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COMMERCE COMMISSION

Decision No. 526

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

IAG NZ LIMITED

and

MIKE HENRY TRAVEL INSURANCE

The Commission: David Caygill
Peter J M Taylor

Summary of Application: The acquisition by IAG NZ of 100% of the shares in Mike Henry Travel Insurance Limited ("MHTI")

Determination: Pursuant to section 66(3) (a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition.

Date of Determination: 24th June 2004

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EXECUTIVE SUMMARY

The Proposal

1. A notice pursuant to s 66(1) of the Commerce Act was received on 24th May 2004. The notice sought clearance for the acquisition by IAG NZ of 100% of the shares in Mike Henry Travel Insurance Limited ("MHTI").

Market Definition

2. The Commission concludes that, for the purposes of the present application, the relevant markets are:
   - the national supply of underwriting services for travel insurance; and
   - the national wholesale distribution of travel insurance.

Counterfactual

3. The Commission considers the appropriate counterfactual to be the status quo with the exception of the joint venture between Vero and Comprehensive Travel Insurance.

Competition Analysis

4. In this proposed acquisition, there would be horizontal aggregation in the national wholesale distribution of travel insurance. Further, the acquisition increases the degree of vertical aggregation, as IAG is active at the retail and wholesale distribution and the underwriting levels of the travel insurance market, whereas MHTI is solely a wholesale distributor of travel insurance.

5. In the national wholesale distribution of travel insurance, post acquisition, there is likely to be sufficient existing competition from Comprehensive, a major wholesale distributor and a number of underwriters that are vertically integrated into wholesale distribution. Further, post acquisition, the combined entity is likely to be constrained from sufficient potential competition.

6. In the national supply of underwriting services for travel insurance, the proposed acquisition is unlikely to lead to a substantial lessening of competition. The proposed acquisition does not change the number of competitors operating at this level. The combined entity would be constrained by existing competition, from Tower, Vero and QBE and from potential entrants.

7. Despite the vertical aggregation resulting from the acquisition, it is considered that, post acquisition, the combined entity would not have market power in either functional level. Therefore, overall the proposed acquisition is unlikely to give the combined entity the ability to leverage any market power from the supply of underwriting services for travel insurance, into the wholesale distribution of travel insurance.

Overall Conclusion

8. On balance, the Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition, in the following markets:

- the national supply of underwriting services for travel insurance; and
- the national wholesale distribution of travel insurance.

9. Accordingly, pursuant to section 66(3) (a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by IAG NZ of 100% of the shares in MHTI.

THE PROPOSAL

10. A notice pursuant to s 66(1) of the Commerce Act was received on 25th May 2004. The notice sought clearance for the acquisition by IAG NZ of 100% of the shares in Mike Henry Travel Insurance Limited ("MHTI").

PROCEDURE

11. Section 66(3) of the Act requires the Commission either to clear or to decline to clear a notice given under s 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was agreed between the Commission and the Applicant. Accordingly, a decision on the Application was required by 24th June 2004.

12. The Commission's approach to analysing this proposed acquisition is based on principles set out in the *Commission's Mergers and Acquisitions Guidelines.*

STATUTORY FRAMEWORK

13. Under s 66 of the Commerce Act (the Act), the Commission may grant clearances for acquisitions where it is satisfied that the proposed acquisition would not have, or would not be likely to have, the effect of substantially lessening competition in a market. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.[1]

14. The Commission considers that it is necessary to identify a real lessening of competition that is not minimal.[2] Competition must be lessened in a significant and sustained fashion. For the purposes of its analysis, the Commission is of the view that a lessening of competition and the creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.

15. When the impact of market power is expected to be predominantly upon price, for the lessening, or likely lessening, of competition to be regarded as substantial, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material and able to be sustained for a period of at least two years.

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

ANALYTICAL FRAMEWORK

17. The Commission applies a consistent analytical framework to all its clearance decisions. The first step is to determine the relevant market or markets. As acquisitions considered under s 66 are prospective, the Commission uses a forward-looking type of analysis to assess whether a lessening of competition is likely in the defined market(s). Hence, an important subsequent step is to establish the appropriate hypothetical future with and without scenarios, defined as the situations expected:

    - with the acquisition in question (the factual); and

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[1] Foodstuffs (Wellington) Cooperative – Society Limited v Commerce Commission (1992) 4 TCLR 713, p 721-722.

[2] See Fisher & Paykel Limited v Commerce Commission (1990) 2 NZLR 731, 758, and also Port Nelson Limited v Commerce Commission (1996) 3 NZLR 554.

- in the absence of the acquisition (the counterfactual).

18. The Commission analyses the extent of competition in each relevant market for both the factual and counterfactual scenarios, in terms of:
    - existing competition;
    - potential competition; and
    - various other competition factors, including the countervailing market power of buyers or suppliers.
19. The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in the market between those two scenarios.

THE PARTIES

IAG NZ Limited ("IAG")

20. IAG is a company incorporated in New Zealand under the Companies Act 1993. It is wholly owned by Insurance Australia Group. Prior to a name change on 9th September 2002, IAG NZ was called NRMA Insurance NZ Limited.
21. IAG underwrites and distributes a range of general insurance products, under the State and NZI brands. IAG also underwrites insurance for other retail distributors, such as banks, who sell these products under their own brands.

Mike Henry Travel Insurance ("MHTI")

22. MHTI is wholly owned by Mike Henry New Zealand ("MHNZ"), which was incorporated under the Companies Act 1955 in May 1981.
23. MHNZ operates a number of companies in the distribution of travel, fire, general, motor vehicle warranty and international health insurance. It has a 41.6% shareholding in Travel Wizard Limited, which owns computer software used to sell travel insurance.
24. The shareholders in MHNZ are shown in the table below.

Table 1: MHNZ Shareholders

Shareholder	Percentage of shareholding
Henry Calder (International) Limited	60.7%
Steven Nichols	12.5%
Steven Nichols, Tracy Nichols, Philip Judge	7.5%
Maureen Henry	5.7%
Murray Calder, Raelene Calder, Philip Judge	4.9%
Henry Corporate Trustee Limited	4.7%
Raelene Calder	1.9%
Michael Henry	1%
Murray Calder	1%

25. The shareholders of Henry Calder (International) Limited are listed in the following table:

Table 2: Shareholders of Henry Calder (International) Limited

Shareholder	Percentage of shareholding
Michael Henry	37.1%
Henry Corporate Trustee Limited	32.9%
Maureen Henry	10%
Murray Calder	9.4%
Murray Calder, Raelene Calder, Philip Judge	5.6%
Raelene Calder	5.0%

26. MHTI distributes travel insurance within New Zealand. The vast majority of MHTI's customers are travel agents, who in turn on-sell travel insurance to travellers.

