Public Version
ISSN No. 0114-2720

11.4/10906

COMMERCE COMMISSION

Decision No. 637

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

SUMITOMO FORESTRY CO LTD

and

CARTER HOLT HARVEY LTD (BUILDING SUPPLIES DIVISION)

The Commission: Paula Rebstock
Peter J M Taylor
Anita Mazzoleni

Summary of Application: Sumitomo Forestry Co Ltd has applied for clearance to acquire all of the medium density fibre board assets and business operations of Carter Holt Harvey Ltd (Building Supplies Division) situated at Rangiora.

Determination: Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission determines to decline to give a clearance to Sumitomo Forestry Co Ltd for the acquisition.

Date of Determination: 20 March 2008

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Introduction

E1. The Commerce Commission (Commission) received an Application from Sumitomo Forestry Co Ltd (SFC) seeking clearance for it, or any of its interconnected bodies corporate, to acquire all of the medium density fibre board (MDF) assets and business operations of Carter Holt Harvey Ltd (Building Supplies Division) (CHH) situated at Rangiora. The Commission must consider whether it can be satisfied that the proposed acquisition will not have, nor would be likely to have, the effect of substantially lessening competition in any market.

E2. To aid its analysis, the Commission compares two situations: one in which the acquisition proceeds (the factual); and one in which the acquisition does not proceed (the counterfactual). The impact of the acquisition on competition in a market is then viewed as the prospective difference in the extent of competition between these two situations.

Parties

E3. SFC is a Japanese-based wood processing company that owns Nelson Pine Industries Limited (NPIL). The major business activity of NPIL is the manufacture and sale of medium density fibreboard. NPIL manufactures MDF at its processing facility in Richmond, Nelson.

E4. CHH is wholly-owned by Rank Group Investments Limited. It is a forest products company with significant interests in wood products, pulp, paper and packaging. One activity of the Building Supplies Division of CHH is the manufacture of MDF at its plant near Rangiora.

E5. Dongwha Patinna NZ Limited (Dongwha) is the only other New Zealand manufacturer of MDF panels and is based in Mataura. The Laminex Group (N.Z.) Limited (Laminex) supplies and distributes Dongwha's MDF throughout the country.

The Relevant Markets

E6. To analyse the proposed acquisition the Commission first must define the relevant markets affected by the proposed acquisition in order to assess the likely competition effects.

E7. The Commission considers that the relevant market for the consideration of the competition effects of this acquisition is the national market for the manufacture and supply of raw MDF panels.

Factual and Counterfactual

E8. The factual scenario (with the acquisition) would remove the existing competition between CHH and NPIL. This would result in a reduction in the number of domestic manufacturers and suppliers from three to two. The market would be reduced to a duopoly.

E9. The Commission considers that, on the evidence available to the Commission, the likely counterfactual (without the acquisition) would be that CHH's MDF assets and business operations at Rangiora would be acquired by a new entrant. In the counterfactual, three competitors would remain.

Competition Analysis

E10. In the national market for the manufacture and supply of raw MDF panels, the proposed acquisition would remove NPIL's most significant competitor, CHH. The amount of existing competition would be significantly reduced in comparison to the counterfactual. The Commission considers that the merged entity would face only limited competition from the remaining existing competitor, Dongwha, because of that company's commitments to its export customers and its equity and contractual relationships with the Laminex Group (N.Z.) Limited.

E11. The Commission further considers that de novo entry would be unlikely within two years given the export focus, the dynamics of the market and the time period required for consent and construction of such a plant. The threat of imports, which are significantly more expensive and of lower quality that the local product, would continue to provide limited, if any, constraint on the merged entity. The Commission considers that overall, the merged entity would face limited competition from potential competition in the factual scenario.

E12. The potential for the merged entity to exercise market power would not be constrained by the countervailing power of customers. As a result of the removal of CHH as a competitor, the countervailing power of customers would be reduced. Given the limited constraint from Dongwha/ Laminex and imports, customers would have limited alternative sources of supply of raw MDF panels, other than from the merged entity.

E13. Given these competition factors, the scope for the exercise of unilateral market power by the merged entity (and by the remaining independent competitor), and to increase prices, in the factual relative to the counterfactual, is likely to be enhanced by the proposed acquisition.

E14. The scope for coordinated market power is also likely to be enhanced in the factual by the proposed acquisition, relative to the counterfactual. There is evidence of the three existing suppliers adopting a policy of price following. The reduction of competitors from three to two would heighten the risk and likely effectiveness of such coordinated conduct.

Conclusion

E15. As a result of these considerations, the Commission cannot be satisfied that the proposed acquisition will not have, nor would be likely to have, the effect of substantially lessening competition in the national market for the manufacture and supply of raw MDF panels. Therefore, the Commission declines to give clearance for the proposed acquisition.

THE PROPOSAL

1. A notice pursuant to s 66(1)of the Commerce Act 1986 (the Act) was registered on 23 November 2007. The notice sought clearance for the acquisition by Sumitomo Forestry Co Ltd of Tokyo, Japan, (the Applicant or SFC) or any of its interconnected bodies corporate, of all of the medium density fibre board assets and business operations of Carter Holt Harvey Ltd (Building Supplies Division) situated at Rangiora.

PROCEDURE

2. Section 66(3) of the Act requires the Commission either to give clearance or to decline to give clearance, to the acquisition referred to in a s 66(1) notice, within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was agreed between the Commission and the Applicant. Accordingly, a decision on the Application was required by 27 February 2008.
3. The Commission's approach to analysing the proposed acquisition is based on principles set out in the Commission's *Mergers and Acquisitions Guidelines*.[1]

STATUTORY FRAMEWORK

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

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

6. In determining whether there is a change along the spectrum that is significant, the Commission must identify a real lessening of competition that is more than nominal and not minimal.[4] Competition must be lessened in a considerable and sustainable way. For the purposes of its analysis the Commission is of the view

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[1] Commerce Commission, *Mergers and Acquisitions Guidelines, January 2004.*
[2] *Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission* (1992) 4 TCLR 713-721.
[3] *Air New Zealand & Qantas Airways Limited v Commerce Commission* (2004) 11 TCLR 347, Para 42.
[4] *Fisher & Paykel Limited v Commerce Commission* (1990) 2 NZLR 731, 758; and *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554.

that a lessening of competition and creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.

7. When the impact of market power is expected to be predominantly upon price, for the lessening, or likely lessening, of competition to be regarded as substantial, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and ordinarily able to be sustained for a period of at least two years or such other time frame as may be appropriate in any give case.

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

THE PARTIES

Sumitomo Forestry Co Ltd

9. Sumitomo Forestry Co. Ltd (SFC) is a Japanese based wood processing company. Through a wholly-owned New Zealand resident company, SFC owns Nelson Pine Industries Limited (NPIL).

10. The major business activity of NPIL is the manufacture and sale of medium density fibreboard (MDF) panels. NPIL manufactures MDF panels at its processing facility in Richmond, Nelson. The MDF manufactured by NPIL is sold under the brand name "GoldenEdge".

11. NPIL uses radiata pine chips, sourced from its own and others' forests in the Nelson/Marlborough region, as its raw material for the production of MDF.

12. Around 80% of the MDF produced by NPIL is exported, principally to [ ]. The remaining MDF is sold on the domestic market, either to merchants and distributors or directly to end-users such as furniture and kitchen manufacturers

Carter Holt Harvey Limited

13. Carter Holt Harvey Limited (CHH) is wholly-owned by Rank Group Investments Limited (Rank). It is a forest products company with significant interests in wood products, pulp, paper and packaging. Rank is currently selling the Building Supplies Division of CHH, hence this application from SFC for clearance.

14. One activity of the Building Supplies Division of CHH is the manufacture of MDF panels at its plant near Rangiora. MDF manufactured by CHH is sold under the brand name "Customwood".

15. Around [ ] of the MDF produced by CHH is exported, principally to [ ]. The remaining MDF is sold on the domestic market.

