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PUBLIC VERSION

COMMERCE COMMISSION

Decision No. 436

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

NEWCO

and

MERINO NEW ZEALAND LIMITED

and

WRIGHTSON LIMITED

The Commission: M J Belgrave
P R Rebstock

Summary of Application: The acquisition by NewCo of the assets related to the national and international marketing of merino fine wool, carried on by Merino New Zealand Limited, and the procurement and broking of merino fine wool, carried on by Wrightson Limited.

Determination: Pursuant to section 66(3)(a) of the Commerce Act 1986, and in accordance with a delegation granted under section 105(1), the Commission determines to give clearance for the proposed acquisition.

Date of Determination: 7 June 2001

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INTRODUCTION

1. On 11 May 2001, the Commerce Commission ("the Commission") registered a notice pursuant to section 66(1) of the Commerce Act 1986 ("the Act"), in which clearance was sought for the acquisition by NewCo of:

    - the business assets related to the national and international marketing of merino fine wool fibre, carried on by Merino New Zealand Limited ("Merino NZ"); and
    - the business assets related to the procurement and brokering of merino wool fibre, carried on by Wrightson Limited ("Wrightson").

2. In the notice, the applicant states that NewCo will be a joint venture company to be formed by Merino NZ, or a new entity established to represent the interests of growers, and Wrightson. As a preliminary step towards formation of NewCo, the parties to the acquisition have entered into a Heads of Agreement. In accordance with that agreement, the assets that are proposed to be contributed to the joint venture consist largely of personnel, intellectual property rights, supply contracts, experience and knowledge, customer lists and databases.

3. Wrightson will retain ownership of its wool stores and other logistical and infrastructure assets. These will be provided to NewCo under a service provider agreement yet to be finalised. The agreement will be for a two-year period, and it is the intention of the parties that the provision of logistics will be put out to tender at the expiry of the initial agreement.

THE PROCEDURES

4. The notice was registered on 11 May 2001. Section 66(3) of the Act requires the Commission either to clear or to decline to clear a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. The Commission sought, and the applicant agreed, to a time extension until 7 June 2001.

5. In its application, the applicant sought confidentiality for specific aspects of the application. A confidentiality order was made in respect of the specific information for a period of 20 working days from the Commission's determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply to the information.

6. The Commission's determination is based on an investigation conducted by staff. In the course of its investigation, Commission staff discussed the application with the following parties:

    - the New Zealand Wool Board;
    - Federated Farmers of New Zealand (Inc.);
    - provincial merino wool growers' associations;

- individual merino wool growers;
- Pyne Gould Guinness Limited;
- Reid Farmers Limited;
- CRT PrimaryWool;
- Central Wool Auctions Ltd;
- the Federation of New Zealand Wool Merchants (Inc.);
- the New Zealand Council of Wool Exporters (Inc.); and
- various wool exporters.

7. Commission staff have also sought further information and comment from the parties to the application.

THE PARTIES

NewCo

8. NewCo, a company yet to be formed, will provide the vehicle to effect the proposed acquisition. According to the Business Plan, the initial shareholding will be as follows:

• growers via a holding company called Merino Growers Investments Ltd	65%
• Wrightson	35%

9. It is proposed that NewCo will be involved in several stages of the value chain, including sales and distribution, marketing and promotion, and research and development, and innovation.

10. The applicant advises that NewCo's business operations will in future be funded from income from commercial transactions. For the first year only, the New Zealand Wool Board ("NZ Wool Board") will provide about $2m of funding to assist NewCo in the transition from levy funded marketing to commercially funded marketing.

11. In the application, clearance is sought for the acquisition of certain specified assets, but does not extend to the transitional funding arrangement, or any other arrangements that may accompany the implementation of the acquisition. Accordingly, the protection provided by section 69 of the Act will apply only to the acquisition of those assets detailed in the application. It is the applicant's responsibility to ensure any arrangements outside the scope of the acquisition do not raise any issues under Part II of the Act, unless expressly authorised.

Merino New Zealand Limited

12. Merino NZ is a company owned jointly by Merino New Zealand Inc., and the NZ Wool Board. It was formed in 1995 by merino woolgrowers as an

industry development organisation, dedicated solely to the marketing and promotion of New Zealand merino fibre.

13. Merino NZ is contracted to fulfil the statutory obligations of the NZ Wool Board in respect of merino fibre. Its current activities include marketing merino fibre overseas, and facilitating the making of supply contracts between New Zealand suppliers, such as Wrightson, and overseas manufacturers. These activities have been funded by grower levies provided to Merino NZ in terms of a contract with the NZ Wool Board. This contract is due to expire on 1 July 2001.

14. Merino NZ was also responsible for launching the "New Zealand Merino ™" brand, which it established in 1995. The ownership of the brand currently resides with the NZ Wool Board, but it is proposed that the intellectual property rights to the brand will be transferred to Merino New Zealand Inc, which in turn will sub-licence it to NewCo.

Merino New Zealand Inc

15. Merino NZ Inc is an incorporated society formed to represent the interests of all growers of merino wool fibre. It currently provides an "industry good" role. Under the proposed restructuring plan, Merino NZ Inc will continue to be 100%-owned by growers, and will assume responsibility for "industry good" education and training, and research and development and innovation activities, currently undertaken by Merino NZ. It will be funded by a levy from merino growers.

16. Under the restructuring proposal, Merino NZ Inc will sever all ownership and other links with NewCo, and will operate independently of the joint venture company.

The New Zealand Wool Board

17. The NZ Wool Board is a body established under the Wool Board Act 1997. Its statutory objective is to "help in the attainment, in the interest of growers, the best possible net ongoing returns for New Zealand wool" (section 5(1) of the Wool Board Act refers).

18. The NZ Wool Board is responsible, amongst other things, for:

- developing industry strategy;
- managing consultation and accountability;
- providing strategic information to industry players; and
- collecting levies and allocating them to various business unit programmes.

19. The NZ Wool Board co-ordinates work in wool production, research and development, technology transfer and international marketing through its four business units (Wools of New Zealand Ltd, NZ Merino, Wool Production Technology Ltd and WRONZ Inc).