27. MHTI is not an underwriter. It obtains underwriting services from American Home Assurance Company ("AHA"), which is a member of the American International Group ("AIG").

Other Relevant Parties

American International Group ('AIG")

28. AIG is a major international insurance and financial services organisation, with operations in more than 130 countries. AIG member companies, which include American Home Assurance Company, serve commercial, institutional and individual customers through a range of insurance products.

29. In New Zealand, AIG underwrites travel insurance through a variety of distributors. It underwrites travel insurance for MHTI.

Tower Insurance Limited ("Tower")

30. Tower is owned by Tower New Zealand which is owned by the Tower Group. In addition to general insurance, Tower New Zealand is active in offering a range of financial products from savings, investments, trusts and asset management. It distributes travel insurance directly to end-customers as well as through wholesale and retail distributors.

QBE Insurance (International) Limited ("QBE")

31. QBE is part of the QBE Group, which operates in 38 countries around the world. It is a major insurance company in New Zealand offering services in liability, corporate property, marine trade credit and travel. The QBE Commercial Division offers insurance products to small to medium sized businesses through a nationwide branch network.

32. QBE distributes travel insurance, mainly through travel agents and airlines.

Vero Insurance Limited ("Vero")

33. Vero is the new name for the previously named Royal & SunAlliance general insurance businesses in Australia and New Zealand. It formally began trading as Vero Insurance New Zealand Limited on September 1, 2003. Vero is part of the recently re-branded Promina Group and is made up of a number of specialist businesses. These include Vero, Vero Liability, Vero Marine, Mariner Underwriters Ltd and Axiom.

34. Vero offers a range of insurance and risk management solutions for New Zealanders. With regards to travel insurance it distributes its products through a variety of retail

distributors.

Southern Cross Benefits Limited ("Southern Cross")

35. Southern Cross employs approximately 1,500 people. The organisation is made up of two entities - Southern Cross Medical Care Society and Southern Cross Health Trust. Southern Cross Travel Insurance is part of the Southern Cross Health Trust and operates independently of Southern Cross Medical Care Society.

Insurance Council of New Zealand ("ICNZ")

36. The ICNZ was established in 1895. It is an industry organisation that represents fire and general insurers in NZ. The ICNZ has 20[3] members who write approximately 95% of New Zealand's general insurance business. Its members protect approximately half a trillion dollars worth of assets. Last year, its members paid claims of $1.5 billion to New Zealanders.

INDUSTRY BACKGROUND

37. Travel insurance is a specific type of insurance that is available to a person who is planning to travel in the future. Travel insurance comes in many different varieties ranging from trip cancellation or interruption insurance to emergency medical or catastrophe insurance.

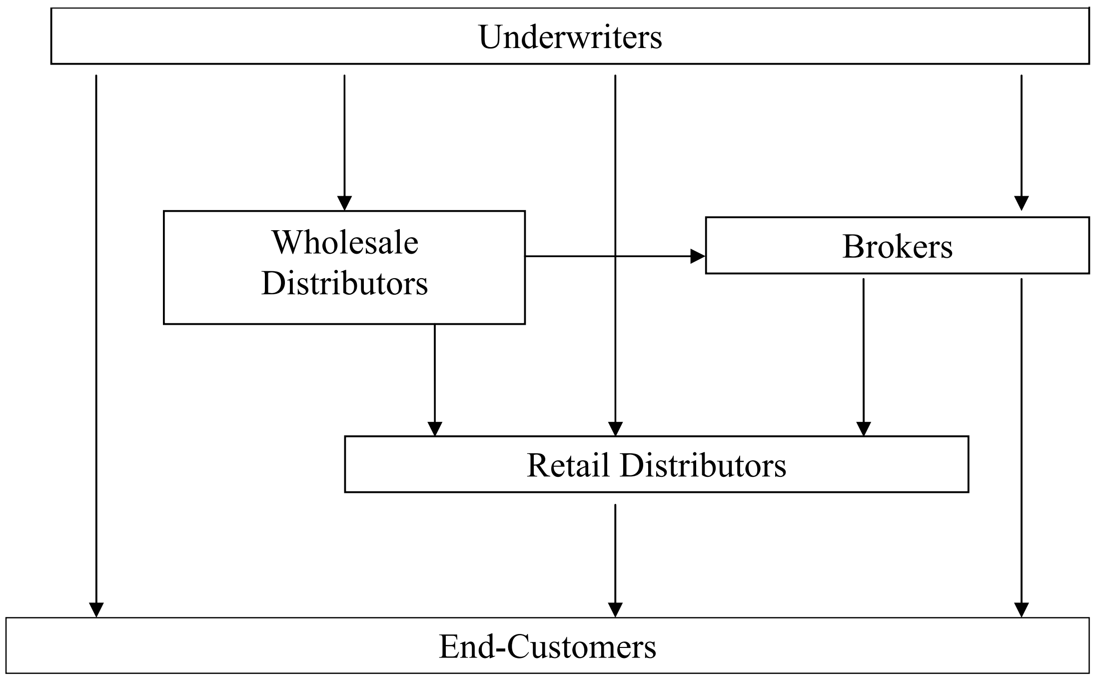
38. The supply of travel insurance involves a number of market participants, which are listed and shown in the diagram below:

- underwriters ;
- brokers;
- wholesale distributors;
- retail distributors; and
- end-customers.

39. The role of each of these participants is considered in further detail below.

[3] Insurance Council Members as at 31 December 2003: Ace Insurance, Allianz New Zealand, American Home Assurance Company, AMI Insurance, China Insurance, Civic Assurance, EIG-Ansvar, Employers Reinsurance, Farmers' Mutual Group, GeneralCologne Re, IAG Insurance, Lloyds, Lumley General Insurance, Medical Insurance Society, Mitsui Sumitomo Insurance, Munich Re, Sunderland Marine, Swiss Re, Tower Insurance, and Vero.