Dongwha Patinna NZ Limited / The Laminex Group (N.Z.) Limited

16. Dongwha Patinna NZ Limited (Dongwha) is currently 80% owned by Dongwha Hong Kong International Co Limited and 20% owned by the Laminex Group (N.Z.) Limited (Laminex).

17. Laminex manufactures and distributes decorative surface products and related materials. Its brands include Formica, Laminex, Melteca and Lakepine MDF. Laminex, a wholly-owned subsidiary of Fletcher Building Limited (FBL), has an option to purchase another 30% of the shares of Dongwha in the period 1 January 2009 to 31 December 2010, and increase its shareholding in Dongwha to 50%. FBL previously operated an MDF plant at Taupo, but that plant was destroyed by fire in September 2006. Laminex announced on 10 May 2007 that the plant was not going to be rebuilt.

18. Around [ ] of the MDF produced by Dongwha is exported, [ ] is sold to Laminex, and the balance [ ].

19. MDF manufactured and sold into the domestic market from Dongwha's plant at Mataura is almost completely distributed by Laminex under its Lakepine brand. This has always been the case, but the volumes involved have increased significantly since the fire at FBL's Taupo plant 18 months ago (which meant Laminex's alternative New Zealand source of raw MDF was no longer available to it).

20. [ ][5]

21. [ ]

22. [ ]

23. The supply agreement between Dongwha and Laminex provides that [ ].

24. [ ]

25. For the purposes of considering the proposed acquisition, Dongwha and Laminex are treated as a single competitor. This is because of the equity and contractual relationships between the two. In effect, Dongwha is the manufacturer and Laminex the supplier/distributor of the same raw MDF panels.

INDUSTRY BACKGROUND

26. MDF is a reconstituted wood-based panel product used in many interior construction applications, predominantly kitchens, furniture and other cabinets. The raw material required in the production of MDF is wood fibre in the form of wood chips. In simple terms, woodchips are broken down into wood fibres, resin is added, the resulting material is then dried, formed and pressed. Pressing may be either into a continuous sheet or into separate sheets, depending on the

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[5] For example,
[ ]

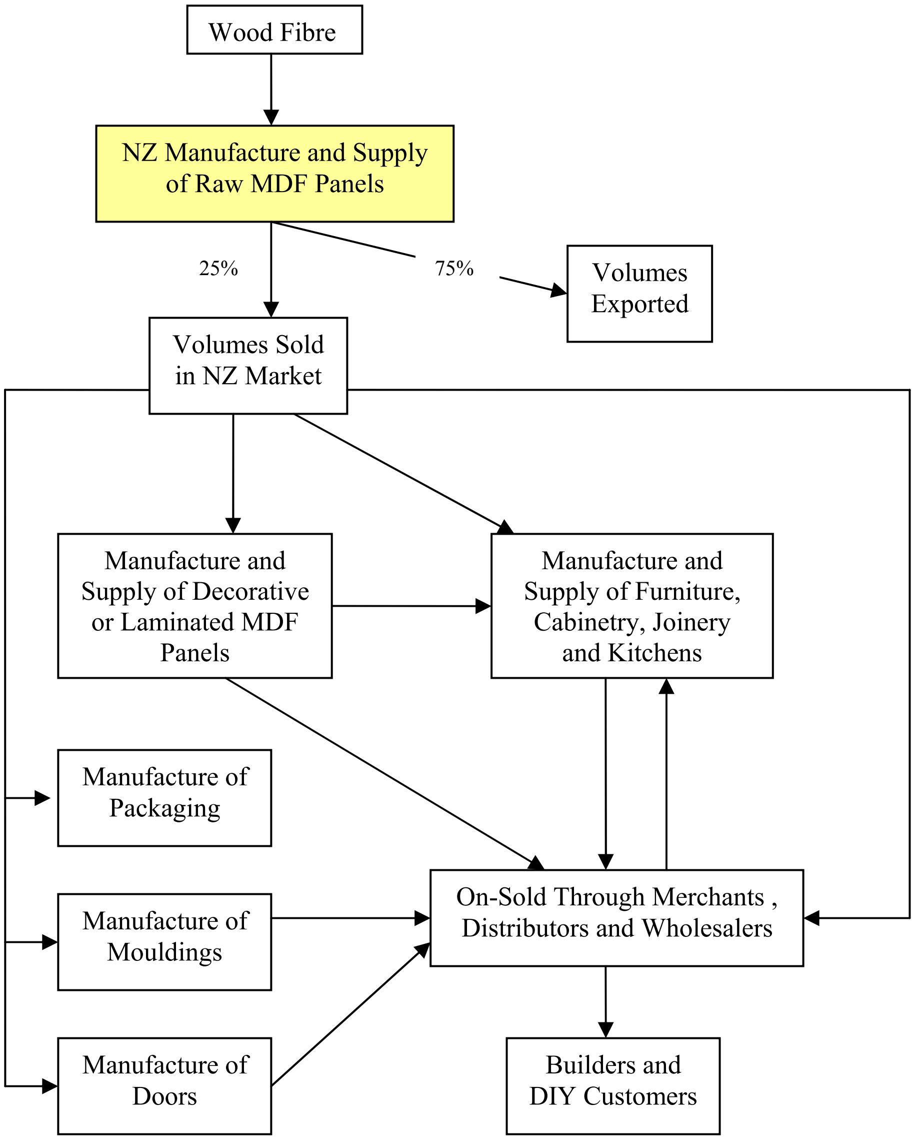
technology of the particular plant. The MDF panel is then sanded and cut as required.

27. MDF plants produce a range of MDF panels of different densities and thicknesses. Most MDF plants can produce panels from three to 35 millimetres thick. Most common thicknesses are 16 or 18 millimetres.

28. Around three-quarters of the raw MDF panels manufactured in New Zealand are exported. MDF manufactured in New Zealand is regarded as being of high quality and, as a result, attracts a premium price in overseas markets.

29. Diagram 1 outlines the structure of the industry and its different functional levels.

Diagram 1: MDF Industry and Functional Levels



30. Over [ ] of the raw MDF panels sold domestically are further processed by the three entities CHH Interion, Laminex and Prime Panels who produce and supply laminated or decorative MDF panels. These decorative panels are then used in the manufacture of furniture and cabinetry. However some large furniture-makers (for example, [ ]) decorate raw MDF panels themselves as part of their manufacturing process. Only a small proportion or raw MDF panels remain undecorated in their end-uses.

31. Depending on their MDF purchase volumes, furniture and cabinetry manufacturers may either obtain MDF supply direct from the domestic manufacturers or from merchants.[6]

32. Both NPIL and CHH also manufacture MDF mouldings. Southern Pine, a South Island manufacturer of wood products, is the third major supplier of MDF mouldings from its Christchurch plant. Industry participants have advised the Commission that there are a number of substitutes for MDF mouldings. Accordingly, while the acquisition would result in some aggregation of market share in the manufacture and supply of MDF mouldings, the Commission considers that the merged entity would be constrained in the factual by mouldings made from other products. The matter of mouldings is not, therefore, considered again in these reasons.

PREVIOUS COMMISSION DECISION

Decision 431

33. The Commission has previously considered the MDF market in *Decision No. 431: Nelson Pine Industries Ltd /Rayonier MDF New Zealand*, 31 May 2001. Aggregation of market share in MDF markets would have occurred through NPIL acquiring what was then Rayonier's Mataura MDF plant. At the time of Decision 431 there were MDF plants at Taupo (FBL), Nelson (NPIL), Rangiora (CHH) and Mataura.

34. In Decision 431, the Commission identified two markets of potential relevance:

    - the New Zealand wide market for the manufacture and supply of MDF to distributors and end users; and
    - regional markets in Nelson/Marlborough and Otago/Southland for the supply/acquisition of wood fibre.

