have therefore considered where rival firms of the merged entity or new entrants would be able to source inspectors from.
130. We consider in turn, the expansion of competitors of the merged entity by:
- 130.1 obtaining accredited inspectors from the merged entity;
  - 130.2 obtaining accredited inspectors from other inspection companies; and
  - 130.3 expansion by hiring unaccredited individuals and making them trainee inspectors.
131. For entry, we have considered below:
- 131.1 entry by accredited inspectors from the merged entity (including, as noted above, inspectors who do not have an accreditation currently but are experienced inspectors);
  - 131.2 entry by unaccredited individuals ('Greenfields' entry); and
  - 131.3 entry sponsored by customers.

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<sup>100</sup> Commerce Commission *Mergers and Acquisition Guidelines* (July 2013) at [3.96 ff].

132. Given our conclusion that such entry or expansion is not likely, we have not considered how many inspectors an entrant or competitor would need to constrain the merged entity. At a minimum, competitors would need to obtain inspectors in each of the relevant markets of concern for us to consider that expansion would be of sufficient extent.

*Expansion by obtaining accredited inspectors from the merged entity*

133. Taking on an experienced inspector represents considerably less risk for an expanding inspection company as they are able to bring loyal customers with them and do not require extensive training and accreditation. In the last decade, expansion in the sprinkler inspection markets has largely come about through the movement of accredited inspectors, including the acquisition of existing inspection companies. Examples include Aon, who have taken on FPIS inspectors, and Argest when it bought Kensway, including its accredited inspectors and books of business. However, these movements have not involved the movement of inspectors from Aon to other inspection companies.

134. We expect that Aon would likely retain most of FPIS’s inspectors through the proposed acquisition, [ ]<sup>101</sup>

135. The Commission has therefore considered Aon’s ability and incentive to deter inspectors from leaving its employ post-acquisition.

136. Aon would be likely to have an incentive to protect any gain in market power from this acquisition by discouraging inspectors from leaving through incentives, such as higher pay, and/or through deterrents, such as the enforcement of employee contractual provisions. [ ]<sup>102</sup> At interview, Aon explained that, among other things,<sup>103</sup> [ ]<sup>104</sup>

<sup>101</sup>

[ ]

<sup>102</sup> Aon’s Fire Protection Inspections Limited Due Diligence Report (17 November 2016) at 5 and 24.

<sup>103</sup>

[ ]

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<sup>104</sup> Meeting with Aon, 7 December 2017.

137. Aon’s contracts contain a restraint of trade [ ]. Aon has enforced restraint of trade clauses in the recent past.<sup>105</sup>
138. Aon’s due diligence documents indicate that it believes its restraints of trade to be [ ].<sup>106</sup> [ ].<sup>107</sup> We consider that Aon has the ability and incentive to deter inspectors from leaving.
139. We note also that the majority of FPIS employee contracts contain a restraint of trade. Post-acquisition, FPIS’s restraints of trade will only be relevant to FPIS employees that do not accept employment with Aon because they will still be subject to those restraints. Therefore, some employees who do not accept employment with Aon will still be subject to a restraint. [ ].<sup>108</sup>

Will Aon’s restraint of trade clauses discourage inspectors from leaving Aon?

140. Aon submitted that the restraint of trade provisions in its employment contracts [ ].<sup>109</sup>
141. We are concerned that the restraint of trade provisions in Aon’s employment contracts, and Aon’s interpretation of these clauses, appears sufficiently wide so as to limit the potential entry and/or expansion of competitors. In particular, [ ], would not appear to leave much scope for establishing an effective competitor, given the extent of Aon’s operations and that the large proportion of the market for new inspections is channelled through a relatively small number of fire protection companies. For re-inspections, our understanding is that personal relationships with clients are also very important.
142. The relevant question is not whether the FPIS inspectors could leave either FPIS or Aon, but whether they would do so. We do not consider that the ultimate enforceability of these clauses is determinative of our competition analysis. The issue

<sup>105</sup> *Aon New Zealand v West (No 2)*, [2016] NZERA Auckland 74.

<sup>106</sup> Aon’s Fire Protection Inspections Limited Due Diligence Report (17 November 2016) at 5.

<sup>107</sup> Ibid. For example, at page 24 Aon states that “[ ].”

<sup>108</sup> Draft Sale and Purchase Agreement at 8.2(a).