Figure 1: Diagram to Show Supply Chain in the Supply of Travel Insurance



Underwriters

40. The underwriters of travel insurance are financial companies that agree to undertake the risk of insuring travellers. In most cases the underwriter designs, produces and packages the travel insurance policy. There are some examples where the wholesale distributor, such as MHTI, has worked with the underwriter in designing the travel insurance policy.

41. The underwriter sets the terms and conditions of the travel insurance, the type of cover provided and the cost of the premium. Most travel insurance policies broadly cover the traveller for the same occurrences, and have similar exclusions.

42. The underwriter distributes its travel insurance product either directly to the end-customer through its own distribution channels or through a distributor or broker. Underwriters tend to have formal agreements with their distributors. The notice period for these ranges from 3 to 12 months.

43. Generally the underwriter will handle any claims made by the end-customer, although there are some instances where the claims are processed by a third party.

44. All companies underwriting travel insurance need to be registered under the Insurance Companies (Ratings and Inspections) Act 1994. Each company is also required to disclose a credit rating from an approved rating agency to show their ability to pay claims. This rating is lodged with the Registrar of Companies.

45. The Insurance Companies Deposits Act 1953 requires an underwriter to lodge approved securities with a market value of not less than $500,000 with the Public Trustee. This Act further requires annual reports and statements of financial condition to be provided to the Ministry of Economic Development.

46. The major underwriters of travel insurance in New Zealand are:
    - IAG;
    - AIG;
    - Vero;
    - Tower;
    - QBE; and
    - Southern Cross.
47. A smaller underwriter of travel insurance is Ace Insurance Limited ("Ace"). Ace mainly provides corporate travel insurance which covers employees when travelling on business. Its travel insurance product tends to be part of a wider insurance package.

Brokers

48. Brokers provide an intermediary service between the underwriter and the retail distributor or between the underwriter and the end-customer.
49. Brokers tend to offer travel insurance to corporate clients, who could be employers or individuals. These brokers may handle all of a client's insurance requirements and travel insurance would be a component of the product offered. A company may estimate the number of trips its employees would undertake in a year and pay a deposit. At the end of the year the company would declare the actual number of trips taken and pay per day of travel.
50. The broker always acts on behalf of the client and searches for the underwriter or wholesale distributor that would best serve the client's needs. The broker may deal with claims on behalf of the client depending on the size of the claim, or the client can deal directly with the underwriter. The broker obtains a commission for placing business with the underwriter. A broker estimated that it obtained a commission of [ ] of the amount paid by the client.
51. There are two industry organisations for brokers in New Zealand. The Corporation of Insurance Brokers NZ ("CIBNZ") has 83 incorporated member firms and is the "voice of insurance broking" in New Zealand, dealing with the government, the insurance industry and other professional organisations, as well as the media on a wide range of insurance related topics and enquiries. The Independent Insurance Brokers Association ("IIBA") has some 160 members, the majority being independent owner-operated that focus mainly on fire and general insurance.
52. The large broking chains in New Zealand are:
    - Marsh Ltd;
    - Willis Ltd; and
    - AON Risk services Ltd;
53. There are also smaller brokers, which include Crombie Lockwood Group and Brokernet.

Distributors

54. In the supply of travel insurance, there are wholesale and retail distributors. Wholesale distributors supply travel insurance to retailers, in particular, travel agents. Retail distributors supply travel insurance directly to the end-customer.

Wholesale

55. In NZ, there are two main wholesale distributors that are solely active in the distribution of travel insurance to retailers. They are MHTI and Comprehensive Travel Insurance ("Comprehensive"). Both of these companies act as an intermediary between the underwriter and the retail distributor and carry out the following functions:

 - providing a travel insurance product;
 - providing claims handling services;
 - providing training to travel agents;
 - providing electronic systems for selling travel insurance; and
 - marketing the travel insurance product to end-customers.

56. At present both MHTI and Comprehensive have a formal agreement with their underwriter. MHTI's underwriter is AIG and Comprehensive is with Tower.

57. MHTI mainly supplies travel insurance to the following travel groups:

 - Harvey World Centre;
 - Flight Centre;
 - Holiday Shoppe; and
 - House of Travel.

58. Comprehensive supplies travel insurance to around [ ] travel agents, which include the branches of United Travel and First Group. It also supplies travel insurance to around [ ] insurance brokers.

59. The other wholesale distributors of travel insurance are the underwriters, such as IAG, Tower and Vero. These companies are vertically integrated into wholesale and retail distribution. QBE and AIG are vertically integrated into wholesale distribution only.

Retail

60. A retail distributor on-sells travel insurance to the end-customer. It is supplied either by

 - a broker;
 - wholesale distributor; or
 - directly from the underwriter.

61. Where the retail distributor sources a travel insurance product direct from the underwriter, the distributor acts as an agent for the underwriter and sells the travel insurance under its own brand name.

62. The retail distributor is responsible for issuing and cancelling contracts of travel insurance to end-customers within the limits set by the underwriter. Industry participants estimated that in 95% of cases, travel insurance is sold to individuals on the spot, as they are within the underwriter's limits. Where an individual falls outside the underwriter's limits (e.g. pre-existing medical condition) or because of the nature of travel undertaken, the retail distributor would obtain a specific risk assessment of that individual from the underwriter. If the underwriter approves it would provide the retail distributor with the appropriate quote.

63. The retail distributor collects the premiums paid by the end-customer and pays the underwriter, wholesale distributor or broker minus a commission. The Commission

found that these commissions [

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64. The retail distributor owns the customer relationship. Therefore, if the relationship between the distributor and the underwriter ceases, the customer remains with the distributor.

65. Travel insurance is distributed to end-customers through a variety of channels and retail distributors compete on price and quality of service. The retail distributors of travel insurance mainly consist of:

- vertically integrated underwriters;
- banks;
- travel agents;
- airlines;
- companies like The Warehouse and Fly Buys; and
- Internet-based retailers.

66. Each of these distribution channels is described in further detail below.

67. Some underwriters may supply travel insurance through their own distribution networks, involving a direct relationship with the policyholder. IAG via its State and NZI brands, Tower and Southern Cross are all active in supplying travel insurance direct to the end-customer. It is estimated that around [ ] of IAG's travel insurance is sold directly to end-customers through its own distribution channels.