35. The Commission considered that MDF may be substituted for other wood-based products in some applications, although it noted that there are various factors that may limit the degree of substitutability. Accordingly, for the purpose of analysing the earlier application the Commission adopted a narrow MDF market. If there were no dominance concerns (that was the test in 2001) arising out of this narrow market, there were unlikely to be any dominance concerns within a broader product market, such as the market for construction materials.

36. The Commission determined that the proposed acquisition would not lead to an acquisition or strengthening of dominance in the national MDF market. The Commission reached this conclusion due to the constraint likely to be provided by other MDF manufacturers (most significantly CHH), the possibility of imports, which could provide some constraint, and the countervailing power of MDF purchasers.

37. The Commission found that the wood fibre markets were regional in nature and, since the parties to the acquisition sourced wood fibre from different regions, the Commission concluded that no horizontal aggregation would result from the acquisition.

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[6] The merchants, distributors and wholesalers of MDF include Carters, Placemakers, Mitre 10, Bunnings, ITM, Independent Building Supplies, Impeys Hardware and Timber, and Anthony Shearer.

MARKET DEFINITION

38. 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]

39. 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 (a SSNIP), 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 dimensions of the market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increases in price that is sustained for a period of one year.

40. The Applicant submitted that the only market affected by this proposed acquisition is the national market for the manufacture and supply of MDF to distributors and end-users.

41. The Applicant submitted that, as in Decision 431, the wood fibre markets remain regional and that no horizontal aggregation would result from the proposed acquisition.

Wood Fibre

42. The three MDF manufacturers each predominantly source their wood fibre from within the region surrounding their plants. NPIL sources fibre from the Nelson/Marlborough region. CHH sources all of its fibre requirements from various suppliers in the Canterbury region. Dongwha sources its fibre from the Otago/Southland region. The three MDF manufacturers confirmed that, due to the cost of transporting bulky chips (or logs), it is not viable for them to source wood fibre from further afield than those individual local regions, unless as part of a truck backload.

43. The Commission considers that there continues to be discrete regional geographic markets for wood fibre supply to each MDF plant. Accordingly, no horizontal aggregation of market share results from the proposed acquisition, and so no further consideration of wood fibre markets is necessary in respect of this Application.

MDF

Product Market

44. 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 or supplied in the same market.

45. The Applicant submitted that the market relevant to the analysis of the proposed acquisition is a narrow MDF product market, but did note that the product market boundaries for MDF are unclear, as was acknowledged by the Commission in Decision 431.

46. The question is whether hardboard, plywood or particle board are such close substitutes for MDF that the sale and purchase of some of all of the four

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[7] S 3(1A) of the Commerce Act 1986.

products occurs in a single market. This may be answered by determining whether, in response to the incentive provided by a ssnip:

- a significant proportion of buyers of one of the four products would switch to one or more of the products; and
- suppliers of the products can easily shift production, using largely unchanged production facilities and little or no additional investment in sunk costs.

47. The Commission has been advised that the prices of hardboard and plywood are between 50% and 100% greater than the price of MDF (for equivalent sizes of panel) and that a SSNIP in MDF prices would be unlikely to cause MDF customers to switch to plywood, hardboard and/or particle board. Moreover, the veneering technology/plant required to manufacture hardboard and plywood is quite different to that used to produce MDF. A significant investment in new plant would be required for an MDF manufacturer to switch to hardboard or plywood manufacture. In the Commission's view, a small reduction in the price of MDF would not induce such a change.

48. Because of the absence of ready demand- and supply-side substitutability, the Commission does not consider that hardboard and plywood form part of the MDF product market.

49. Industry participants were of the view that the only possible economic substitute for MDF is particle board. Accordingly, the Commission's analysis focused on the degree to which MDF purchasers could use particle board as an alternative. The views of the industry are summarised in Table 1.

Table 1: Industry Survey on Product Substitutability

Participant	Comment on Substitutability between Particle Board and MDF
Impey's Hardware and Timber	[ ]
Independent Building Supplies	[ ]
Plycoselect	[ ]
Mitre 10	[ ]
Formway Furniture	[ ]
Tawa Doors	[ ]
Laminex Group	[ ]
Dongwha	[ ]
Anthony Shearer	[ ]

50. Particle board is around 10% cheaper than MDF. However, MDF has physical properties that are superior to particle board for some applications. The question is whether the addition of a SNNIP to the existing price difference between MDF and particle board would induce a significant proportion of users of MDF

(above those who are already using particle board to the maximum extent possible), to switch from MDF to particle board.

51. The industry participants that the Commission has interviewed, and whose statements on substitutability are summarised above, generally believe that MDF has a number of advantages over particle board, including a better surface finish (thus producing a better painted finish), more consistent colour, and is easier to machine to produce sharp rather than burred edges. As a result, particle board is often used for the interiors of cabinetry, where surface finish and general appearance is less important, whereas MDF is used for exterior surfaces where the opposite applies. [ ] submitted that particle board pricing does not greatly influence MDF pricing.

52. Overall, the Commission considers that the evidence it has gathered supports the following propositions:

- particle board can be used as a substitute for MDF in certain special applications in cabinetry – it cannot, however, be used as a substitute in doors;
- some applications require the extra strength of MDF and particle board is not an appropriate substitute;
- particle board cannot be substituted for thin sheet MDF because it is not produced in narrow thicknesses;
- given its lower price, where particle board can substitute for MDF, it is already being used; and
- given a *SSNIP*, there would not be a significant proportion of MDF buyers who would switch to particle board.

53. The Commission concludes that for the purpose of assessing the competitive effect of the proposed acquisition, the relevant product market is a market for raw MDF panels.

Functional Market

54. In Decision 431, the Commission defined the functional level of the markets as the manufacture and supply of MDF. The Applicant submitted that this is the functional level of the market.

55. Once raw MDF panels are produced, they are either sold in that raw form or undergo further manufacturing (such as lamination), before being sold as value-added MDF products (as outlined in Diagram 1).

56. The proposed acquisition results in aggregation of market shares in the manufacture and supply of raw MDF panels. There is no aggregation in respect of decorative MDF panels. The Commission considers that the relevant functional level of the market is the manufacture and supply of raw MDF panels.

Geographic Market

57. 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.

58. In Decision 431, the Commission found that the geographic extent of the MDF market was nationwide. The Applicant submitted that the market is still national. Other parties agreed. All three manufacturers of MDF, while based in the South

Island, supply MDF throughout the country (and also export to overseas markets).

59. The Commission considers that the geographic dimension of the market is national.

Conclusion on Market Definition

60. The Commission concludes that the relevant market for assessing the proposed acquisition is the national market for the manufacture and supply of raw MDF panels.

COUNTERFACTUAL AND FACTUAL

61. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission compares the likely outcomes in two hypothetical situations, one with the acquisition (the factual) and one without (the counterfactual).[8] The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition. The Commission uses a forward-looking type of analysis to assess whether a lessening of competition is likely in the defined market(s).

Factual

62. In the factual, the Applicant would acquire the CHH Rangiora plant. This would result in a reduction in the number of participants in the national market for the manufacture and supply of raw MDF panels from three to two. The other remaining domestic competitor in this market post-acquisition would be Dongwha. The market would essentially be reduced to a domestic duopoly.

63. In the factual, NPIL proposes to continue to operate the CHH Rangiora plant as a going concern.
[

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64. [

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Counterfactual

65. The Applicant submitted that, given the CHH Building Supplies Division sale process, there will inevitably be speculation over potential counterfactual scenarios.

66. In summary, the Applicant has identified three possible counterfactual scenarios:

- a counterfactual that includes Dongwha and/or FBL as the potential purchasers;
- a counterfactual that includes only new entrants; or
- a counterfactual that includes a combination of the above scenarios.

67. The Commission has been advised by Rank of the names of the other bidders for the assets.

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[8] *Air New Zealand & Qantas Airways Ltd v Commerce Commission*, (2004) 11 TCLR 347, Para 42.

[

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68. Therefore, the Commission considers that the most likely counterfactual would be the purchase of the assets by a new entrant. Hence, in the counterfactual, three competitors would remain.