<sup>109</sup> Letter from Aon to the Commission (15 December 2016).

is whether the existence of these clauses, enforceable or not, may dissuade or impede the entry or expansion of competition if there is a credible and likely threat of legal proceedings.

143. We consider that Aon would likely attempt to enforce its restraint of trade clauses on its staff. In this respect, we note Aon’s recent successful Employment Court action regarding a similar restraint of trade in Aon’s insurance broking business.<sup>110</sup> The Employment Court found that the restraint was reasonable because:

143.1 protecting against the solicitation of clients by former employees was a legitimate basis for the restraint;

143.2 employees had access to sensitive information about their clients, including renewal dates and product development for those clients by Aon;

143.3 a 12 month restraint of trade was reasonable in the context that renewal contracts with those clients was on a yearly basis; and

143.4 a national restraint was reasonable because customers were located nationally.

144. Therefore, regardless of the outcome, we consider that an ex-employee would face a credible threat of legal proceedings, and that the expected cost and delay of such proceedings may contribute to discouraging potential competition.

145. We also consider that the restraint of trade clauses may significantly increase the implicit costs faced by a prospective entrant (or by an existing competitor considering expansion).

146. Aon submitted that its employment contracts [ ].<sup>111</sup> However, the Commission’s concern is that the threat of restraints of trade will make accredited inspectors less likely to leave and therefore constrain the merged firm.

147. Aon further submitted that Fire System Consultants (FSC) was able to enter the market, even though its owner was subject to similar restraints of trade.<sup>112</sup>

[ ].<sup>113</sup> Therefore, we do not consider that the FSC case adequately illustrates the ease of entry or expansion.

### Aon’s waiver of restraints

<sup>110</sup> *Aon New Zealand v West (No 2)* [2016] NZERA Auckland 74.

<sup>111</sup> Aon’s response to the Commission’s Letter of Issues (24 January 2017) at [23].

<sup>112</sup> Aon’s response to the Commission’s Letter of Issues (24 January 2016) at [35] and [36].

<sup>113</sup> Telephone call with Mr Bill Harper (2 February 2017).



148. Clearance cannot be granted conditional on the merging parties acting in a particular way post-acquisition. The Commission must therefore consider the incentives of the merging parties once clearance has been granted to act in a particular way, and cannot rely on firms to act against their own interest post-acquisition. The reason for this approach is illustrated by the events that post-dated the Commission’s decision in *Atlas Copco/Ash Air*.<sup>114</sup>
149. In *Atlas Copco*, the Applicant waived non-compete clauses it had made in offers to the target’s staff. It did so in response to concerns raised by the Commission in the course of the consideration of that clearance application. The Commission placed some weight on the waivers in granting clearance in that case. Post-acquisition, the target company filed proceedings against two managers who had left days before the acquisition was completed to establish a competing firm, for breach of the employees’ restraints of trade in their original contracts with the target. The merged firm stated these proceedings were necessary to protect the goodwill of their investment, indicating that ultimately they were incentivised to act in their own interests post-acquisition.
150. In our meeting with Aon on 7 December 2016, Aon told us that it would apply its standard restraints of trade clauses to the FPIS employees to which it offered employment. In late December 2016, Aon made conditional offers of employment, on its standard terms, to [ ] FPIS’s inspectors across the country.<sup>115</sup>
151. On 13 February 2017, Aon received a Letter of Unresolved Issues from the Commission which identified that the restraint of trade provisions in Aon’s employment contracts may significantly constrain the ability of accredited sprinkler inspectors to successfully change employers or establish new firms.  
[ ] Aon waived the relevant restraint of trade provisions in the conditional employment agreements offered to the FPIS inspectors.<sup>116</sup>
152. We considered whether the waivers could be used by the individuals concerned. In order to meet the common law test for waiver, former FPIS staff would have to show they had ‘relied’ on the waiver.<sup>117</sup> Because a large number of FPIS staff had agreed to the contracts before the waiver was issued, and because there is nothing to prevent Aon revoking the waiver as soon as the day after clearance, the Commission is concerned it may be difficult for an employee to show they had relied on the waiver.
153. Whether or not they were enforceable, of greatest concern to the Commission is that the lack of restraints would not endure post-acquisition, because the financial incentives for Aon to retain restraints of trade would be unchanged.

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<sup>114</sup> Atlas Copco South Pacific Holdings Limited and Lancaster Group Limited [2014] NZCC 11.

<sup>115</sup> Email from Aon to the Commission (22 December 2016).