68. Banks offer travel insurance as an adjunct to other travel or financial services such as foreign currency or credit cards. For example, some gold credit cards offer complementary travel insurance packages to their customers at no cost beyond the annual card fees, or only if the air-tickets are purchased using the credit card.

69. The bank's underwriter for travel insurance is often the same underwriter it uses for selling other types of insurance. The banks tender their underwriting requirements every two to three years. The main suppliers of travel insurance to the banks are IAG and Tower.

70. The majority of travel insurance is distributed by travel agents. Industry participants estimated that around 50-66% of travel insurance is sold through travel agents as it is a convenient complementary purchase to the sale of travel.

71. Most of the travel agents in NZ obtain travel insurance from wholesale distributors such as MHTI and Comprehensive or QBE. An industry participant estimated that in the supply of travel insurance to travel agents, the three main suppliers were MHTI with [ ] of the market, and QBE and Comprehensive each with [ ] of the market.

72. The main airlines selling travel insurance are Air New Zealand and Qantas. They are supplied by QBE.

73. The Warehouse, through The Warehouse Financial Services Limited, offers travel insurance for travel to Australia and Pacific only and was found by Consumer Online to offer good service when handling claims. Their supplier of travel insurance is IAG.

74. Loyalty New Zealand Limited manages Fly Buys, which is the largest business-to-consumer multi-participant loyalty programme in New Zealand. Fly Buys members can

purchase travel insurance only via the Internet. Fly Buys' supplier of travel insurance is IAG.

75. Internet-based retail distributors focus on supplying travel insurance through the internet, although they may also supply their products through the telephone. Such retailers include Downunder Insurance and Columbus Direct, both of which are underwritten by Lloyds of London.

End-Customers

76. There are a range of factors that are likely to affect the end-customer's demand for travel insurance, including how risk averse the traveller is and the likely dangers/risks associated with travel. The decision as to whether to take out travel insurance or the type of travel insurance required is likely to depend on the purpose of travel, the travelling distance, the length of stay, the possibility of illness or accident and the associated costs of medical care and the value of the possessions carried whilst travelling. Other factors that would affect demand are:

- convenience;
- branding/reputation of supplier;
- the quality of service;
- cost of premium; and
- product offerings.

77. There are two types of end-customers that purchase travel insurance, namely, leisure and business travellers. Each of the above factors will have varying degrees of importance to each customer.

PREVIOUS DECISIONS

CGU/Norwich Union

78. The Commission cleared the merger between CGU and Norwich Union[4] Plc on 9 May 2000. Norwich Union plc and its subsidiary State Insurance Ltd merged with CGU plc and its subsidiary, New Zealand Insurance Limited ("NZI"). The new merged entity became CGNU and was then renamed Aviva.

79. In the CGU/Norwich Union Plc merger the Commission found that it was not necessary to conclusively define the relevant product markets because, even on the narrowest definition of the market, there were no competition issues. Therefore, taking a narrow definition, the relevant markets considered were for the national supply of:

- domestic house and contents insurance;
- domestic motor vehicle insurance;
- commercial property insurance;
- commercial motor vehicle insurance; and
- commercial liability insurance.

[4] Commission Decision No.391

IAG/Aviva

80. In January 2003 Aviva sold its remaining business (having sold State Insurance Ltd to IAG in 2001), NZI, to IAG. The Commission investigated[5] this acquisition and found that the merger would not result in a substantial lessening of competition. The relevant markets considered were the same as those considered in the CGU/Norwich Union merger.

ANZ/National

81. The Commission cleared the acquisition of ANZ Banking Group (New Zealand) Limited ("ANZ") of the National Bank of New Zealand Limited ("National")[6] in September 2003.

82. Both companies were retail distributors of general insurance. The relevant markets considered were consistent with those identified in previous insurance mergers, namely those outlined above. In each of the relevant markets the aggregation was minor as insurance companies were the major providers of insurance.

MARKET DEFINITION

83. The Act defines a market as:

> ". . . a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them[7]".

84. For competition purposes, a market is defined to include all those suppliers, and all those buyers, between whom there is close competition, and to exclude all other suppliers and buyers. The focus is upon those goods or services that are close substitutes in the eyes of buyers, and upon those suppliers who produce, or could easily switch to produce, those goods or services. Within that broad approach, the Commission defines relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration, bearing in mind the need for a commonsense, pragmatic approach to market definition.[8]

85. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised is defined in terms of the five dimensions of a market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

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[5] The Commerce Act ("the Act") provides for a voluntary notification regime for proposed acquisitions, under which parties contemplating an acquisition may submit an application for clearance or authorisation if they are in doubt as to whether their proposed acquisition might contravene s 47. If parties choose to proceed with an acquisition without seeking prior clearance or authorisation, the Commission may initiate an investigation under s 47 of the Act. The analytical and investigation process is the same as it is for clearances. The difference is in the format and publication of the report.

[6] Commission Decision No. 507

[7] s3 (1) of the Commerce Act 1986

[8] Australian Trade Practices Tribunal, *Re Queensland Co-operative Milling Association*, above note 10; *Telecom Coporation of NZ Ltd v Commerce Commission & Ors* (1991) 3 NZBLC 102,340 (reversed on other grounds).

Product Market

86. Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. For each initial market so defined, the Commission considers whether the imposition of a SSNIP would be likely to be profitable for the hypothetical monopolist. If it were, then all of the relevant substitutes must be incorporated in the market.

87. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market. The degree of demand-side substitutability is influenced by the extent of product differentiation.

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

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

90. The Applicant considered the relevant product market to be travel insurance.

Demand-Side Substitutability

91. There is no demand-side substitutability between travel insurance and other types of insurance. Insurance products are differentiated in that they generally provide protection against different risk/losses, and/or where the insurance products overlap in terms of the cover provided, they are not sufficiently comprehensive to provide an effective substitute. For example, contents insurance might cover luggage taken overseas, which could be a substitute for part of the travel insurance but it wouldn't provide cover for all of a traveller's requirements such as medical care.

Supply-Side Substitutability

92. On the supply-side, there is likely to be some substitutability between travel insurance and other types of insurance as many insurance products are underwritten and distributed in similar ways. The only significant cost associated with an existing insurer expanding into new insurance products is the cost of familiarisation with pricing, risk and claims handling, the necessary knowledge of the product being insured (which can be readily acquired by existing insurers or through outsourcing) and accessing an appropriate distribution network.