COMPETITION ANALYSIS

Introduction

69. The Commission's analytical framework is to assess the impact of the merger by analysing whether the proposed acquisition would lead to a substantial lessening of competition (SLC) in the affected markets.

70. An SLC could be likely if the Commission reaches the view that in the factual, the potential for the merged entity, or other market participants, to exercise market power is enhanced when compared to the counterfactual. Acquisitions that increase concentration in markets enhance the potential for market power to be exercised in two main ways:

    - by reducing competition constraints that lead to an increase in market power of the remaining firms acting independently (non-coordinated, or unilateral, effects); and/or
    - by changing the nature of competition in a way that makes tacit or express coordination between firms more likely, effective and stable (coordinated effects).

71. The potential for the enhancement of a unilateral or a co-ordinated exercise of market power, is assessed in terms of:

    - existing competition;
    - potential competition; and
    - other competition factors, such as the countervailing market power of buyers or suppliers.

72. In summary, the competition analysis carried out by the Commission assesses whether the potential for exercising unilateral or co-ordinated market power is enhanced in the factual when compared to the counterfactual by analysing existing and potential competition and other possible competitive constraints.

73. The Applicant has submitted that although the proposed acquisition would result in the reduction of market participants from three to two, there are unlikely to be competition concerns in the national market for the manufacture and supply of raw MDF panels. The Applicant considers the merged entity would be constrained by the following factors:

    - the ability of Dongwha to supply substantially all of domestic MDF demand, including by diversion of its export output to the domestic market;
    - MDF is an internationally traded commodity, bringing with it the discipline of import parity pricing;
    - the potential for entry and expansion through imports; and

- the countervailing power exercised by customers.

74. The Commission's analysis (set out below) did not find that these constraints exist to a sufficient degree to constrain the potential for unilateral exercise of market power in the factual as compared to the counterfactual.

75. In summary, the Commission considers that the facts and analysis below show that:

    - Dongwha has informed the Commission that
      [
      ];
    - imports would not constrain the merged entity – the convenience of domestic supply and other non-price factors would require a very large increase in price before purchasers would consider resorting to imported raw MDF panels;
    - entry by a new MDF manufacturer would be unlikely within the Commission's two year analysis time frame due to the time required to install and commission the relevant plant; and
    - there is little evidence that customers would be able to exercise countervailing power in the factual.

76. Additionally, the Commission considers that the potential for co-ordinated market power would be significantly enhanced in the factual when compared to the counterfactual.

77. This section sets out the Commission's reasoning and views on the likelihood of an SLC between the factual and the counterfactual.

Unilateral Effects

78. An acquisition that significantly increases seller concentration in a market may lead to circumstances where competition between firms in the market is seriously reduced. In markets that are sufficiently concentrated, the actions of individual firms can have identifiable effects on their competitors, such that firms recognise their interdependence. The interdependence of firms may lead them to anticipate competitors' responses to their own actions and take this into account in their own decisions. The repeated nature of such decisions can have significant effects on business strategies and on competition.

79. The Commission notes that it is the creation of the potential for a business to exercise market power that is the focus of the analysis, rather than whether or not the market power would actually be exercised should it be obtained. In the circumstances here, where the merged entity faces only limited constraint from either Dongwha/Laminex or from potential entry and where other competition factors are insufficient to nullify the market power, the Commission considers that the merged entity (and the other remaining entity in the market) would be likely to have the ability to exercise unilateral market power much more strongly, compared to the counterfactual scenario where there would be three substantial competitors.

80. This section assesses the potential for unilateral market power to be exercised, and whether an SLC would arise in the factual when compared to the counterfactual. The potential for unilateral market power to be enhanced takes into account the scope for existing and potential competition, and other potential

constraints, such as countervailing power held by purchasers, as between the two scenarios.

81. In summary, the Commission has found that the counterfactual scenario is likely to be more competitive than the factual. Customers would have greater scope to seek competitive bids from alternative parties, switch between suppliers, obtain volume discounts, and exercise some countervailing power. However, in the factual scenario this competition from a major supplier would be eliminated. The remaining competition factors that apply in both scenarios, from Dongwha/Laminex, potential competition and the countervailing power of customers, would mean that the combined entity would face only limited competition.

Existing Competition

82. 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).

83. 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.

84. The Commission considers that a business acquisition is unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

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

85. The market shares for the national market for the manufacture and supply of raw MDF panels are set out in Table 2. As each of the domestic MDF plants are operating at, or about, full productive capacity, market share analysis based on productive capacity is not materially different from an analysis based on domestic sales volumes.

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Table 2: Estimate of Market Shares for MDF Market

Supplier	**NZ Market ($000m^3$)**	**% of NZ Market**	**Plant Capacity ($000m^3$)**	**% Capacity**
NPIL	[ ]	[ ]	[ ]	[ ]
CHH	[ ]	[ ]	[ ]	[ ]
Combined Entity	**[ ]**	**[ ]**	**[ ]**	**[ ]**
Dongwha	[ ]	[ ]	[ ]	[ ]
Total	**[ ]**	**100.0%**	**[ ]**	**100.0%**

86. Table 2 indicates that the merged entity would have a market share of [ ]% and the three-firm concentration would be 100%. The remaining [ ]% market share would be held by Dongwha. This is well outside the Commission's safe harbour guidelines.

87. 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.

88. This section now sets out the Commission's analysis of existing competition from Dongwha/Laminex, CHH and near competitors in the factual and counterfactual.

<u>Existing Competition</u>

89. This section outlines the Commission's assessment of existing competition, including from the potential for export diversion, and for the expansion of production facilities by Dongwha/Laminex in the factual as opposed to the counterfactual.

Dongwha/Laminex

90. Dongwha/Laminex would be the merged entity's only competition in the factual scenario.[9] The Commission has investigated the level of competition provided by Dongwha/Laminex, and its likely behaviour in response to a price increase in the factual.

91. As discussed in these reasons:
    - Laminex is linked to Dongwha as a result of its 20% shareholding in Dongwha with an option to increase that to 50%;
    - at present, Laminex relies on Dongwha for its domestic supplies of raw MDF panels;
    - other than domestic sales to Laminex, Dongwha is primarily an exporter of MDF; and
    - [ ].

92. The ability of Dongwha/Laminex to compete with the merged entity in the national market for the manufacture and supply of raw MDF panels is limited because:

[9] As noted in paragraphs 114-116, Juken provides only minimal competition at the fringes.

- about [ ] of the raw MDF panels that Dongwha supplies to Laminex are used within Laminex's own manufacturing processes, and so never reach the market as raw MDF; and
- in total, [ ] of the raw MDF panels supplied by Dongwha to the domestic market in 2007 were sales to the FBL group. Around [ ] were sales to third parties through Laminex. The residual [ ] were sales made directly by Dongwha. Of the quantity that is on-sold by Laminex into the market [ ] as raw MDF about [ ] is sold to Laminex's sister companies in the FBL group, Placemakers [ ] and the O'Brien Group [ ]. That means that the quantity of raw MDF that Laminex sells into the domestic market outside the FBL group is limited - [ ]; and
- these factors limit the constraint that Laminex would have on the merged entity's pricing to customers outside the FBL group in the factual.

93. When questioned about the extent to which it competes, Laminex advised that [ ]

94. In terms of merchant chains, Laminex is a significant supplier only to [ ] NPIL and CHH are the preferred or predominant suppliers to all other merchants and distributors.

95. Market participants consider that Laminex is a passive competitor in the market for the supply of raw MDF panels. For example, [ ] commented that it does not always see Laminex competing for business. In addition, [ ].

96. However, [ ] and not a direct competitor to Laminex's laminated panel business, does receive most of its MDF laminated panel supply from Laminex. Nevertheless, [ ] informed the Commission that in its view, NPIL and Laminex had never sought to take market shares from each other.