<sup>116</sup> Aon’s response to the Commission’s Letter of Unresolved Issues (23 February 2017) at [11].

<sup>117</sup> See *Connor v Pukerau Store Ltd* [1981] 1 NZLR 384 (CA) at pp 386 – 388. Per Cooke J “the idea behind the kind of waiver or estoppel with which Lord Denning is concerned is that it may be unjust to allow a party to resile from what he has said. If his statement has had no effect at all on the conduct of the other party, there does not seem to be anything unfair in allowing him to withdraw it.”

154. Prior to the acquisition, Aon had good reasons to include these restraints, including:
- 154.1 previous entry and expansion in the industry has been largely based on the movement of accredited inspectors;
  - 154.2 customer relationships are very important in this industry;
  - 154.3 Aon has acquired FPIS customers by hiring FPIS employees, and [ ]; and <sup>118</sup>
  - 154.4 [ ].<sup>119</sup>
155. Aon originally put these restraints in the contracts with prospective FPIS inspectors. In our view, Aon's only incentive to waive the restraints was for the purposes of the Commission's clearance. Aon would not be restricted from re-imposing restraints of trade by offering new employment terms to inspectors post-acquisition.
156. Accordingly, the Commission cannot exclude the real chance that Aon would, post-acquisition, introduce restraints of trade provisions into the employment contracts with former FPIS employees.
157. We consider that the credible threat of legal proceedings raises the implicit costs of competitors expanding. We consider that expansion with current staff to a sufficient extent in a reasonable time is not likely. Taking into account the incentives faced by Aon post-acquisition we cannot exclude the real chance that the restraints will be re-introduced post-acquisition. Therefore, we do not consider it likely that competitors would obtain accredited inspectors from the merged entity post-acquisition.

*Obtaining accredited inspectors from other inspection companies*

158. We do not consider that the hiring of inspectors from remaining competitors, post-acquisition, is likely to prevent a substantial lessening of competition in all relevant markets. Shifting market share between the merged entities' competitors is unlikely to change the competitive constraint on the merged entity. [ ]. Therefore, inspection companies are unlikely to sufficiently constrain the merged entity in all relevant markets.
159. In addition, shifting inspectors between the merged entities competitors from one geographic or product market to another may strengthen the competitive constraint in that market but would be likely to weaken the competitive constraint in the other.

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<sup>118</sup> Meeting with Aon (7 December 2016).

<sup>119</sup> Aon's Fire Protection Inspection Services Limited Due Diligence Report (17 November 2016).

*Expansion by hiring unaccredited individuals and making them trainee inspectors*

160. In reaching our view on whether the hiring of unaccredited inspectors by competitors is likely, we have primarily considered the views expressed by those existing competitors. However, we have also carefully considered the analysis of the profitability of such an expansion. We have found no reason to doubt the views expressed by those competitors.

161. Smaller inspection companies have told us that while they may seek to expand with experienced, accredited inspectors, training inspectors is time consuming and expensive. As set out above, [ ]<sup>120 121</sup>  
 [ ]<sup>122</sup>  
 [ ]<sup>123</sup>

162. Although the larger inspector companies take on trainee inspectors, it does not appear to be economic for smaller inspection companies. This is because the sunk costs and risks of taking on a trainee are high relative to expected profitability associated with a trainee. These costs include approximately [ ] p.a. in accreditation fees and new equipment,<sup>124</sup> and [ ] in insurance costs p.a.<sup>125</sup> [ ] also noted that [ ]% of the owner’s time was taken up by the supervision of his then-trainee inspector.<sup>126</sup>

163. Further, trainees are typically courted from adjacent industries, such as sprinkler installation or design. We understand that these individuals must be compensated for their opportunity cost, given that they are preferably experienced designers or installers, even if they do not immediately generate significant revenue as trainee inspectors.<sup>127</sup> As such, trainees’ salaries range between [ ],<sup>128</sup> and [ ]<sup>129</sup> p.a.

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<sup>120</sup> [ ]  
<sup>121</sup> [ ]

[ ]  
 [ ]

<sup>122</sup> [ ]

<sup>123</sup> [ ]

<sup>124</sup> While the accreditation fees are sunk costs, the equipment component of these costs are unlikely to be sunk. [ ]

<sup>125</sup> See telephone calls with [ ]. We note this is broadly in line with [ ] separate estimate of his costs of de novo entry, with some exceptions. A new business has greater set up costs for equipment (\$[ ]) and accreditation (\$[ ]), which is understandable given the need, for example, to write a compliance manual for the new business. These figures were generally corroborated by our call with [ ] [ ]

<sup>126</sup> [ ]

<sup>127</sup> Aon’s response to the Commission’s Letter of Issues at [9] and [10] (24 January 2017).