93. With regards to the distribution network, most travel insurance for business customers is distributed through brokers, while travel insurance for leisure customers is often distributed via travel agents. Therefore an underwriter distributing travel insurance for leisure customers may need to develop or draw on existing contacts with brokers if it wishes to distribute travel insurance to the commercial sector.

94. The Applicant states that all forms of travel insurance sold can be considered to be in the same product market. Although different cover is provided, there is supply-side substitutability between the different types of travel insurance packages offered. The Commission agrees with the Applicant as all of the underwriters provide services for a range of travel insurance products.

Conclusion on Product Markets

95. The Commission therefore concludes that the relevant product market is travel insurance.

Functional Markets

96. The production, distribution and sale of a product typically occur through a series of functional levels, conventionally arranged vertically in descending order. Generally, the Commission identifies separate relevant markets at each functional level affected by an acquisition, and assesses the impact of the acquisition on each.

97. Figure 1 above illustrates the functional levels involved in the supply of travel insurance.

98. Some underwriters are vertically integrated and are wholesale and retail distributors of travel insurance. However the fact that there are parties that operate solely at each level of the market suggests that there is functional separation between underwriting, brokering, wholesale and retail distribution of travel insurance. Further, as highlighted in the industry background in paragraphs 40-75, the underwriter, broker, wholesale distributor and retail distributor have different functions. In particular, the underwriter bears all the risk when supplying travel insurance.

99. The Commission concludes that there are four functional levels in the travel insurance market:

- underwriting;
- brokering;
- wholesale distribution; and
- retail distribution.

100. In this proposed acquisition, the brokering of travel insurance and the retail distribution of travel insurance are not affected and are, therefore not considered further.

Geographic Markets

101. The Commission defines the geographic dimension of a market to include all of the relevant, spatially dispersed sources of supply to which buyers would turn should the prices of local sources of supply be raised.

102. The Applicant submitted that the relevant geographical dimension, at the underwriting and distribution level, is the whole of New Zealand.

103. In the CGU/Norwich Union Plc merger, the Commission stated that the geographic dimension for general insurance products is national.

> *"There is considerable uniformity in products available throughout the country, many of the insurers have a physical presence in the major provincial and metropolitan centres and all appear to be accessible nationally by telephone, fax and/or the Internet"*[9].

104. There is no reason to believe that this geographic market has changed. All of the underwriters in New Zealand provide services on a national basis. Similarly, at the distribution level, distributors sell travel insurance through a nation-wide distribution

[9] Commission Decision 391 para43

network or through the internet. For instance, IAG sells direct to end-customers through telephone call-centres, the internet and retail sale sites.

105. The Commission is of the view that the relevant geographic market is national in the supply of underwriting services for travel insurance and in the wholesale distribution of travel insurance.

Conclusion on Market Definition

106. The Commission concludes that for the purposes of this application, the relevant markets are:

- the national supply of underwriting services for travel insurance; and
- the national wholesale distribution of travel insurance.

COUNTERFACTUAL AND FACTUAL

107. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a "with" and "without" comparison rather than a "before" and "after" comparison. The comparison is between two hypothetical future situations, one with the acquisition (the factual) and one without (the counterfactual).[10] The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

Factual

108. In the factual scenario the combined entity would operate in both markets defined as relevant by the Commission. In the underwriting of travel insurance, several other players including Tower, Vero and QBE would continue to operate. A change is expected in relation to Vero as from 1st August it will form a joint venture with Comprehensive. This will increase Vero's supply of travel insurance and will be considered as part of the factual scenario.

109. The Applicant states that post acquisition [

]

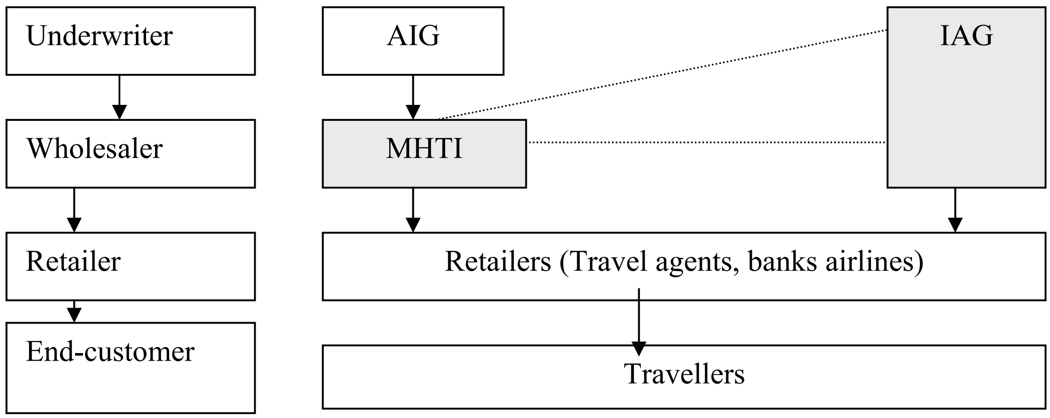
110. [

]

111. The proposed acquisition would result in horizontal aggregation at the wholesale distribution level of the market, where IAG and MHTI both operate. Further, the proposed acquisition would increase the degree to which the overall travel insurance market is vertically integrated. (IAG is already integrated into the retail and wholesale distribution of the market and MHTI is involved in the wholesale distribution level of the travel insurance market.)

[10] Commerce Commission, *Decision 410: Ruapehu Alpine Lifts Ltd/Turoa Ski Resorts Ltd (in receivership), 14 November 2000*, paragraph 240, p 44.

Figure 2: Diagram To Show Areas of Aggregation



Notes: Shaded area refers to companies involved in the proposed acquisition.

112. [

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113. The Applicant considers that the proposed acquisition would allow it to distribute its travel insurance through an additional channel, namely travel agents, which it currently doesn't distribute through.

114. The Applicant also stated that the acquisition would lead to increased specialisation in the travel insurance industry, resulting in a higher quality of underwriting. It also said that IAG is currently under-represented in the supply of travel insurance [

]. Post acquisition, in the wholesale distribution of travel insurance, the combined entity may achieve greater economies of scale which could result in lower travel insurance premiums.

115. The [ ] considered that the proposed acquisition could benefit the industry. It considered that the merger between IAG/Aviva had resulted in rationalisation but it had lead to stability, competition and a more efficient insurance market. It considered that the proposed acquisition would not affect the dynamics of the insurance market.