97. Market participants also consider that Laminex has chosen largely not to supply raw MDF to merchants and distributors; rather, its strategy is to focus on supplying end-users directly. For example, [ ]

98. In addition, [ ][10] has observed Laminex selling direct to customers at lower prices than those offered by Laminex to other distributors.

99. This evidence overall suggests that Laminex appears reluctant to supply market participants that compete with it in distribution or downstream markets, and in particular to compete on price with the existing larger suppliers. In consequence, the Commission considers that Laminex would provide a weak, or no, constraint on the pricing of the merged entity, to what is a large section of the relevant market.

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[10] As noted above [ ] is a wholesaler/distributor/retailer of building products.

100. This discussion leads the Commission to the view that Dongwha/Laminex currently provides only limited competition to NPIL and CHH, and that this would continue in the factual with respect to the pricing behaviour of the merged entity with regard to the supply to:

- non-FBL group companies;
- to competitors in downstream markets; and
- to merchants and distributors, other than [ ].

Export Diversion

101. The Commission has considered the potential for export diversion by incumbents to be a competitive force in the domestic market. This is relevant because 75% of all MDF manufactured in New Zealand is exported.

102. The three manufacturers of MDF advised the Commission that, given the preponderance of their export sales, they take a long-term view in respect of export diversion into the domestic market. For example, the MDF manufacturers advised the Commission that despite margins on domestic sales currently being higher than those on export sales, because of the high value of the New Zealand dollar, they have not taken a short-term view and diverted sales to the domestic market, as doing so would jeopardise on-going sales to their large-volume export customers. [ ] also stated that a likely consequence of the diversion of export volumes to the smallish domestic market would be a fall in domestic prices and margins.

103. [ ] Therefore, the Commission considers that in the factual, Laminex would be more likely to adopt a strategy of following price rises, by pricing up to the level charged by NPIL, than to divert product from export markets.

104. Prior to a fire that destroyed FBL's Taupo MDF plant, FBL was a key source of MDF supply for Laminex. Following the fire (in the last 18 months), Dongwha has diverted MDF export sales from its export markets in order to increase its supply to Laminex. Prior to the fire, Dongwha was exporting approximately [ ]% of its production and selling only [ ]% into the domestic market. Today, [ ]% of its MDF production is sold domestically. However, [ ]. This is the only recent example of export diversion that the Commission has found.

105. Domestic margins on raw MDF sales are currently higher than export margins. Due to general expansion in MDF production capacity in the Asia/Pacific region, competition to Dongwha for new export sales contracts is likely to continue to be vigorous from overseas suppliers, and so lower margins in export markets are likely to remain. [ ]

106. As a result, the Commission does not consider that the potential for export diversion by Dongwha into the New Zealand market is likely to competitively constrain the merged entity in the factual.

Expansion of Dongwha Plant

107. Dongwha has one manufacturing line at present, which is operating at full production capacity, but its factory building was originally sized for two lines. A second line could be operational in [ ]. Dongwha advised that [ ]

108. In the Commission's view:

- [ ]
- [ ]
- whilst the least time to commission a new plant would be [ ], there is uncertainty about that time, as it assumes no delays due to consenting issues, or to the general exigencies of major construction projects.

109. In the light of these factors, the Commission does not consider that the capacity of Dongwha's plant will be expanded within the two year timeframe (as generally used to assess new entry), and that even if the Commission were incorrect in this view, the potential for expansion by Dongwha would not act to competitively constrain the merged entity because the extra production would be directed into export markets.

Conclusion on Competition from Dongwha/Laminex

110. For the reasons given above, the Commission considers that in response to a price increase by the merged entity, Dongwha/Laminex would be unlikely to increase supplies of raw MDF in the domestic market, and is more likely to act as a price follower. Accordingly, the Commission considers that Dongwha/Laminex provides only limited competition on the supply of raw MDF panels in the factual, as it would in the counterfactual.

<u>Removal of Competition from CHH</u>

111. The factual results in the loss of CHH as a competitor. The evidence indicates that the majority of the existing competition in the supply of raw MDF panels is between CHH and NPIL, with Dongwha/Laminex only competing at the fringes.

112. As between CHH and NPIL there is evidence of:

- customers switching between CHH and NPIL, in entirety or for significant proportions of their purchase volumes, depending on who offers the best price;[11]

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[11] For example, [ ]

- customers being able to seek competitive quotes by playing off CHH and NPIL against one another;[12] and
- CHH pitching for the business of NPIL customers;[13] and
- CHH and NPIL competing for large volume customers through the offering of volume rebates and discounts.[14]

113. Without CHH in the market, customers would have little ability to negotiate to place pressure on NPIL's prices. There would be less competition for customers and less switching between suppliers. Likewise, the potential for CHH to divert exports from overseas to the domestic market would be lost. Similarly, the potential for CHH to expand production would be lost. Therefore, the Commission considers that the removal of CHH as a competitor in the counterfactual would, absent other significant competition factors yet to be evaluated, result in an SLC in the factual compared to the counterfactual.

<u>Competition from Near Competitors</u>

114. Juken NZ Ltd manufactures MDF panels as part of the production of its specialist Triboard product at its plant in Northland. Triboard is a layer of strand board sandwiched between two layers of MDF. While most of its MDF panel manufacture is used for Triboard production, it does sell a very small amount of low grade MDF domestically (around [ ] m^3 per annum). However, it does not actively seek to grow its sales of MDF panels.

115. The MDF that Juken sells is mainly used for mouldings and packaging (uses for which quality is a less important consideration. Juken has spare capacity, and could increase MDF production by an extra [ ] m^3 per annum. However, Juken stated that
[

]

116. Accordingly, the Commission considers that Juken would not provide material competition to the merged entity in the factual scenario.

<u>Conclusion on Existing Competition</u>

117. The acquisition would result in a reduction in the number of participants in the national market for the manufacture and supply of raw MDF panels from three in the counterfactual to two in the factual. CHH would be removed as NPIL's most important competitor. The Commission believes that in the factual, Laminex's incentive to compete prices downwards is likely to be weak, and so the degree of competition faced by the existing producer from Laminex would be limited.

118. The Commission concludes that the merged entity would face only limited existing competition in the factual scenario, compared to the counterfactual.

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[12] For example, in its last price negotiations, [ ]
[13] For example,
[ ]
[14] For example, [ ]

Potential Competition

119. 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 competitive constraints from the threat of market entry. 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 impediments they might encounter should they try. In order for market entry to be a sufficient constraint, entry must satisfy the LET test (be likely, sufficient in extent and timely).

120. In Decision 431, the Commission considered the factors that would affect entry into the MDF market. It considered that entry might take 18 to 24 months for a greenfields plant, but noted that this period could extend by a further 12 months, depending on Resource Management Act issues that could arise. The Commission concluded that new entry was unlikely.

121. For this Decision, the Commission has considered whether de novo entry would be is likely, efficient and timely, and also whether entry via import is feasible.

<u>De Novo (Greenfields) Entry</u>

122. The Applicant submitted that de novo entry may be possible, and would be most likely to occur in the Northland region where there would be sufficient uncommitted supplies of wood fibre to satisfy the needs of an entrant. Other industry participants were also of the view that any new entry would only occur where there are plentiful future wood fibre supplies.

123. However, parties interviewed by the Commission do not consider de novo entry to be likely, given that existing production capacity is over three times greater than domestic demand, and that 75% of MDF production is exported. [ ] all submitted that if entry occurred, it would be likely to be based on supplying export markets, not the domestic market.

124. Entry would involve the building and commissioning of an MDF plant. This would be likely to take at least 18 to 24 months. But the entrant would first have to obtain Resource Management Act consents, and in recent years, it has proved increasingly difficult for the wood processing industry to obtain such consents. Further, an entrant might also need to secure export contracts in advance so as to make its plant viable. Overall, these pose difficult conditions of entry.

125. Therefore, the Commission concludes that de novo entry is neither likely nor would be timely, even in response to any domestic price increase that might result from the merger, because there would be likely to be regulatory approval and construction periods of over two years.