<sup>128</sup> See telephone call with [ ]

<sup>129</sup> See Aon’s response to the Commission’s Letter of Unresolved issues (23 February 2017) at [33].

Together these costs take between six<sup>130</sup> to twenty four,<sup>131</sup> months to recover before a trainee starts contributing to company profits.<sup>132</sup>

164. According to Aon, an inspection company typically trains new employees to carry out one particular type of routine re-inspection work, and then progressively builds employees' expertise and competence to perform more complex re-inspection and new inspection work.<sup>133</sup> [ ] told us that when it hires new staff, trainees require considerable training, and that it might take 18 months until they are competent to do routine sprinkler inspections for commercial buildings.<sup>134</sup> This period is essentially an unofficial apprenticeship to a more senior inspector.
165. [ ] estimated that it would take up to 18 months overall before all costs have been recovered.<sup>135</sup> [ ] advised that it could take two to three years before trainee inspectors 'break even', but noted that these time frames could be shortened if the individual had sufficient prior experience with sprinklers.<sup>136</sup> [ ] told us that it takes roughly two years to train someone sufficiently that they become an asset.<sup>137</sup>
166. The smallest unit of expansion is one full-time trainee and so is not fully incremental. As only smaller and/or regional competitors would remain following the proposed merger, to take on an additional inspector its revenues would need to increase significantly. In order to cover the total costs of a new trainee inspector ranging from \$[ ] to \$[ ] per annum,<sup>138</sup> the merging parties' competitors would need to win between 15% and 49% more business, on a revenue basis, in order to merely cover this additional employee's costs, before taking into account training costs. This is why hiring experienced inspectors, who can bring a book of business and immediately begin to contribute to the company revenues, is important. In addition, with small companies these costs must be shared across fewer active inspectors and so is a larger portion of profits risked.
167. We note that if it takes around two years before a trainee inspector breaks even, we consider that a single smaller competitor would not be likely to train more than one inspector in a timely manner. This raises concerns that even a company willing to train inspectors would not be able to constrain the merged entity to a sufficient extent in a timely manner.
168. Accordingly, our analysis of the risks and costs involved in such expansion supports the views expressed by existing competitors.

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<sup>130</sup> [ ]  
<sup>131</sup> [ ]; and [ ]

<sup>132</sup> These figures were generally corroborated by our call with [ ].

<sup>133</sup> Meeting with Aon (7 December 2016).

<sup>134</sup> [ ]

<sup>135</sup> [ ]

<sup>136</sup> Ibid.

<sup>137</sup> [ ]

<sup>138</sup> Being the sum of salary, insurance, accreditation and equipment costs noted above.

*Entry by accredited inspectors from the merged entity*

169. As noted above, expansion by accredited inspectors, either directly, or by purchasing an existing inspection company presents less risk than the alternatives. We consider a similar analysis applies to entry by accredited inspectors. For example, Aon entered several inspection markets by purchasing CIS, and Argest entered by purchasing FSC.

170. Our analysis of the movement of accredited inspectors to other competitors above, particularly in regard to restraints of trade, is relevant to our analysis of new entry by those same accredited inspectors. Aon submitted that an accredited inspector employed by FPIS, [ ], did not accept Aon’s offer of employment, and was currently considering his options, including possibly establishing a sprinkler inspection business [ ].<sup>139</sup> Accordingly, he is not subject to Aon’s restraints of trade.<sup>140</sup> We consider that [ ] is unlikely to enter that market post-acquisition. Further, we consider that [ ] evidence in this regard is relevant to our consideration of whether it is profitable, that is likely, that accredited inspectors would leave the merged entity to enter one of the relevant markets.

171. [ ]<sup>141</sup>  
[ ]  
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172. [ ]

173. [ ]

174. [ ]

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<sup>139</sup> Aon’s response to the Commission’s Letter of Unresolved Issues (23 February 2017).

<sup>140</sup> [ ]

<sup>141</sup>

[ ]  
].

].<sup>142</sup>

175. Based on the evidence from [ ], and taking account of the above evidence in regard to restraints of trade, we consider entry by existing accredited inspectors is not likely.