Counterfactual

116. [

], the Commission is of the view that the appropriate counterfactual is the status quo with the exception of the Vero joint venture with Comprehensive.

COMPETITION ANALYSIS

Wholesale Distribution of Travel Insurance

Existing Competition

117. Existing competition occurs between those businesses in the market that already supply the product, and those that could readily do so by adjusting their product-mix (near competitors). Supply-side substitution by near competitors arises either from redeployment of existing capacity, or from expansion involving minimal investment, in both cases involving a delay of no more than one year.

118. An examination of concentration in a market can provide a useful indication of the competitive constraints that market participants may place upon each other, providing there is not significant product differentiation. Moreover, the increase in seller concentration caused by a reduction in the number of competitors in a market by an acquisition is an indicator of the extent to which competition in the market may be lessened.

119. The Commission identifies market shares for all significant participants in the relevant market. Market shares can be measured in terms of revenues, volumes of goods sold, production capacities or inputs (such as labour or capital) used.

120. An aggregation that would result in a low concentration level is unlikely to be associated with a substantial lessening of competition in a market. On this basis, indicative safe harbours may be specified.

121. A business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exists:

    - where the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is below 70%, the combined entity (including any interconnected or associated persons) has less than in the order of a 40% share; or
    - where the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is above 70%, the market share of the combined entity is less than in the order of 20%.

122. The Commission recognises that concentration is only one of a number of factors to be considered in the assessment of competition in a market. In order to understand the impact of the acquisition on competition, and having identified the level of concentration in a market, the Commission considers the behaviour of the businesses in the market. Specifically, the Commission seeks to understand the dynamics of the competition that would exist between the remaining firms in the market, compared to what would exist in the absence of the merger.

123. In this proposed acquisition there is a horizontal aggregation in the wholesale distribution of travel insurance. MHTI is solely a wholesale distributor while IAG is vertically integrated into the underwriting, wholesale and retail distribution of travel insurance.

124. In the wholesale distribution of travel insurance, market shares are measured by revenue, namely the commission received by MHTI and Comprehensive and the net premium (GWP excluding commission) received by the vertically integrated underwriters, from providing wholesale distribution services.

125. In the wholesale distribution of travel insurance, it is estimated that, the combined entity would have a market share of [ ] by revenue. This is shown in Table 4 below. Post acquisition, the three-firm concentration ratio, would be [ ], which is outside the Commission's safe harbours.

Table 4: Market Shares in the Wholesale Distribution of Travel Insurance

Company	**Revenue in $**	**Market Share**
IAG	[ ]	[ ]
MHTI	[ ]	[ ]
Combined	**[ ]**	**[ ]**
Comprehensive	[ ]	[ ]
AIG	[ ]	[ ]
Post acquisition three firm concentration ratio		**[ ]**
Southern Cross	[ ]	[ ]
QBE	[ ]	[ ]
Tower	[ ]	[ ]
Vero	[ ]	[ ]
Total	**[ ]**	**100%**

Source: Commerce Commission estimates

Notes: The calculation of revenue figures is outlined in the Annex

126. Post acquisition, the Commission found that the retailers of travel insurance would continue to have ample choice of travel insurance providers. Retailers or brokers could switch to Comprehensive or they could deal directly with vertically integrated underwriters.

127. For instance, [

].

128. One example of a retailer actually switching is [ ], which switched from [ ] to [

].

129. [ ] said that it would look for an underwriter/supplier that had experience in travel insurance, could help expand its business, could offer a good quality of service, provide

training to its travel agents, settle claims promptly and fairly and have a good network and infrastructure in place.

130. Another example of a retailer switching occurred last year, where an independent travel agent called [ ] switched from [ ] to [ ].

131. [ ]

132. [ ]

133. Further, the Commission found that some of the underwriters would consider expanding and providing services to retailers. For example, [ ]

134. In conclusion, in the national distribution of travel insurance, the Commission considers that, post acquisition, existing competition is likely to constrain the combined entity due to the presence of Comprehensive and other vertically integrated underwriters, namely QBE, Tower and AIG.

Potential Competition in Wholesale Distribution of Travel Insurance

135. An acquisition is unlikely to result in a substantial lessening of competition in a market if the businesses in that market continue to be subject to real constraints from the threat of market entry.

136. The Commission's focus is on whether businesses would be able to enter the market and thereafter expand should they be given an inducement to do so, and the extent of any barriers they might encounter should they try. Where barriers to entry in a market are clearly low, it may be unnecessary for the Commission to identify specific businesses that might enter. In other markets, where barriers are higher, the Commission may seek to identify possible new entrants as a way of testing the assessed entry barriers.

<u>Barriers to Entry</u>

137. The likely effectiveness of the threat of new entry in preventing a substantial lessening of competition in a market following an acquisition is determined by the nature and effect of the aggregate barriers to entry into that market. The Commission is of the view that a barrier to entry is best defined as anything that amounts to a cost or disadvantage that a business has to face to enter a market that an established incumbent does not face.

138. In the wholesale distribution of travel insurance, the main barriers to entry can be considered to be the following:

- the ability to assist with claims handling;
- establishing appropriate infrastructure;
- access to a distribution network;
- reputation as a credible supplier of travel insurance;

- the need to obtain underwriting services; and
- the need to obtain resources to market and promote the product.

139. With the exception of the latter two barriers listed above, the main barriers to entry in the wholesale distribution of travel insurance can also be considered to be barriers to entry in the supply of underwriting services for travel insurance.

140. In the CGU/Norwich Union Plc merger, the Commission noted the low barriers to entry in the supply of insurance and found that entry via an alliance was more likely than de novo entry. It was found that a potential entrant would choose to enter by forming an alliance with an existing operator to take advantage of an established distribution network or would enter the market targeting specific customers. There is no reason to believe that this finding has changed and it is considered to be applicable to travel insurance.

141. However, specific to the travel insurance market, [ ]

142. [ ]

143. [ ].

144. [ ]

145. [ ].

146. Post acquisition there is likely to be little change from the status quo. At present, only MHTI customers and AIG have access to the Wizard software. [ ] Further, the combined entity would not own Wizard as it is owned by Travel Wizard Limited, in which MHNZ has a 41.6% shareholding. [ ]

147. Therefore, the Commission is of the view that in the wholesale distribution of travel insurance, establishing an appropriate infrastructure is not a major barrier to entry as retailers could use software used by other participants in the travel or insurance industry or could expand in-house systems.