<u>Entry via Imports</u>

126. The Applicant submitted that new entry is more likely to arise from imports. It considers that there are no barriers preventing the entry of imports, and noted that the threat of imports was recognised by the Commission as a source of competition in Decision 431.

127. Decision 431 relates to the situation in 2001. The Commission has considered the role that imports currently play in the market, and the degree to which imports would provide a competitive constraint on the merged entity in the future.

128. Historically, there have only ever been small volumes of raw MDF panels imported into New Zealand. Laminex has in the past manufactured a proportion of the MDF panels that it sells in New Zealand at its Australian plant. Otherwise no-one has imported raw MDF panels from Australia for many years, since CHH and Laminex acquired independent Australian MDF manufacturers, thus removing potential Australian exporters that were not independent of New Zealand market participants. [ ] did import some raw MDF from Malaysia two years ago, but has not done so again as customers complained that the MDF was of poor quality.

129. From a wide survey of potential importers, the Commission could find no evidence either of actual importing at this time, or of any party proposing to import in the future, despite annual MDF price increases by the domestic manufacturers for a number of years ranging up to about 7%. The Commission has no evidence that any customers have actually switched to imports as a result of these or other price increases, or as a result of the currently high New Zealand dollar, which makes the economics of importing more favourable. The Commission considers that at present, the threat of imports provides only limited constraint on suppliers and on domestic MDF prices, and it does not accept the Applicant's view (stated in its Application) that the domestic market is disciplined by import parity pricing.
[
]

130. A major issue identified by MDF end-users and other industry participants is that imported MDF is generally of a lower quality than the local product. New Zealand radiata pine-based MDF is highly regarded in terms of its quality. In contrast, Asian rubberwood-based MDF is considered to be of lower and varying quality. It tends to be less consistent in finish (for example, it can contain bark) and has less ability to produce a clean, sharp edge. However, some South American manufacturers produce high quality pine-based MDF, consistent with the quality of that produced in New Zealand. The Commission believes that high transport costs ex South America, would rule out imports from this source.

131. In addition to quality issues, there are a number of additional 'inconvenience' costs associated with importing. These include minimum order quantities, longer lead times of over one month to receive product, the cost of money (as a result of paying for product at the time of order before its receipt), the costs of storing bulky volumes of MDF panels, and the costs of distribution around New Zealand from the port of arrival.

132. Given the additional costs of importing, consumers have informed the Commission that the landed cost of imports would need to be significantly lower than domestic MDF prices before they would consider importing. [ ] stated that the landed cost would need to be 40% below domestic prices. [ ] stated that the landed cost would need to be 25-30% below domestic prices. Similarly, [ ] stated that domestic prices would need to increase approx 30% before it would be worthwhile to import. [ ] stated that domestic prices would need to increase by 18% before it would consider imports. The average of these estimates of the 'inconvenience' cost if importing is nearly 30%.

133. Very few industry participants have any data on, or knowledge of, the current cost of imports, further suggesting that imports are not regarded as being viable.

[ ] estimated that the landed cost of imports was 17% higher than domestic prices in 2007.

134. The market participants do not in general even monitor the cost of imports. For example, neither [ ] were able to provide the Commission with any in-house data on the cost of imports in relation to domestic market prices. In the Commission's view, if importing were to be viable the margin between imported and domestically-produced MDF prices would be small, as local producers would set their prices on an import-parity basis. [ ], the Commission concludes that neither NPIL nor CHH feels threatened by imports, and that imports would be unlikely to constrain the merged entity.

135. To check this conclusion, the Commission has attempted to estimate the current delivered cost of importing raw MDF panels. Quotes were obtained from manufacturers in Asia and South America. To these prices, the cost of shipping, customs and domestic transport were added to arrive at estimates of the delivered cost. Table 3 details the estimates of current delivered cost of importing raw MDF panels, compared to domestic MDF prices. As the delivered cost of imports varies materially with changes in the foreign exchange rate, a range of estimates was derived. Prices at the lower end of the range are based on a US$ rate of 0.77 (current rate), and at the upper end of the range a rate of 0.68 (the rate around late 2006). The prices are exclusive of any volume discounts or rebates.

Table 3: Delivered Cost Estimates
(NZ$/m^3 price for 18mm MDF delivered to Auckland customer)

Origin	Price
New Zealand	[ ]
Asia(i)	[ ]
South America (ii)	[ ]

Notes:
(i) *Based on quote from manufacturer in Shanghai of [ ]*
(ii) *Based on quote from manufacturer in Brazil of [ ]*

136. The lowest bound of the Asian estimate is 17% higher than the current domestic price. This accords with the calculations conducted by [ ] last year. Prices from South America are higher than Asian prices due to higher shipping costs. Based on the estimates in Table 3, domestic prices would need to increase by 17% before imports became economic.

137. However, the figures in Table 3 do not incorporate the other non-price costs of importing discussed above. Based on the information provided by market participants, the additional 'inconvenience' and non-price costs of importing are likely to add approximately 30% of the price of locally made MDF to the landed cost estimates (being [ ]). This further widens the gap between domestic prices and the delivered cost of imports.

138. The Commission concludes that a price increase far above 10% would be required before importing would become a realistic alternative to sourcing MDF

from New Zealand suppliers. Importing is also unlikely to be a complete substitute for local supply due to the quality factors discussed. Therefore, in the Commission's view, the threat of imports is highly unlikely to provide a competitive constraint on the merged entity's prices.

Conclusion on Potential Competition

139. The Commission concludes that in both the factual and the counterfactual suppliers would face limited if any constraint from potential competition, either in the form of imports or of de novo entry

Countervailing Power

140. In some circumstances the potential for the merged entity to exercise market power may be sufficiently constrained by a buyer or supplier to redress concerns that an acquisition may lead to a substantial lessening of competition.

141. The merged entity could be constrained if purchasers were able to exert a substantial influence on the price, quality or terms of supply of the good or service. A purchaser may be able credibly to exert such countervailing power if it were large in relation to suppliers, well informed about alternative sources of supply, readily able to switch from one supplier to another, and able to foster new supply.

142. In Decision 431, the Commission concluded that there would be sufficient constraint provided by MDF purchasers to constrain the merged entity, largely because the prices offered by alternative manufacturers could be used as leverage to ensure prices from the merged entity were competitive. However, the Commission notes that the acquisition in Decision 431 would have resulted in a change from four manufacturers in the counterfactual to three in the factual, whereas this acquisition would lead to a change from three suppliers in the counterfactual to two in the factual. That new factual scenario in this acquisition immediately reduces the number of suppliers that purchasers may leverage between to obtain lower prices.

143. The Applicant submitted that major acquirers, such as distributors and end users, could exercise countervailing power in the factual as contracts for supply are non-exclusive, and are of a short duration (ranging from spot purchasers to contracts of 6 or 12 months duration). Accordingly, the Applicant considers that such acquirers would be able to constrain any attempt by the merged entity to raise prices above the current level because of their ability readily to switch to alternative sources of supply.

144. The Commission's inquiries confirm that fixed volume or fixed term supply contracts are not prevalent in this industry. Customers are not prevented from switching between suppliers by contractual restraints. Prices and supply terms tend to be negotiated on an annual basis.

145. At present, some customers consider that they have countervailing power. They tend to push back in negotiations and query the reasons for price rises, rather than merely accepting the prices offered. Many seek alternative price quotes in order to keep their existing suppliers 'honest'. A few claim to use the threat of importing as another lever. The merchants tend to find that while they cannot always influence the gross list prices, they can lessen the effect of price rises through volume discounts and rebates. Customers are ultimately prepared to switch if they can get a cheaper price from another domestic supplier. The

Commission considers this would continue to be the situation in the counterfactual.

146. However, in the factual scenario where CHH is removed as a competitor, the countervailing power of customers will, in the Commission's view, be severely reduced. Merchants and end-users expressed concern about the loss of CHH as an alternative supplier in the factual. For example,
[
] As discussed above, Dongwha/Laminex and imports would provide a limited competitive constraint.