*Entry by unaccredited individuals ('Greenfields' entry)*

176. We consider it unlikely that entry would occur from parties outside of the fire inspection industry. We understand that there have been no instances of entry by unaccredited individuals outside of the relevant markets in about the last 10 years without an acquisition.
177. IANZ has indicated to us that there would now be practical impediments to accrediting a novice inspector without the support of an existing inspection company. This is due, among other reasons, to the accreditation requirement that IANZ observe apprentice inspectors as they conduct 'live' inspections.<sup>143</sup>
178. Aon submitted two examples of entry by those without prior accreditation: [ ](FSI) and [ ](formerly of CIS and FSC).<sup>144</sup> However, we do not consider either FSI or FSC to be compelling examples of entry by unaccredited individuals given that they were set up by persons who had already operated as inspectors. As noted above, we consider such individuals should be treated as 'accredited inspectors', because they were able to bring with them former clients, which a 'Greenfields', unaccredited individual would not be able to.
179. FSI advised us that until the company was accredited in 2008, FSI performed inspection work for CIS on a sub-contract basis and then submitted inspection reports to CIS which in turn arranged for sign-off.<sup>145</sup>
180. [ ] set up FSC around 2013 after spending many years as an inspector with CIS. Given his significant previous experience, [ ] was granted provisional approval by IANZ for a twelve month period to enable him to set up FSC.<sup>146</sup> We are not aware of any other occasions when this situation has occurred.
181. Aon submitted that potential inspectors could approach dissatisfied clients of inspection companies who would agree to a 'live' inspection to facilitate entry.<sup>147</sup> We have received no evidence of this occurring and consider it would be unlikely for a

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<sup>142</sup>

[ ]

<sup>143</sup> Telephone call with IANZ (21 December 2016).

<sup>144</sup> Telephone call with Aon (20 February 2017); Aon's response to the Commission's Letter of Unresolved Issues (23 February 2017) at [40]; and Aon's response to the Commission's Letter of Issues (24 January 2017) at [16 (b)].

<sup>145</sup> Telephone call with FSI (3 February 2016).

<sup>146</sup> Telephone call with Mr Bill Harper (2 February 2017).

<sup>147</sup> Aon response to the Commission's Letter of Unresolved Issues (23 February 2017) at [42] (a).

prospective inspector to convince a customer to permit 'live' inspections solely for accreditation purposes. Without the participation of an accredited inspector, such inspections would not assist a customer in satisfying building warrant of fitness requirements.

*Entry sponsored by customers*

182. We consider it unlikely that a customer would have the incentive to sponsor entry. The evidence suggests that customers are more quality than price sensitive, although there is price competition, including competitive tendering.<sup>148</sup> The cost of the relevant inspections is small relative to the total cost of the project (particularly in the case of new inspections). However, the potential risk (and liability) is high for the customer if a lower quality service is provided.
183. Many fire protection companies, which are the largest customers, also pass on the costs of inspection. In some cases of new inspections these customers merely add their own margin to inspection costs.<sup>149</sup> As such, a small but substantial price increase might not be sufficient for a customer to sponsor an entrant.<sup>150</sup>
184. Further, these inspection markets are susceptible to, and appear to be characterised by, price discrimination. Only certain customers are sufficiently large to sponsor entry, by granting a long term contract of sufficient size. Therefore, the merged entity could price discriminate and impose a price increase only on smaller customers, or those less likely to sponsor entry. This way it could exert market power without risking entry by sponsorship.
185. [ ]<sup>151</sup>
186. [ ]
187. We therefore consider that sponsorship of a new entrant is unlikely.

*Conclusion*

188. We remain concerned whether a price increase, or reduction in quality, by the merged entity would be sufficient to incentivise expansion by existing (capacity-constrained) firms and/or entry by new firms. Further, whether such entry or expansion would be of sufficient extent to defeat a price increase in each of the relevant markets.

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<sup>148</sup> For example, telephone call with FPIS (24 November 2016); and [ ]

<sup>149</sup> [ ]

<sup>150</sup> Historically, sponsorship has occurred in this industry, although in the SSC market this was due to a quality decrease.

<sup>151</sup> See draft Aon/FPIS sale and purchase agreement attached to Aon's email (15 December 2016).