148. The last two barriers identified in paragraph 138 are also considered to be low. A new entrant in the wholesale distribution of travel insurance would need to obtain underwriting services. This could be outsourced, which is currently the case with MHTI and Comprehensive.

149. A new entrant would also need to invest in resources to advertise the travel insurance product and there are a wide range of advertising options available. For example, [ ] said its marketing has been successful, enabling it to increase its business. It advertises on billboards and places inserts in mail sent to existing customers. Next year [ ] plans to spend [ ] on advertising.

150. The Commission considers that overall barriers to entry in the national wholesale distribution of travel insurance are low.

<u>The "LET" Test</u>

151. In order for market entry to be a sufficient constraint, entry of new participants in response to a price increase or other manifestation of market power must be Likely, sufficient in Extent and Timely (the LET test).

152. The mere possibility of entry is, in the Commission's view, an insufficient constraint on the exercise of market power, and would not alleviate concerns about a substantial lessening of competition. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational business would be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on its investment, including allowance for any risks involved.

153. If it is to constrain market participants, the threat of entry must be at a level and spread of sales that is likely to cause market participants to react in a significant manner.

154. If it is to alleviate concerns about a substantial lessening of competition, entry must be feasible within a reasonably short timeframe, considered to be two years, from the point at which market power is first exercised.

155. In the wholesale distribution of travel insurance, entry is considered likely from:

- existing underwriters currently not active or who have limited activities in travel insurance;
- overseas underwriters not currently operating in NZ; and
- a large travel agent chain integrating backwards (i.e. up the supply chain).

156. [ ].

157. [ ].

158. However, in the IAG NZ/Aviva merger, the Commission found that there was likely to be entry from overseas companies if entry conditions were profitable. There is no reason to believe that this has changed. For example, overseas underwriters are currently active in NZ, namely Lloyds of London which underwrites for Downunder Travel and Columbus Direct, and Allianz Australia which currently underwrites for World Nomads.

An overseas underwriter could form an alliance with an established wholesale distributor with local knowledge.

159. As stated in paragraph 143, the fact that [ ] would and could consider expanding into wholesale distribution, suggests that entry could be likely from large travel agent chains.

160. Further, with regard to the extent of entry, the costs involved in expanding into the wholesale distribution of travel insurance will be less for an existing participant in the travel industry or an existing participant in other lines of general insurance. The incumbents would have some experience in wholesale distribution such as claims handling, although they would need to gain specific knowledge of travel insurance.

161. Post acquisition, [ ]

162. The Commission notes that [ ]

163. The Applicant considered that a new distributor could enter into the distribution of travel insurance within 2-3 months. However, the Applicant makes no distinction between entry at the wholesale level and entry at the retail level. Whilst the time frame is likely to depend on the type of entrant identified in paragraph 155, the Commission considers that entry is likely within the two year time frame.

164. The Commission considers that in the wholesale distribution of travel insurance, entry is likely, timely and sufficient in extent to constrain the combined entity.

<u>Conclusion on Potential Competition</u>

165. In conclusion, the Commission is of the view that post acquisition, in the national wholesale distribution of travel insurance, the combined entity would be constrained by potential competition as barriers to entry are low and entry is likely, timely and sufficient in extent.

Overall Conclusion in Wholesale Distribution of Travel Insurance

166. Similarly, the Commission considers that, in the national wholesale distribution of travel insurance, the proposed acquisition is unlikely to lead to a substantial lessening of competition, as post acquisition the combined entity would be constrained by sufficient existing and potential competition.

Underwriting of Travel Insurance

167. In this proposed acquisition, there would be vertical aggregation, as IAG is active at the wholesale distribution level, as well as at the underwriting level. MHTI is only a wholesale distributor and does not underwrite travel insurance. Both companies compete for sales to retailers. If IAG either currently has, or would gain through the proposed acquisition, market power in either functional level, it may be able to leverage this power into other markets.

168. Vertical acquisitions are those that involve businesses operating at different functional market levels in the production of a particular good or service. Where a vertical acquisition also has horizontal implications, the Commission considers each aspect of the acquisition in its own right.

169. The Commission is of the view that, in general, the vertical aspects of acquisitions leading to vertical integration are unlikely to result in a substantial lessening of competition in a market unless market power exists at one of the affected functional levels. Where such a situation is found to exist, the Commission considers whether the acquisition would strengthen that horizontal position, or have vertical effects in upstream or downstream markets, and whether that change would substantially lessen competition.

170. In order to assess the vertical aggregation, the Commission has considered whether the combined entity has market power in the following markets:

- the national supply of underwriting services for travel insurance; and
- the national wholesale distribution of travel insurance.

171. In the national wholesale distribution of travel insurance, as stated in paragraph 166, post acquisition, the combined entity would be constrained by sufficient existing and potential competition. Therefore, the combined entity is unlikely to have market power in the national wholesale distribution of travel insurance.

172. The effects of the vertical aggregation in the national supply of underwriting services for travel insurance are considered in further detail below. If there is sufficient competition at this level, the increase in vertical integration of IAG would not lead to a substantial lessening of competition.

173. In the national supply of underwriting services for travel insurance, market shares have been measured by Gross Written Premium (“GWP”) which is the actual premium charged to clients, less all premium refunds. The Commission also measured market shares by revenue but found that there was no significant difference between the markets shares measured by GWP.

174. The Applicant stated that the market share data collected by the ICNZ data gives an incomplete picture of the market, in that it is not always clear how the figures are calculated. In particular, it is not clear whether the GWP quoted is inclusive or net of any commission or margin added to the premium by the travel insurance distributor. Consequently the Commission has sought data from the individual companies to compile its own market share estimates.

175. The Applicant also considers that the ICNZ figures significantly overstate the participants' involvement in the market, as a significant portion of travel insurance underwriting activity is not reported to ICNZ, particularly those of overseas based underwriters. Consequently, the Commission considers that the market shares for the underwriters represent a “maximum estimate”.

176. In the national supply of underwriting services for travel insurance, [ ] IAG would have a market share of [ ] by GWP. This is shown in table 5 below.