147. The Commission has also considered whether the ability of customers to switch to imported, disassembled, "flat-packs" of furniture, kitchen and other cabinetry components might provide some opportunity to exercise countervailing power or constraint. It is possible that the rise of imports of these products has contributed to demand in the raw MDF market being relatively static, despite the growth in housing construction.

148. [ ] advised that the majority of imported, disassembled, MDF products are aimed at the lower quality, lower price, end of the market for furniture, kitchens and cabinetry, whereas locally produced MDF tends to compete across the full range. In the Commission's view, flat-pack imports would be likely to be only a weak constraint on the merged entity over the entire product range in the relevant market. Moreover, as MDF constitutes only a proportion of the cost of the end product, the competitive impact of imported furniture product is attenuated accordingly. Certainly given the reasonably substantial and on-going regular price rises by local producers detailed in Table 4 below, the constraint on existing MDF suppliers posed by the ability of consumers to switch to these flat-pack products does not appear to be strong.

149. The Commission concludes that customers would have limited, and certainly much reduced, countervailing power to constrain the merged entity in the factual scenario, compared to the power they would wield in the counterfactual.

Conclusion from Qualitative Analysis on Potential for Unilateral Effects

150. The Commission has qualitatively assessed the potential for unilateral market power to be enhanced in the factual relative to the counterfactual. Taking all of the above-discussed competition factors into account, it has reached the clear view that a substantial lessening of competition would be likely to result from the proposed acquisition. The combined entity would be likely to face little competition from any of existing and potential competition, and from other potential constraints, such as countervailing power held by purchasers. These competition factors - in particular, existing competition and customers' countervailing power - would be substantially stronger in the counterfactual scenario.

Modelling the Potential for Unilateral Effects

151. The Commission decided to put to the test the underlying qualitative analysis that it had used to form its view to decline the Application by undertaking a cross-check using quantitative economic modelling.

152. A simple, Cournot, merger simulation model was applied to estimate the price increases that could potentially occur in the factual, relative to the counterfactual, as a result of the proposed acquisition. The model embodied various

assumptions that were designed as far as possible to reflect the market at issue. The key assumptions were:

- Cournot-type competition in the market (implying, amongst other things, that firms act independently in seeking to maximise their own profits);
- the market demand function is linear;
- all firms have constant marginal costs;
- the marginal cost for the combined entity is the smaller of the marginal costs of the two merging firms;
- entry occurs by import only, and in estimating the potential impact of imports on competition, a single importer is assumed, who also behaves in a Cournot fashion; and
- the impact of countervailing power is ignored.

153. Sensitivity tests were carried out on the market price elasticity of demand and the marginal cost of imports, as the precise values of these variables is uncertain. Also worth noting are the following points:

- the assumption of a linear demand rather than other possible functional forms is likely to understate the potential price increase;
- the assumption of one importer could lead to an understatement of the competitive impact of imports, but given the likely economies of scale to importing, and absence of imports to date (see paragraph 126 onwards), it seems reasonable to assume only one importer; and
- in order for imports to enter into the domestic market, the importer would likely have to overcome certain entry barriers, one of which is the fixed cost of its set-up. However, the merger simulation model used here does not attempt to gauge whether an importer would be able to overcome the entry barriers and enter the market. Rather, it simply assumes that imports would enter. These simplifications will tend to overstate the potential competitive impact of imports.

154. The above considerations show that the Commission has taken a conservative approach to the modelling, in the sense that the estimated price effects are likely to understate the 'true' price effects. The modelling results for the end-points of the market demand elasticity range used suggest that the removal of CHH as a competitor would lead to price increases in the range from 8.4% to 20.9%.

155. The Applicant expressed concern about the confidence that could be attached to the wide range of price increase predictions, and also as to the reliability of the Commission's merger simulation analysis given some of the assumptions used. Specifically, concern was expressed over the applicability of the particular model, the basis for the 30% non-price disadvantage for imports, and the exchange rate predictions used. More sensitivity testing was considered to be needed. CHH similarly expressed concern about the approach, assumptions and sensitivity testing.

156. The Commission provided both the Applicant and CHH with further details of its modelling calculations. The Commission also responded to the concerns raised by the Applicant in relation to the assumptions made. Further, the Commission offered to undertake (and provide details of) further sensitivity testing, but acknowledged that as this would take an estimated four additional

days, it would require the Applicant to agree to a short extension to the date on which the Commission was required to make a decision on the Application.

157. The Commission specifically made clear to the Applicant that, even without the additional sensitivity testing, it was evident from the modelling that:

- the merger would result in significant price increases absent the entry of imports;
- imports would not restore the competitiveness of the market because the cost of imports would be substantially higher than the cost of domestic products; and
- minor changes in assumptions about inputs into the model would be unlikely to lead to different conclusions.

158. In response, the Applicant advised that:

- it had no further submissions to make on its Application; and
- its Application stood on the basis of information on the record at the required decision date.

159. In effect, this advice from the Applicant meant that it did not agree to any extension to the date for a decision on its Application. CHH also advised that it had no further submissions to make on the Application.

160. As to the Applicant's concerns, the Commission considers that the sensitivity testing that was undertaken is sufficient to be confident that the merger simulation analysis finds the merger likely to result in a price increase. The Commission is of the view that its modelling results support its view to decline the Application based on the primary, qualitative assessment of the Application.

161. As discussed, the Commission has concluded, on the basis of the qualitative assessments previously outlined in this decision, that the scope for unilateral market power is likely to be enhanced by the proposed acquisition. In reaching its conclusions on unilateral effects, the Commission has not relied on the merger simulation analysis for the purpose of assessing the price effects of the merger. In almost all cases, measuring the competition impacts of acquisitions necessarily involves a mix of quantitative and qualitative assessments. However, the Commission acknowledges that—without due care—there could be a risk that undue focus is given to those factors that can be quantified at the expense of those that cannot. In the context of this clearance application, the economic modelling provided a quantitative cross-check on the Commission's conclusions on the scope for increased unilateral market power, arrived at as a result of the Commission's qualitative analysis.

Overall Conclusion of Potential for Unilateral Effects

162. The Commission has assessed the potential for unilateral market power to be exercised to the extent that an SLC would be caused when comparing the factual to the counterfactual, and concludes that the potential for unilateral market power to be constrained by existing and potential competition and other potential constraints, such as countervailing power held by purchasers, will be lessened in the factual. Quantitative modelling supports the view reached by the Commission via its qualitative analysis.

Coordinated Effects

163. As well as increasing the scope for the exercise of unilateral market power, an acquisition that significantly increases seller concentration in a market may lead to circumstances where coordination between firms in the market is enhanced. In particular, it can become rational for firms to refrain from initiating price cuts that would be unavoidable in more competitive circumstances, or alternatively to initiate price increases, in the knowledge that their competitors will do likewise. As a result, prices can become higher than they would in a more competitive market.

164. As in its assessment of the potential for an enhancement of the exercise of unilateral market power, the Commission considers existing, potential, and other factors such as the countervailing power of buyers in assessing the potential for an enhancement of the exercise of co-ordinated market power between the factual and the counterfactual.

165. The Applicant submitted that the proposed acquisition would be unlikely to result in any coordinated effects in the market for the manufacture and supply of MDF. Pricing forces would be unlikely to change in this market as a result of this proposed acquisition. In particular, according to the Applicant, the dynamics of import parity pricing will hinder the potential emergence of coordination.

166. As already noted, the Commission considers that the reduction in number of market participants from three to two, where in the Commission's view one is a non-aggressive competitor, may well change pricing forces in the national market for the manufacture and supply of raw MDF panels. Also, it has found that the threat of imports would provide very little, if any, constraint on the merged entity.