20. The NZ Wool Board is funded by growers, each of whom currently pay a 5% levy based on the gross value of their wool sales. The levy is deducted by wool brokers, licensed wool exporters and other registered wool buyers (in

their capacity as collection agents), and then forwarded to the NZ Wool Board. The NZ Wool Board retains a proportion of the levy it receives on merino wool to cover its core costs and contributions to Wool Production Technology Ltd, and pays the residual amount to Merino NZ to fund industry good marketing and research and development activities. (see paragraphs 44–46 for details of proposed changes to the levy structure).

Wrightson

21. Wrightson is a publicly listed rural servicing company, which provides various agricultural services and products to the primary sector throughout New Zealand. The largest shareholder in the company is Guinness Peat Group Plc, which holds about 21% of the shares through a subsidiary company.

22. Wrightson's activities include involvement in wool, livestock, rural supplies, research, forestry, grain and seed, real estate, agricultural and horticultural consultancy, and insurance.

23. Of relevance to this acquisition are Wrightson's interests in the New Zealand merino wool industry. This involves the provision of various wool broking services. Wrightson prepares wool for auction, including grading and storage, provides auction services, and buys wool from growers direct for on-sale.

Other Parties

Pyne Gould Guinness Ltd

24. PGG, a wholly–owned subsidiary of Pyne Gould Corporation Limited, is involved in the provision of various rural and financial services in the upper South Island. The company's activities span involvement in livestock, wool, grain and seed, rural merchandise, rural finance, banking, insurance and real estate marketing.

25. Of relevance to the acquisition are the activities of PGG's wool division, which engages in the provision of wool broking services for merino and other types of wool, including auction services, and the purchase of merino wool from growers under direct supply contracts. PGG also operates the wool auction facility at Christchurch, which is the principal auction centre for wool (including merino wool) in the South Island.

Reid Farmers Limited

26. Reid Farmers is a publicly-listed company based in Dunedin. Pyne Gould Corporation is the principal shareholder in the company with approximately 44% of the shares. Reid Farmers is engaged in the provision of various rural services in the lower South Island, including wool broking for merino and other wool types, farm merchandise, and grain and seed.

Other Wool Brokers/Buyers

27. In addition to the companies outlined above, the following are active on a smaller scale in procuring and/or buying merino wool:

- CRT Society Limited, a Dunedin-based farmer co-operative, which carries out wool trading operations through its CRT PrimaryWool division;
- Central Wool Auctions Ltd, Invercargill;
- Associated Wool Exporters (NZ) Limited; and
- various individuals and companies who purchase wool direct from growers under private treaty for on-sale.

Wool Exporting Companies

28. There are a number of companies involved in the exporting of New Zealand-grown wool, including the following who export merino wool fibre:

    - J S Brooksbank & Co Australasia Limited;
    - Chargeurs Wool (NZ) Ltd;
    - A Dewavrin Fils (NZ) Ltd;
    - Schneider New Zealand Limited
    - Fuhrmann NZ (1983) Ltd;
    - G Modiano (NZ) Limited;
    - John Marshall & Co Limited;
    - Lempriere (N.Z.) Limited; and
    - PBM Wools Limited.

29. Most wool exporters are wholly-owned subsidiaries of overseas-based companies with downstream wool processing interests. These companies purchase wool on behalf of their customers, mainly through the auction system. Some exporters also purchase merino wool from farmers under direct supply contracts. Wool exporters organise the shipping and other services associated with exporting the product to their overseas clients.

BACKGROUND

Overview

30. Wool grown in New Zealand is graded in terms of the fibre diameter. Merino wool is at the fine end at between 14 and 23 microns. It represents approximately 4% of total New Zealand wool production, and is used mainly in high fashion garments and accessories. At the other end is “strong wool” at between 31and 42 microns. Strong wools make up about 74% of production, and are mostly processed into carpets. The balance of production is in the mid-micron fibre range, which includes wool and lambs wool. This wool is used largely for textile manufacture.

31. There are some 700 merino growers in New Zealand of any significance. Most merino sheep are farmed in the high country regions of Otago, Canterbury and Marlborough. In addition, a relatively small number of merino sheep are farmed in the North Island.

32. Merino sheep are reared almost exclusively for their wool. They are shorn once a year. Once the fleece is removed, it is baled and then transported from the farm to a wool store where it is prepared for sale.

33. Wool is sold either through the auction system, or by direct contracts between farmers and wool buyers. Currently, about 80% of the merino clip is sold at auction, and the balance is sold mainly by direct contract. Some merino wool is also purchased from meat processing companies, but the volumes are relatively small. This category of wool is referred to as "slipe wool", which is the wool removed from the skins after the animals have been slaughtered.

34. The major traders (wool brokers) involved in merino fibre are Wrightson, which accounts for about 70% of the total New Zealand merino clip, PGG and Reid Farmers, which together account for the bulk of the remaining clip.

35. In addition, merino wool is procured and/or purchased by the following parties:

- smaller wool brokers, including CRT PrimaryWool and Central Wool Auctions;
- some wool exporters;
- a large number of private wool buyers, who are involved in the purchase of wool direct from farmers under private treaty; and
- meat processors, which on-sell merino "slipe" wool, primarily to exporters (see para 32).

36. The majority of merino wool grown in New Zealand is purchased by exporters via one of the sales channels. A list of the major merino wool exporters is provided in paragraph 28. Merino wool is exported in bales in a "greasy" state to be combed, spun and woven by overseas companies. The major export markets are Italy, France, Germany, France and the United Kingdom. Currently, European markets account for around 80% of New Zealand's total merino wool production, while another 10% is sold to Asian markets.

37. Domestic downstream manufacturers use only around 10% of the total New Zealand merino wool clip. These include Icebreaker and Glengyle Knitwear (NZ) Ltd, both of which use locally-produced merino wool to produce apparel.

38. Most of the value-added processing occurs offshore. This involves the following steps:

- scouring of the wool, which entails washing the wool to rid it of impurities;
- top making/combing, which involves converting raw wool into a "top"[1];
- spinning, which comprises converting "top" into yarn;
- weaving and knitting, which involves converting yarn into cloth;
- manufacturing, which involves making the fabric into apparel; and
- retailing.

[1] A top is a bundle of a specific quantity of wool. Combers are also known as "top makers".

39. Spinning and weaving of fine wool are highly specialised operations, carried out solely overseas. In New Zealand, NZ Tops Limited, a subsidiary of Chargeurs Wool (NZ) Ltd, undertakes some combing at its Timaru plant.