189. We consider that existing inspection companies are best placed to constrain the merged entity. We consider successful expansion that meets the LET test would rely on obtaining accredited inspectors from the merged entity. The merged entity's competitors, at a minimum, would need to obtain such inspectors in each of the relevant markets of concern for us to consider that expansion would be of sufficient extent. We consider this is not likely given the merged entity's incentives regarding its restraints of trade. A potential entrant must also consider its expected profitability in the context of a degree of customer price insensitivity and loyalty.

### **Fire alarm inspections**

190. The proposed acquisition would result in some overlap in the fire alarm inspections market in each of the affected geographic markets. While FPIS has a strong presence in fire alarm inspections, Aon is a minor player in those markets.

191. No significant concerns were raised by industry participants or customers for alarm inspection services, especially given BFS, Argest, and Hudson would remain competitors in their respective geographic markets with relatively substantial market shares.<sup>152</sup>

192. Given that we are not satisfied that this merger would not result in a substantial lessening of competition in the sprinkler inspection markets, we have not given further consideration to these markets.

### **Vertical effects**

193. Given that Aon is presently the only SSC operating in New Zealand, we considered whether the acquisition would likely result in an increased ability or incentive for Aon to foreclose its competitors in downstream fire inspection markets. However, on the basis of the available evidence, we do not consider that the acquisition is likely to give rise to vertical effects that would result in a substantial lessening of competition.

194. In particular, we note that the acquisition does not result in further vertical integration. We consider that Aon already has the ability to foreclose competitors through its SSC operations, if it were so inclined, and we do not consider that this ability would materially change with the proposed acquisition.

195. We have also considered whether the increased market share of the merged entity would significantly alter Aon's incentives to foreclose rivals. In our view, this is unlikely, due to the credible threat of entry by another SSC.

196. Aon entered as an SSC to compete against the previous incumbent, FPIS. At the time, FPIS owned Verifire Limited, the only SSC. We understand that a number of customers were dissatisfied with the service of Verifire.<sup>153</sup>

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<sup>152</sup> [ ]

<sup>153</sup> Email from Aon to the Commerce Commission (19 December 2016).



197. Aon attracted the services of Mr Chris Mak, an experienced fire protection engineer employed by Wormald. Mr Mak set up Aon's SSC business [ ].<sup>154</sup> Over the next two years, Aon expanded its SSC services at the expense of Verifire. Ultimately, Verifire withdrew from the certification market which we understand was around 2009/2010.
198. As noted previously, to operate as a SSC, an organisation must employ a chartered professional engineer (CPEng), preferably with professional fire practice qualifications. Aon identified [ ] companies<sup>155</sup> that employ appropriately qualified fire engineers, and considers that there are many other engineers working in the wider fire industry that are likely to have the appropriate fire engineering qualifications.
199. Our enquiries have confirmed that there are several fire engineers that are likely to possess the necessary experience and qualifications to carry out the role of SSC, if they were so inclined. These include fire engineers [ ].<sup>156</sup>
200. We consider that there is currently sufficient work for at least two individuals. Aon's entry as an SSC supports this view, as Aon competed with FPIS in the SSC market for several years, and Aon has submitted it currently employs [ ] full time equivalent employees in its SSC role.<sup>157</sup>

*Conclusion on vertical effects*

201. We consider that the proposed acquisition is unlikely to strengthen Aon's existing vertical integration, in a manner sufficient to result, by itself, in a substantial lessening of competition in any market.

**Conglomerate effects**

202. We also considered whether the proposed acquisition could increase the likelihood of the combined entity tying or bundling together its certification and inspection services, and whether this bundling would have a foreclosure effect on the merged entity's competitors.
203. While Aon has attempted to offer bundles of sprinkler certification services and sprinkler inspection services, the available evidence indicates that these attempts have not generally succeeded.
204. In part, we consider that this is due to certification and inspection services generally being purchased by separate sub-contractors, with each customer valuing its own choices and relationships. As this is not likely to change under the proposed

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<sup>154</sup> Meeting with Aon (7 December 2016).

<sup>155</sup> [ ].

<sup>156</sup> [ ]

<sup>157</sup> Meeting with Aon (7 December 2016).

acquisition, we do not consider that a substantial lessening of competition is likely to arise through conglomerate effects.

## **Determination**

205. We are not satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market in New Zealand.
206. Under s 66(3)(b) of the Act, the Commerce Commission determines to decline to give clearance to Aon New Zealand, to acquire the book of business, assets and certain liabilities of Fire Protection Inspection Services Limited.

Dated this 2nd day of March 2017

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Dr Mark Berry  
Chairman