167. In this case, competition may be lessened as a result of the enhanced ability of the two remaining firms—the merged entity and Dongwha/Laminex—to coordinate their behaviour. This could occur either by each individually coming to a mutually profitable expectation as to coordination (tacit collusion), or by the two together reaching an agreement over coordination (explicit collusion).

168. This section covers the Commission's assessment of recent price changes, which was undertaken in order to understand current pricing behaviour in the MDF market, and to inform the Commission's view of likely pricing behaviour in the counterfactual. Subsequently, the Commission's assessment of the market characteristics facilitating or impeding coordination in the national market for the manufacture and supply of raw MDF panels is outlined.

Pricing in the Market

169. In 1994-95, the Commission investigated a complaint from [ ] of price fixing between domestic manufacturers of MDF under Part 2 of the Commerce Act. The Commission's investigation did not find evidence of a contract, arrangement or understanding that had the purpose or effect of fixing, controlling or maintaining MDF prices. However, it did find that MDF buyers were quick to notify the manufacturers of any price increase posted by a competitor. Moreover, if the market accepted one manufacturer's price increase, then it was likely that other manufacturers would follow by increasing their prices accordingly.

170. Such price-following behaviour was to be expected, given the industry characteristics found by the investigation. These were a high degree of concentration, an undifferentiated product offering, transparent supply terms and pricing, and a practice of suppliers issuing notifications of price changes weeks in advance. The Commission, in its investigation report, also stated that such market conditions lend themselves to outright price-fixing.

171. The Commission's investigation of this clearance indicates that the industry characteristic of similar price increases identified in 1994-95 continues today. MDF buyers observe that price increases tend to get notified by one manufacturer, and then the others tend to follow. Table 4 summarises the price increases notified by NPIL, CHH and Laminex in the last three years.

172. While it is accepted that prices may be increased at similar times because all three suppliers face the same cost increases, the Commission considers that the information in Table 4 shows evidence of potential price-following by suppliers. Price increases are not always exactly the same for all three suppliers, although they are very similar, and occur at similar times.

Table 4: MDF Price Increases

Notification Date	Effective Date	% Increase	Supplier
2005			
07/10/05	01/12/05	3.5%	NPIL
19/10/05	01/12/05	3-5%	CHH
2006			
07/07/06	01/09/06	3.75%	Laminex
01/08/06	01/10/06	3.75%	CHH
07/08/06	01/11/06	3.5%	NPIL
2007			
30/05/07	01/08/07	6-7%	NPIL
06/06/07	15/07/07	7%	CHH
04/07/07	01/09/07	7%	Laminex

Ingredients of Coordination

173. The Commission is of the view that where an acquisition materially enhances the prospects for any form of coordination between businesses, the result is likely to be a substantial lessening of competition. In broad terms, effective coordination can be thought of as requiring three ingredients: the possibility of increased profits through collusion: the possibility of detection of non-adherence; and the scope for retaliation.

174. Tables 5 to 7 outline the Commission's assessment of the market characteristics facilitating or impeding coordination in the national market for the manufacture and supply of raw MDF panels, using the analysis set out in the Commission's *Mergers and Acquisitions Guidelines*.

Table 5: Scope for Coordinated Market Power in the Factual

Factor	Commission Assessment
High concentration of sellers	Yes. The market is already highly concentrated, and the proposed acquisition would reduce suppliers from three to two.
Undifferentiated product	Yes.

Factor	Commission Assessment
Price inelastic market demand	The market demand for raw MDF panels in NZ appears to be quite price inelastic (we have seen rising prices, but no decrease in demand). This may encourage coordination, as price increases can be more profitable.
Entry by new firms is slow	No likelihood of entry within the timeframe for analysis.
Few fringe competitors	No fringe competitors or imports.
Loss of an aggressive competitor	Proposed acquisition removes the most effective competitor to NPIL.
Static production technology	Yes.
History of anti-competitive behaviour	The Commission has previously in 1994-95 investigated allegations of price-fixing between the domestic manufacturers of MDF, although did not find evidence of the necessary covert contract, arrangement or understanding.
Purchasers have countervailing power	Customers would have reduced countervailing power to constrain the merged entity in the factual scenario.

Table 6: Detection of Deviation from Coordination

Factor	Commission Assessment
High concentration of sellers	Yes. Two players. Sales gained by one would be lost by the other.
Frequent sales	New customers are infrequent. Customers place orders for varying quantities as and when needed. Suppliers try to forecast orders a few months in advance.
Stable, slow growth in demand	Market demand has been stable for a number of years.
Price transparency	Some. Suppliers send out price increase notifications to customers. Discounts and rebates offered by suppliers make actual prices paid by individual customers less transparent. However, customers may revela price offers in attempts to secure better deals.
Cost similarities between businesses	Likely. The manufacturers are exposed to the same changes in major costs (such as resins and wood fibre).
Multi-market contact	No.
Lack of vertical integration	The proposed acquisition by NPIL removes existing vertical integration within CHH. Laminex remains somewhat vertically integrated.

Table 7: Ability to Retaliate

Factor	Commission Assessment
Credibility of threats to abandon collusion and expand output should prices fall	Output expansion would require capture of rival's customers, and possibly output diversion.
Availability of excess capacity in hands of non-deviating parties	Yes. All participants have capacity that exceeds domestic demand (75% of output is exported).

Factor	Commission Assessment
Non-deviating parties have strong profit incentive to preserve the collusion	All parties have similar profit incentives.
Ability to disadvantage deviating business by dumping output in deviating party's market	While parties compete in the same market, a deviating party wishing to raise prices could easily be punished by the other coordinator taking its domestic or export market share by use of lower prices.

175. What is important is whether coordination is more likely, effective and stable in the factual than in the counterfactual. The Commission considers this to be the case. In particular:

- the proposed acquisition would create a duopoly of two competitors that would make coordination easier;
- NPIL and Dongwha/Laminex sell an undifferentiated product on which they could coordinate prices;
- with the elimination of CHH, there are unlikely to be any factors, such as another competitor, that would destabilise coordination; and
- demand appears to be price-inelastic, which enhances the scope for profitable price rises.

176. The Commission concludes that the scope for, and risk of, the coordination of pricing in the national market for the manufacture and supply of raw MDF panels would be significantly enhanced by the proposed acquisition.

Conclusion on Unilateral and Coordinated Effects

177. The Commission concludes that the proposed acquisition would significantly enhance the scope for the exercise of both unilateral/non-coordinated and coordinated market power in the relevant market.

OVERALL CONCLUSION

178. The Commission has considered the probable nature and extent of competition that would exist, subsequent to the proposed acquisition, in the national market for the manufacture and supply of raw MDF panels.

179. The Commission has also considered the probable nature and extent of competition that would exist in the same market in the likely counterfactual, which involves CHH's MDF manufacturing business being sold to a new entrant, thereby preserving the existence of three competitors.

180. In comparing the amount of competition expected in the factual with that expected in the counterfactual, the main competition factors bearing on the Commission's decision are as follows:

- the likely limited existing competition between the merged entity and Dongwha/Laminex in the factual, compared to the competition between CHH, NPIL and Dongwha/Laminex in the counterfactual;
- the threat posed by de novo entry or by imports would be insubstantial or non-existent in both scenarios; and

- the degree to which buyers could exercise countervailing power would be much reduced in the factual compared to the counterfactual.

181. Against this background, the Commission considers that the scope for the exercise of unilateral market power is likely to be enhanced by the proposed acquisition, relative to the counterfactual.

182. Further, the Commission considers that the scope for the exercise of coordinated market power is likely to be enhanced by the proposed acquisition, relative to the counterfactual.

183. Therefore, the Commission cannot be satisfied that the proposed acquisition will not have, nor would be likely to have, the effect of substantially lessening competition in the national market for the manufacture and supply of raw MDF panels.

DETERMINATION ON NOTICE OF CLEARANCE

184. Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission determines to decline to give clearance to Sumitomo Forestry Co Ltd for the proposed acquisition.

Dated this 20th day of March 2008

Paula Rebstock

Chair
Commerce Commission