40. The price of merino wool is determined by the forces of international supply and demand, and reflects such factors as the price of mid-micron wool at the finer end, the price of other natural fibres (eg cashmere, silk and mohair), and the price of synthetic fibres and cotton. Prices are also influenced by manufacturer and customer preferences. Australian merino wool, which accounts for 95% of world production, has a major influence on global pricing from the supply–side. By contrast, New Zealand merino wool production constitutes only about 1.5% by weight of total world supply, and therefore has only a very limited impact on the global market.

41. The McKinsey Report[2] noted that, on the basis of available data, average prices for New Zealand merino wool of 20 microns or less have improved relative to equivalent Australian merino wool since 1997, when Merino NZ commenced operations. However, while acknowledging that this appears to have been due in large part to the efforts of Merino NZ, the report states that it is difficult to prove that price improvements have been a direct result of levy–funded activities. Notwithstanding such pricing improvements, the report stated that " the fine wool price and the relative prices of fine wool continue to be subject to significant volatility, reinforcing the view that the effect of promotion on market prices is overwhelmed by external market factors".[3]

42. On the basis of discussions with interested parties, it appears that Merino NZ's major contribution has been to raising the profile of NZ merino wool, and developing relationships with overseas manufacturers, and other end users, although it is difficult to quantify the overall benefits in terms of returns to growers.

43. A diagram summarising the structure of the merino wool industry is shown below in Figure 1.

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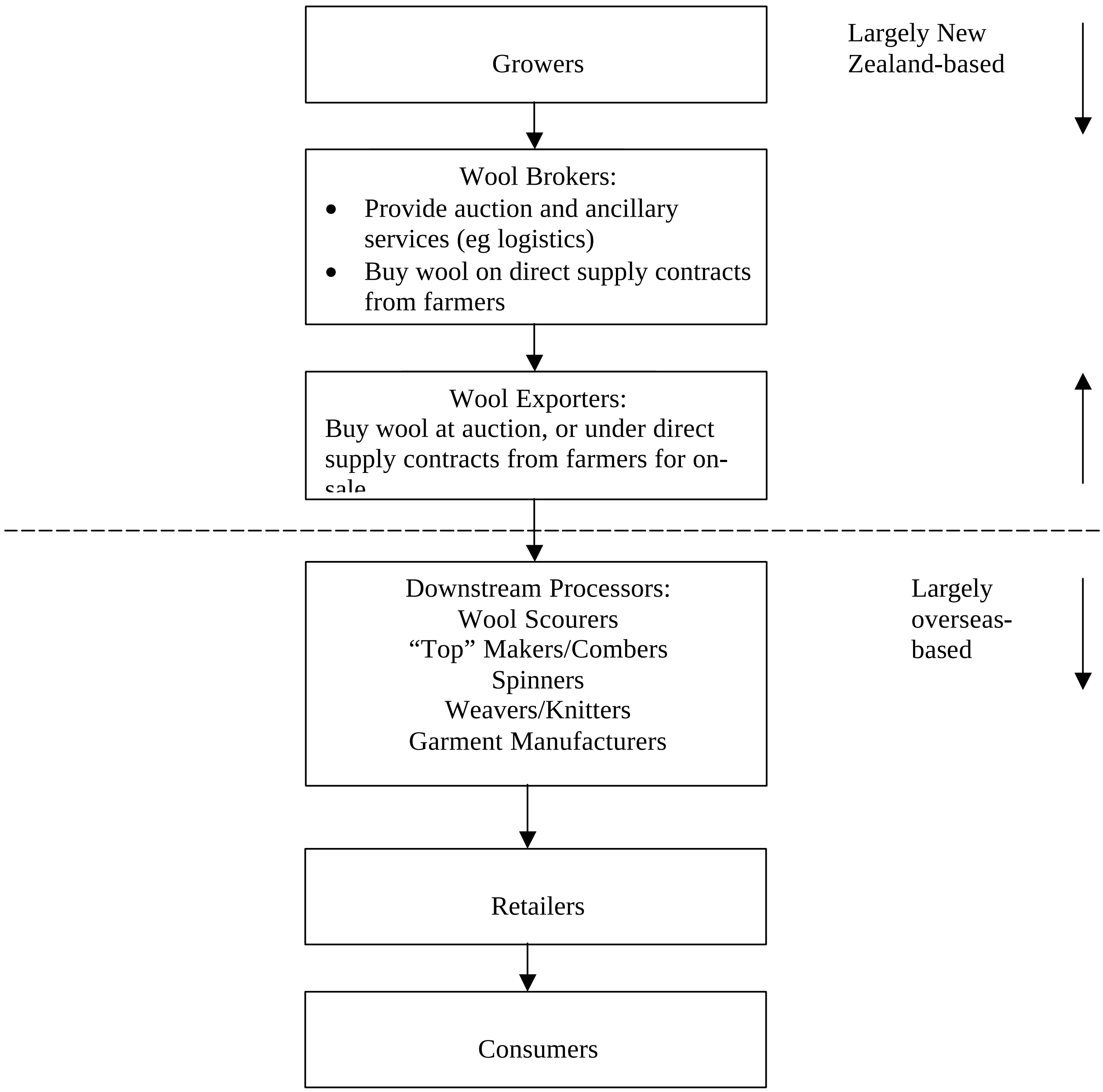
[2] See paragraph 44 for background details on the McKinsey Report.
[3] *Report to New Zealand Woolgrowers on Improving Profitability*, McKinsey & Company, June 2000, p. 71.

Figure 1

Overview of the Merino Wool Industry



Industry Restructuring

44. In 1999, the NZ Wool Board commissioned an independent report on improving the profitability of the New Zealand wool industry. The declining profitability of wool growing, and grower dissatisfaction with the existing strategies and structures prompted this. The report became known as the McKinsey Report and it made recommendations, which included the

dissolving of the Wool Board, reduction of levies, greater use of the Internet and technology, and the commercialisation of current wool marketing companies. Subsequently, the majority of wool growers adopted the recommendations in the McKinsey Report.