Table 5: Market Shares in the National Supply of Underwriting Services for Travel Insurance in 2003

Company	Gross Written Premium in $	Pre-Acquisition Market Share	Post – Acquisition Market Share
IAG NZ	[ ]	[ ]	[ ]
AIG	[ ]	[ ]	[ ]
Tower	[ ]	[ ]	[ ]
Post Acquisition – 3 firm concentration ratio		**[ ]**	**[ ]**
QBE	[ ]	[ ]	[ ]
Southern Cross	[ ]	[ ]	[ ]
Vero	[ ]	[ ]	[ ]
Total	**[ ]**	**100%**	**100%**

Source: Commerce Commission estimates

177. Around [ ] of AIG's GWP is attributable to underwriting of MHTI business. [ ]. Post acquisition, the three firm concentration ratio would remain the same and would be [ ]. Post acquisition, there would continue to be the same number of underwriters [ ].

178. As stated above in paragraph 126, post acquisition, the Commission found that both IAG's and MHTI's retail distributors of travel insurance would continue to have ample choice of existing underwriters. The retail distributors of the combined entity could switch to any of the other underwriters in NZ if the quality of service provided or the commission paid to the retail distributor or broker was reduced.

179. Post acquisition, [ ].

180. Further there is a recent example of a wholesale distributor switching underwriter. Comprehensive has entered into a 50/50 joint venture with Vero, which comes into effect from 1st August 2004. Tower, which currently supplies Comprehensive, [ ].

181. In conclusion, in the national supply of underwriting services for travel insurance, the Commission considers that, post acquisition, the wholesale and retail distributors of travel insurance are likely to have sufficient choice of underwriters, due to the presence of several existing underwriters. Post acquisition, the number of underwriters would not change, [ ].

Conclusion on Vertical Aggregation

182. In conclusion, despite the vertical aggregation resulting from the acquisition, it is considered that, post acquisition, the combined entity would not have market power in either functional level. Therefore, overall the proposed acquisition is unlikely to give the combined entity the ability to leverage any market power from the supply of underwriting services for travel insurance into the wholesale distribution of travel insurance.

OVERALL CONCLUSION

183. The Commission has considered the probable nature and extent of competition that would exist in the following markets:

   - the national supply of underwriting services for travel insurance; and
   - the national wholesale distribution of travel insurance.

184. The Commission considers the appropriate counterfactual to be the status quo with the exception of the joint venture between Vero and Comprehensive Travel Insurance.

185. In this proposed acquisition, there would be horizontal aggregation in the national wholesale distribution of travel insurance. Further, the acquisition increases the degree of vertical aggregation, as IAG is active at the retail and wholesale distribution and the underwriting levels of the travel insurance market, whereas MHTI is solely a wholesale distributor of travel insurance.

186. In the national wholesale distribution of travel insurance, post acquisition, there is likely to be sufficient existing competition from Comprehensive, a major wholesale distributor and a number of underwriters that are vertically integrated into wholesale distribution. Further, post acquisition, the combined entity is likely to be constrained from sufficient potential competition.

187. In the national supply of underwriting services for travel insurance, the proposed acquisition is unlikely to lead to a substantial lessening of competition. The proposed acquisition does not change the number of competitors operating at this level. The combined entity would be constrained by existing competition, from Tower, Vero and QBE and from potential entrants.

188. Despite the vertical aggregation resulting from the acquisition, it is considered that, post acquisition, the combined entity would not have market power in either functional level. Therefore, overall the proposed acquisition is unlikely to give the combined entity the ability to leverage any market power from the supply of underwriting services for travel insurance, into the wholesale distribution of travel insurance.

189. On balance, the Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition, in the following markets:

   - the national supply of underwriting services for travel insurance; and
   - the national wholesale distribution of travel insurance.

DETERMINATION ON NOTICE OF CLEARANCE

190. Accordingly, pursuant to section 66(3) (a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by IAG NZ of 100% of the shares in Mike Henry Travel Insurance Limited.

Dated this day of June 2004

David Caygill
Deputy Chair

ANNEX

Table 1: Calculation of Market Shares for Wholesale Distribution of Travel Insurance in 2003

Underwriter	GWP excluding Commission	Wholesale Distributor	Amount of GWP represented by main wholesale distributor	Commission received by main wholesale distributor	Amount of GWP represented by main wholesale distributor excluding commission paid to main distributor	GWP excluding Commission	Revenue from Wholesale Distribution
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	$	$	$	$	$	$	$
AIG	[ ]	MHTI	[ ]	[ ]	[ ]	[ ]	[ ]
Tower	[ ]	Comprehensive	[ ]	[ ]*	[ ]*	[ ]	[ ]
IAG	[ ]	-	-	-	-	[ ]	[ ]
Vero	[ ]	-	-	-	-	[ ]	[ ]
QBE	[ ]	-	-	-	-	[ ]	[ ]
Southern Cross	[ ]	-	-	-	-	[ ]	[ ]

Notes:

- GWP is Gross Written Premium as shown for each underwriter in Table 5 of the report.
- *12 months to date as at 30 May 2004
- Column 3 =Column 3+Column 4

Calculation of Market Shares in Wholesale Distribution of Travel Insurance

1. For the vertically integrated underwriters, the revenue gained from the wholesale distribution of travel insurance is measured by GWP excluding the commission paid to wholesale distributors.
2. The total revenue for the wholesale distribution of travel insurance for AIG and Tower is calculated by subtracting column 5 from column 1. The main wholesale distributor for AIG is MHTI and for Tower it is Comprehensive. For all the other underwriters each company provided figures for their GWP excluding commission.
3. Revenue figures for the underwriter (column 6) include revenue from underwriting and wholesale distribution of travel insurance and in some cases revenue from retail distribution. Therefore, given that the commission received by MHTI and Comprehensive ranges from [ ] of the total GWP it collects, it is assumed that, at the most, [ ] of the revenue received by the underwriter is revenue gained from wholesale distribution activities. Therefore column 7 has been calculated by dividing column 6 by [ ].
4. Those companies that are solely in the wholesale distribution of travel insurance are shown in column 2. Their revenue has been measured as the commission it receives from selling travel insurance to retailers. These figures are shown in column 4.
5. To summarise, the revenue obtained from the wholesale distribution of travel insurance for each of the participants is shown in column 7 and are the Commission's best estimates, which are used in the competition analysis in this proposed acquisition.