45. The McKinsey Report recommended that the compulsory levy be reduced from the current level of 5% on wool sales to 1% on both wool and sheep meat, and that this be utilised to fund research and development. They further recommended that of this 1%, 0.25% go to a new entity "SheepCo", for generic sheep research and development, and that 0.75% go to Merino NZ Inc for merino-specific research and development.[4]

46. The NZ Wool Board has made a decision that, as an interim step, the grower levy would be reduced to 2% from 1 July 2001. Of the 2%, 1.75% will originate from Merino NZ Inc. Merino NZ Inc will enter into a new contractual arrangement with the NZ Wool Board to provide merino-specific industry research and development programmes. This agreement will specifically preclude any of this funding being directed to marketing activities. Rather, Merino NZ Inc will provide funding on a contestable basis to research and development and to education and training providers.

MARKET DEFINITION

Introduction

47. The purpose of defining a market is to provide a framework within which the competition implications of a business acquisition can be analysed. The relevant markets are those in which competition may be affected by the acquisition being considered. Identification of the relevant markets enables the Commission to examine whether the acquisition would result, or would be likely to result, in the acquisition or strengthening of a dominant position in any market in terms of section 47(1) of the Act.

48. Section 3(1A) of the Act provides that:

> ". . . the term 'market' is a reference to a market in New Zealand for goods and services as well as other goods and services that, as a matter of fact and commercial common sense, are substitutable for them."

49. Relevant principles relating to market definition are set out in *Telecom Corporation of New Zealand Ltd v Commerce Commission*,[5] *Commerce Commission v Carter Holt Harvey Building Products Limited*,[6] and in the Commission's *Business Acquisition Guidelines* ("the Guidelines").[7] A brief outline of the principles follow.

50. Markets are defined in relation to three dimensions, namely product type, geographical extent, and functional level. A market encompasses products that are close substitutes in the eyes of buyers, and excludes all other products.

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[4] *ibid*, p. 90ff.
[5] (1991) 4 TCLR 473.
[6] Williams J, 18 April 2000, HC, yet to be reported.
[7] Commerce Commission, *Business Acquisition Guidelines*, 1999, pp. 11-16.

The boundaries of the product and geographical markets are identified by considering the extent to which buyers are able to substitute other products, or across geographical regions, when they are given the incentive to do so by a change in the relative prices of the products concerned. A market is the smallest area of product and geographic space in which all such substitution possibilities are encompassed. It is in this space that a hypothetical, profit maximising, monopoly supplier of the defined product could exert market power, because buyers, facing a rise in price, would have no close substitutes to which to turn.

51. A properly defined market includes products which are regarded by buyers or sellers as being not too different ('product' dimension), and not too far away ('geographical' dimension), and are therefore products over which the hypothetical monopolist would need to exercise control in order for it to be able to exert market power. A market defined in these terms is one within which a hypothetical monopolist would be in a position to impose, at the least, a "small yet significant and non-transitory increase in price" (the *"ssnip"* test), assuming that other terms of sale remain unchanged.

52. Markets are also defined in relation to functional level. Typically, the production, distribution, and sale of products takes place through a series of stages, which may be visualised as being arranged vertically, with markets intervening between suppliers at one vertical stage and buyers at the next. Hence, the functional market level affected by the application has to be determined as part of the market definition. For example, that between manufacturers and wholesalers might be called the "manufacturing market", while that between wholesalers and retailers is usually known as the "wholesaling market".

The Relevant Markets

53. The applicant has argued that the proposed joint venture will involve no horizontal aggregation of market power, as the activities of the two parties to the venture take place at different functional levels. Under the proposal, NewCo will acquire the business assets of Wrightson that specifically relate to the procurement and broking of merino fine wool fibre in New Zealand. This includes the provision of auction services as well as trading merino wool directly. NewCo will also acquire the assets of Merino NZ, which relate to the national and international marketing of New Zealand merino wool, and the facilitation of contracts between overseas manufacturers and domestic growers and brokers.

54. The applicant accepts that the proposal involves vertical integration of different functional activities, although it notes that the majority of Merino NZ's contribution to NewCo will be activities and relationships that are based in overseas markets. The applicant submits that the markets that are relevant to the proposal are:

- the market for wool broking/auction services;
- the market for the direct purchase of wool for on-sale; and
- the market for international marketing, branding, and contract facilitation.

55. These markets are discussed below, in terms of their product, functional and geographic dimensions.

Product Dimension

56. The proposed acquisition relates only to services and assets relating to merino wool. As noted earlier, Merino NZ was established to serve the interests of merino growers in New Zealand, and is involved exclusively in merino fibre. The proposal also relates to those assets of Wrightson that are specific to the merino industry. Generic infrastructure assets, such as those underpinning the proposed logistics contract between Wrightson and NewCo, are to be retained by Wrightson.

57. Wool fibre is graded according to the thickness of the individual fibres. Fibre thickness is measured in microns, with one micron equal to one millionth of a metre. In general, wool fibre is referred to as either fine, medium, or strong, depending on the thickness. Merino wool is at the finer end of the scale, typically 24 microns and less[8].

58. While there may be some demand-side substitution between wool fibre of immediately adjacent thickness, fine, medium, and strong wools are generally produced for quite distinct end-uses. The bulk of merino fibre produced in New Zealand is around the 18-19 micron range, and this is usually exported to garment manufacturers, with Italy and France being the major markets. The fibre tends to be used in the production of higher quality apparel, including suits and knitwear. Larger fibre wool, for example around the 30-micron and 40 micron thicknesses, is used for the manufacture of heavier duty material, such as furniture coverings and carpets.

59. These distinct demand-side characteristics are reflected in price differentials for the various wool grades. Throughout the first four months of 2001, fine wool prices have fluctuated between $16.19 and $16.96 per kg, while the price ranges of medium and strong wool were $5.21-$6.06, and $3.79-$4.22 respectively.

60. The Commission has also considered the likelihood of substitution emanating from the supply-side. Farmers may be able to respond to a change in relative prices by moving between sheep breeds, or moving into other land uses altogether. For example, it appears that some sheep farms have been converted to dairying, as returns have moved in favour of the latter. Between 1984 and 1996, the total stock of sheep in New Zealand fell from around 70 million to about 47 million, a 22% decline. Some of this is likely to have been due to farm conversions.

61. However, the high country terrain, on which most merino stations are located, is especially suited for running merino sheep, and may be less suited for alternative uses. The Commission has been informed that the majority of merino farms could not be converted to other breeds without considerable expense. Merino farming appears to be quite specialised, involving expertise in developing particularly fine and high quality fibre. Over the above period, merino was the only breed to record an increase in stock numbers.

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[8] According to the NZ Wool Board, merino is 24 microns or less, half-bred wool is 25-31 microns, and cross-bred wool is 32 microns and above. There is some arbitrariness in these distinctions.

62. The Commission has also considered whether the market for merino wool should be disaggregated further, for example according to the particular micron or band of microns. On the purchasing side, some manufacturers tend to buy a specific grade of wool (such as 18 micron) in order to produce a particular type of fabric. However, in the face of a sustained change in relative prices, manufacturers may move to adjacent grades of wool and produce a different type of fabric. Other manufacturers purchase wool across a range of fibre thickness, with different fibres being mixed in order to attain a range of characteristics. For example, very fine merino wool tends to be used for its softness; however, it also tends to be relatively weak. Such fibre is mixed with stronger grades of merino, which produces fabric that is both soft and more durable.

63. A number of parties have indicated that buyers as well as growers of merino do respond to changes in prices across micron levels, and this ensures that if the price of a particular micron diverges from other grades, demand and supply will generally respond in such a way as to restore pricing relativities. This type of reaction also tends to occur with respect to other natural fibres such as cashmere, and to a lesser extent (in the case of merino) synthetic fibres. Other important characteristics influencing buyer behaviour include the brightness and length of the fibre.

64. For the purposes of assessing the current application, the Commission has adopted a product market definition for merino fibre.

Functional Dimension

65. Merino wool passes through a number of functional levels in moving from the farmer and the end-user. This chain was set out in Figure 1 above.

66. The applicant has considered auction services separately from direct supply contracts. It could be argued that these two activities be combined in a general broking market, as auctions and direct contracts are alternative mechanisms through which farmers are connected to exporters. However, the Commission has followed the applicant's approach in adopting separate markets in order to assess the proposal.

67. The other activities of relevance to the proposal are those undertaken by Merino NZ, namely the national and international promotion and branding of merino wool produced in New Zealand. This involves the development of relationships with overseas manufacturers, and facilitating contracts between such manufacturers and domestic farmers and brokers. As such, this does not appear to involve a distinct functional level, but instead sits alongside a number of levels, including farmers, brokers, and manufacturers.

68. The bulk of this activity takes place overseas. However, for the purposes of assessing any competition impacts of the proposed vertical merger within a domestic market, the Commission has accepted that the market for the promotion and branding of New Zealand merino wool will be relevant.

Geographic Dimension

69. The bulk of the merino clip in New Zealand is produced in the South Island, in particular in central Otago and Canterbury. The South Island clip is sold either by direct contract, or through auction at the PGG facility at Christchurch. A small amount of merino fibre is grown in the North Island, which tends to be sold through the auction centre in Napier.

70. The Commission has adopted a national geographic market for assessing the impact of the proposal.

Summary of the Relevant Markets

71. The Commission has accepted the applicant's definition of the relevant markets. These are:

- the market for the provision of merino wool auction services in New Zealand ("the auction market");
- the market for the direct purchase of merino wool in New Zealand ("the direct contract" market); and
- the market for the national and international promotion of merino wool and contract facilitation ("the promotion market").

COMPETITION ANALYSIS

Introduction

72. The competition analysis assesses competition in the relevant markets in order to determine whether the proposed acquisition would not result, or would not be likely to result, in an acquisition or strengthening of **dominance**.

73. Competition in a market is a broad concept. It is defined in section 3(1) of the Commerce Act as meaning "workable or effective competition". In referring to this definition the Court of Appeal said:[9]

> "That encompasses a market framework which participants may enter and in which they may engage in rivalrous behaviour with the expectation of deriving advantage from greater efficiency."

74. Section 3(9) of the Commerce Act states:

> "For the purposes of sections 47 and 48 of this Act, a person has … a dominant position in a market if that person as a supplier … of goods and services, is or are in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market and for the purposes of determining whether a person is … in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in a market regard shall be had to-
> (a) The share of the market, the technical knowledge, the access to materials or capital of that person or those persons:
> (b) The extent to which that person is … constrained by the conduct of competitors or potential competitors in that market:
> (c) The extent to which that person is … constrained by the conduct of suppliers or acquirers of goods or services in that market."

[9] *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554, 564-565

The Dominance Test

75. Section 47(1) of the Commerce Act prohibits certain business acquisitions:

> "No person shall acquire assets of a business or shares if, as a result of the acquisition, -
>
> (a) That person or another person would be, or would be likely to be, in a dominant position in a market; or
>
> (b) That person's or another person's dominant position in a market would be, or would be likely to be, strengthened."

76. The test for dominance has been considered by the High Court. McGechan J stated:[10]

> "The test for 'dominance' is not a matter of prevailing economic theory, to be identified outside the statute."
>
> …
>
> "Dominance includes a qualitative assessment of market power. It involves more than 'high' market power; more than mere ability to behave 'largely' independently of competitors; and more than power to effect 'appreciable' changes in terms of trading. It involves a *high degree of market control*."

77. Both McGechan J and the Court of Appeal, which approved this test,[11] stated that a lower standard than "a high degree of market control" was unacceptable.[12] The Commission has acknowledged this test:[13]

> "A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint by competitor or customer reaction."

78. The Commission's *Business Acquisitions Guidelines* state:

> "A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint by competitor {or} customer reaction."
>
> …
>
> "A person in a dominant position will be able to initiate and maintain an appreciable increase in price or reduction in supply, quality or degree of innovation, without suffering an adverse impact on profitability in the short term or long term. The Commission notes that it is not necessary to believe that a person will act in such a manner to establish that it is in a dominant position, it is sufficient for it to have that ability." (p21)

79. The role of the Commission in respect of an application for clearance of a business acquisition is prescribed by the Commerce Act. Where the Commission is satisfied that the proposed acquisition would not result, or would not be likely to result, in an acquisition or strengthening of a dominant position in a market, the Commission must give a clearance. Where the Commission is not satisfied, clearance is declined.

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[10] *Commerce Commission v Port Nelson Ltd* (1995) 5 NZBLC 103,762 103,787 (HC)
[11] *Commerce Commission v Port Nelson Ltd* (1996) 5 NZBLC 104,142 104,161 (CA)
[12] *Commerce Commission v Port Nelson Ltd* (1995) 5 NZBLC 103,762 103,787 (HC) and *Commerce Commission v Port Nelson Ltd* (1996) 5 NZBLC 104,142 104,161 (CA)
[13] *Business Acquisition Guidelines*, Section 7

80. During the investigation, the Commission received expressions of concern from various parties on the proposed acquisition. These included concerns that:

- the business assets of Merino NZ, including the New Zealand Merino brand, have been created using compulsory levy funding contributed by growers, and that access to the New Zealand Merino brand and the benefits of Merino NZ's services, would be denied to growers unless they choose to trade through NewCo;
- NZ Wool Board money, which has been derived from compulsory grower levies, will be provided to NewCo in the transitional phase; and
- the auction system might be abolished as a result of the acquisition.

81. The Commission considers that, in the absence of the clearance application, the concerns outlined in the first bullet point may have raised concerns under Part II of the Act. However, the intellectual property rights associated with the licensing of the New Zealand Merino brand form part of the assets covered by the proposed acquisition. As such, the Commission does not believe this causes concerns under Part II of the Act. The Commission has addressed the concerns raised in the second bullet point in paragraph 11. The third bullet point is discussed below in the section relating to the auction market.

82. The Commission now applies the dominance test in the following competition analysis.

The Auction Market

Market Concentration

83. An examination of concentration in a market provides an indication of whether a merged firm may or may not be constrained by others participating in the market, and thus the extent to which it may be able to exercise market power.

84. Although, in general, the higher the market share held by the merged firm, the greater the probability that dominance will be acquired or strengthened (as proscribed by section 47 of the Act), market share alone is not sufficient to establish a dominant position in a market. Other factors intrinsic to the market structure, such as the extent of rivalry within the market and constraints provided through market entry, also typically need to be considered and assessed.

84. The Commission has estimated market shares on the basis of information provided by the NZ Wool Board. The NZ Wool Board has compiled market shares based on the value of merino wool sales transacted in New Zealand for the 10 months ending 31 March 2001. The shares are based on levy returns submitted by all brokers and other traders of wool.

85. The Commission also considered using volume-based market shares estimates, although this approach was not adopted for a number of reasons. First, the volume information provided by the major brokers and traders has generally

been expressed in bales. However, the weight of a bale of wool may vary considerably. For example, the Commission has been informed that bale weights range from 100 kgs up to 220 kgs, although the average bale weight is approximately 160 kgs. Nevertheless, the range of weights raises a risk that any comparison of volume-based market shares may be of limited value.

86. Second, other than the NZ Wool Board database, there is little information available on the sales of merino wool through the large number of private wool merchants. There are approximately 35 members of the Federation of New Zealand Wool Merchants, although there are many other buyers of merino wool who are not members of the Federation, yet do purchase wool directly from farmers. According to the NZ Wool Board database, there are approximately 124 private buyers of merino wool.[14] The coverage of the NZ Wool Board database is comprehensive in that it includes all sales of merino, including private buyers as well as auction sales.[15]

87. The Commission has, therefore, derived its market share estimates from the NZ Wool Board data, and these estimates are set out in Table 1 below. In the following discussion, some use is also made of the available information on merino volumes where appropriate. The value-based figures are broadly consistent with the volume-based estimates. The market shares for PGG and Reid Farmers have been combined for the purpose of the decision on the basis that those companies are "associated persons" in terms of the Act.[16]

Table 1
Market Shares in the Auction Market for the 10 Months Ending 31/3/01

	Value of Sales ($000)	Share (%)
Wrightson	[ ]	[ ]%
PGG/Reid Farmers	[ ]	[ ]%
CRT PrimaryWool	[ ]	[ ]%
Others	[ ]	[ ]%
TOTAL	[ ]	[ ]%

88. On the basis of the figures provided above, NewCo would acquire the approximate [ ] market share, currently held by Wrightson. PGG/Reid

[14] Of these 124 private buyers, only 44 actually purchased merino wool over the ten months to 31 March 2001.
[15] A small amount of merino wool is also recorded by the NZ Wool Board as being sold by a number of meat processing companies. However, this 'slipe' merino only amounts to 0.6% of the total value of merino sales, and has thus been omitted from the above analysis of market shares.
[16] For the purposes of section 47 and 48 of the Act, a person is associated with another person if that person is able, whether directly or indirectly, to exert a substantial degree of influence over the activities of the other. In the context of section 47, the Commission is of the view that a "substantial degree of influence" means "a great or large influence". Several factors are taken into account by the Commission when assessing whether a company has a substantial degree of influence (see page 9 of the Commission's *Business Acquisition Guidelines*). However, the Commission considers that a company which owns or controls 20% or more of the voting power in another has, prima facie, a substantial influence over that other company. Since Pyne Gould Corporation Limited owns 100% of PGG and about 44% of Reid Farmers, PGG and Reid Farmers are treated as "associated persons" for the purpose of this decision.

Farmers, with around [ ] of the market, would continue to be the other significant market participant. Various smaller players would account for the balance of the market share.

89. Implementation of the acquisition would involve no horizontal aggregation of market share. Rather, the impact of the acquisition would be to combine Wrightson's auction-based activities (less its logistics functions) with Merino NZ's national and international marketing activities. As such, the acquisition would result in some vertical integration.

90. The Commission has assessed the impact of vertical integration on competition in a number of its previous decisions, including *Dunlop/Goodyear* (Decision 204, 1987), *Eachairn/Fluid Control* (Decision 214, 1987), *Carter Holt Harvey/Elders NZFP* (Decision 249B, 1990), and *Goodman Fielder/Defiance Mills* (Decision No. 289, 1997).

91. The Commission has stated that vertical acquisitions are subject to the same tests as horizontal acquisitions, but it "…accepts that, in general, acquisitions leading to vertical integration are less likely to result in the acquisition or strengthening of a dominant position in a market than those which lead to horizontal integration."[17]

92. The Commission also states that "... unless a situation of dominance exists at one of the levels affected by a vertical acquisition, such acquisitions are, in the normal circumstances, unlikely to lead to the acquisition or strengthening of a dominant position in a market. However, "…where a situation of dominance exists at one of the levels affected by the acquisition, the Commission will examine the acquisition to determine whether that dominant position is likely to be strengthened or extended to other markets." [18]

Existing Competition

93. As noted above, around 80% of merino wool is currently sold by auction. The Commission has been told by many parties that the auction system continues to be the most preferred method of sale, and is regarded by growers, and most merino wool purchasers, as still providing the most transparent and effective method of sale.

94. Merino wool is an internationally traded commodity, and New Zealand is essentially a price taker with very limited scope to influence global pricing. Accordingly, it is expected that the prices achieved for merino wool sold at auction in New Zealand would reflect underlying global supply and demand conditions.

95. If the acquisition were to proceed, NewCo would continue to face an effective competitive constraint in the affected market from other wool brokers, especially PGG/Reid Farmers, and to a minor extent, those smaller brokers providing auction services for merino wool. PGG and Reid Farmers have a long and well-established presence in the provision of auction services for merino wool in the South Island, and have developed the necessary infrastructure, including field staff, storage and other logistical services, to

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[17] *Business Acquisitions Guidelines*, page 23.
[18] *ibid*, page 23.

service customer needs. The Commission considers that these brokers could expand readily in response to any change in the market situation.

96. Wool brokers have developed close relationships with growers, based in part on personal contacts with individual brokers and their representatives. However, the Commission considers that if NewCo were to increase its auction fees by say 5% to 10% above the competitive level, or reduce its service levels, there are unlikely to be any obstacles to prevent growers from switching to other brokers. Alternatively, growers may consider increasing the proportion of the wool they currently sell by direct supply contracts (see paras 111 ff).

97. The Commission notes that, in addition to the selling fees associated with providing auction services, NewCo intends to charge a separate market development and promotion fee. This will result in a higher overall fee being charged to growers, reflecting higher downstream marketing costs. NewCo, however, hopes to offset this by achieving a higher return for merino wool sold overseas. The Commission's view is that the higher fee structure may provide scope for competing brokers to attract some customers away from NewCo.

98. Some parties argue that if merino growers wish to market wool via the New Zealand Merino brand, they may feel compelled to sell through NewCo, even if the grower is an existing customer of say PGG or Reid Farmers. The fact that growers have been compelled to contribute levy money to fund Merino NZ is seen as a factor, which may influence a grower's decision to support NewCo. However, a grower will have to weigh up all relevant factors, when deciding with whom to sell. The Commission believes that any underlying loyalty to the New Zealand Merino brand, if indeed it exists, is unlikely to constitute a major impediment to restrict growers from switching to a competing broker following implementation of the acquisition.

99. Many wool exporters contend that they may face restrictions in obtaining equitable access to the merino wool clip, especially the proportion of wool currently being channelled through Wrightson's auction service . However, it is not clear that exporters will be restricted from accessing wool sold by auction through NewCo. In any event, exporters will have the option to increase their purchases from growers under direct supply contracts, or they could integrate forward into wool broking themselves, or they could develop links with wool brokers, including NewCo, who provide auction services for merino wool. The Commission considers that the range of options available to exporters is unlikely to diminish as a result of the acquisition.

Potential Competition

100. In assessing the likely consequences of the vertical acquisitions, one of the key considerations is to assess the ease or difficulty of entry, and then to determine whether such entry barriers are likely to be raised such that the combined entity would acquire or strengthen a dominant position in any market.

101. An assessment of the relevant entry and expansion conditions in relation to the auction market is provided below.

Access to Wool Auction Facility

102. Any existing or prospective market participant requires access to wool auction facilities. As noted above, PGG operates the wool auction centre in Christchurch, from which the majority of South Island merino wool is sold. An access fee is charged by PGG to those parties who wish to use the facility. The acquisition would not affect the ability of brokers to obtain access to PGG's wool auction facility, or any other auction site.

Provision of Auction and Related Services

103. This involves preparation of a catalogue, and carrying out various other services (eg grading, storage and other logistic services, displaying wool etc). The relevant expertise and knowledge appears to be readily available from within the wool broking industry. Further, one merino grower told the Commission that he had organised his own private auction with the support of an existing broker.

Reputation

104. The applicant notes that one of the difficulties a new entrant is likely to face is the need to develop relationships and confidence with farmers and exporters. However, as outlined by the applicant, such relationships and any associated customer loyalty, is contingent on the wool broker meeting customer expectations and providing a competitive service. As noted above, the necessary field staff and other personnel are readily available from within the rural services industry.

Branding

105. Merino NZ notes that only about 5% of merino wool grown in NZ is incorporated into fabric to which the New Zealand Merino trademark is applied. Further, this brand is only available to be used on finished garments that contain 100% New Zealand-grown wool.

106. Merino NZ advises that during the past three years, it has spent about [ ] in total on marketing programmes aimed at lifting the profile of New Zealand–grown merino fibre. It estimates that of that amount, 60% would have been spent on programmes that in some way incorporate use of the brand. As discussed previously, it is difficult to quantify the benefits of the New Zealand Merino brand in terms of returns to growers.

107. However, even if this branding is of any significance, there do not appear to be any obstacles to developing alternative brands. For example, several smaller growers have developed brands for super fine fleece, albeit in market niches. These include Escorial, Stonehenge and Forest Range. Escorial markets wool under its own brand using wool sourced from various growers of the Saxon sheep breed. This has involved Escorial developing relationships with manufacturers and fashion houses in Europe for the manufacture of apparel at the higher quality end. According to the McKinsey Report, this has resulted in the development of a valuable brand image, and has enabled growers who supply to Escorial to achieve a premium for their wool.[19]

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[19] McKinsey Report, p. 73.

108. In the Commission's view, the acquisition is unlikely to limit the scope for growers, brokers and exporters to promote and market merino wool offshore, either individually or collectively. This could be achieved, for example, by taking advantage of existing links that exporters and others have with overseas manufacturers and fashion houses, or through the development of relationships with downstream manufacturers and fashion houses in overseas markets.

Conclusion on Potential Competition

109. Having regard to the above analysis, the Commission considers that entry/expansion barriers are unlikely to be raised as a result of the acquisition such that any person would acquire or strengthen a dominant position in the relevant market.

Conclusion on Dominance in the Auction Market

110. For the reasons outlined above, the Commission concludes that implementation of the proposed acquisition would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in the auction market.

The Direct Contract Market

Market Concentration

111. For the same reasons set out earlier, the Commission has estimated shares of the direct contract market using NZ Wool Board information. These shares relate to the value of merino wool purchased by Registered Private Buyers, as recorded in the NZ Wool Board database. The market shares for PGG and Reid Farmers have been combined for the purpose of this decision on the basis that those companies are "associated persons" in terms of the Act.

112. The estimated market shares for the ten months ending 31 March 2001 are set out in Table 2 below.

Table 2
Market Shares in the Direct Contract Market for the 10 Months Ending 31/3/01

	Value of Sales ($000)	Share (%)
Wrightson	[ ]	[ ]
PBM Wools	[ ]	[ ]
Wool Marketing	[ ]	[ ]
John Marshall & Co	[ ]	[ ]
Yaldhurst Wools Ltd	[ ]	[ ]
PGG/Reid Farmers	[ ]	[ ]
Others	[ ]	[ ]
TOTAL	[ ]	100%

113. On the basis of the figures provided above, NewCo would acquire the approximate [ ] % market share, currently held by Wrightson. However, if volume-based estimates were used, Wrightson's share is likely to increase, although in the Commission's view this would not affect the conclusions reached in this decision. A range of parties, including wool exporters, brokers and merchants, would hold the balance of the market share, with no party holding more than a [ ]% share.

114. The acquisition would involve no material change in market shares. It would merely result in NewCo acquiring Wrightson's existing market share with no horizontal aggregation. Like the auction market, the acquisition would lead to some vertical integration.

Existing Competition

115. Direct supply contracts are often regarded as an alternative to the auction system as they mitigate risk and provide some pricing stability. However, the Commission has been advised, and holds information, which shows that prices for direct supply contracts are closely related to auction prices.

116. Many of the points raised in the section on auction market apply to the competition analysis in the direct contract market. In particular, the main concerns expressed to the Commission related to the impact of NewCo having exclusive rights to the New Zealand Merino brand.

117. Following implementation of the acquisition, NewCo would continue to face an effective competitive constraint from various parties, including other wool brokers, wool exporters who buy direct, and to a lesser extent, merchants who purchase direct from growers for on-sale.

118. The Commission considers that, were NewCo to raise its prices, or to reduce its service levels, growers could readily switch to an alternative provider of direct contract services.

Potential Competition

119. Many of the entry/expansion conditions outlined in the section on the auction market are relevant to direct contracts.

120. For the reasons explained above, entry/expansion barriers are unlikely to increase as result of acquisition such that any person would acquire or strengthen a dominant position in this market.

Conclusion on Dominance in the Direct Contract Market

121. The Commission concludes that implementation of the acquisition would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in the direct contract market.

The Promotion Market

122. As noted above, Merino NZ carries out various marketing and promotional activities, which have been funded from levies collected by the NZ Wool Board. This role has been somewhat unique, and as such the acquisition would not alter existing market shares. As noted by the applicant, the compulsory levy-funded activities of Merino NZ in the past have removed much of the incentive for a number of exporters (and other parties) to carry out their own overseas marketing programmes.

123. Merino NZ estimates that about 10-12% of total fine wool sales has been assisted by its efforts. In the past season, the company facilitated direct supply contracts for around 817 tonnes of merino wool. This represented about 7% of the total merino wool clip (although only about two-thirds of this was sold under the New Zealand Merino brand). This tonnage was allocated as outlined in Table 3:

Table 3

Allocation of Merino NZ Contracts

	Tonnes	**%**
Wrightson	754	92.2
Reid Farmers/PGG	28	3.4
Wrightson/Reid Farmers/PGG	35	4.4
Total	817	100

124. Merino NZ advises that, in most cases it has not been possible to allocate contracts to brokers other than those listed in Table 3, as they do not have sufficient quantities of wool available to service the contracts.

125. The Commission considers that following implementation of the acquisition, there is unlikely to be any major change to the market situation. Further, the combined entity would continue to face effective competition in this market from wool exporters, many of which have links with overseas manufacturers. In addition, the potential may exist for other parties, such as brokers, to

promote and market merino wool, possibly in conjunction with an established exporter or an overseas manufacturer.

126. As noted above, there is likely to be a substantial capital investment in launching a major brand. However, as also discussed above, this does not appear to have precluded smaller growers, and other parties from promoting and marketing merino wool fibre overseas.

127. The Commission has not identified any other significant entry barriers into the provision of export facilitation/assistance services.

Conclusion on Dominance in the Promotion Market

128. The Commission concludes that the acquisition would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in the promotion market.

OTHER ISSUES

129. The applicant advises that, during the implementation of the acquisition, and the associated restructuring process, a number of agreements will be entered into by various parties. These include a licensing agreement for use of the New Zealand Merino Wool brand between Merino NZ Inc and NewCo, a logistics contract between NewCo and Wrightson, and a transitional funding arrangement between the NZ Wool Board and NewCo. As noted previously, any clearance which is given relates only to the acquisition of the assets of a business, or shares, and does not give protection to any other agreements or arrangements which are entered into by the parties. Such agreements or arrangements remain subject to the restrictive trade practice provisions of the Act.

OVERALL CONCLUSION

130. The Commission has considered the likely effects of the acquisition in the following markets:

- the market for the provision of merino wool auction services in New Zealand;
- the market for the direct purchase of merino wool in New Zealand; and
- the market for the national and international promotion of merino wool and contract facilitation.

131. On balance, the Commission is satisfied there are sufficient constraints in each of the relevant markets such that dominance will not be acquired or strengthened.

132. Having regard to the various elements of section 3(9) of the Act, and all other relevant factors, the Commission concludes that it is satisfied that the proposal would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in any market.

DETERMINATION ON NOTICE OF CLEARANCE

133. Accordingly, pursuant to section 66(3)(a) of the Act 1986, and in accordance with a delegation given under section 105(1), the Commission determines to give clearance for the proposed acquisition by NewCo of:

- the business assets related to the national and international marketing of merino fine wool fibre, carried on by Merino NZ; and
- the business assets related to the procurement and brokering of merino wool fibre, carried on by Wrightson.

Dated this 7th day of June 2001

M J Belgrave
Chair