COMPETITION TRIBUNAL
REPUBLIC OF SOUTH AFRICA

Case No: 23/LM/May01

In the large merger between

Schumann Sasol (South Africa) (Pty) Ltd

and

Price's Daelite (Pty) Ltd

REASONS FOR THE TRIBUNAL'S DECISION – NON-CONFIDENTIAL VERSION

Decision

1. The Competition Tribunal prohibited the merger between Schumann Sasol (Pty) Ltd (SCHS) and Price's Daelite (Pty) Ltd (PD) on 1 July 2001. The reasons for the decision follow.

The Proposed Transaction

2. Schumann Sasol (South Africa)(Pty) Ltd (SCHS), the primary acquiring firm, will acquire the entire issued share capital of Price's Daelite (Pty) Ltd (PD), the primary target firm. The shareholders of PD will transfer the entire issued share capital of PD to SCHS.

3. Schumann Sasol International Aktiengesellschaft holds 100% of the shares in SCHS. The ultimate holding company of the Sasol Group is Sasol Limited. SCHS does not have any subsidiaries.

4. The Leo Goodman Family Trust owns 62,6% of the issued share capital in PD. The Leo Goodman Family Trust also controls Cambridge Candles. PD has no subsidiaries but it does control Price's Candles (South Africa)(Pty) Ltd and Price's Candles (Natal) (Pty) Ltd.

5. SCHS previously disinvested from the candle manufacturing market in 1995 by selling its business known as Price's Candles to the Goodman family because, it avers, it wanted to end the situation of being both a major supplier and competitor in the same market as its customers.

6. The effect of the current transaction would be to return the parties to the situation that they were in before the Goodman family purchased Price's Candles from SCHS in 1995.

7. The transaction, according to the parties, is the unavoidable consequence of the financial situation of PD, which is heavily indebted to SCHS, and the unresolved disputes between the parties. The parties aver that the transaction is to be viewed as part and parcel of a settlement agreement resolving the disputes between SCHS and the Goodman family.

8. SCHS avers that post the transaction PD will continue operations as an independent subsidiary of SCHS with full profit and loss responsibility. Its Board will consist of the Chairman and the Managing Director of SCHS and the Managing Director of PD.[1] According to the parties SCHS will supply PD with wax on an arms length basis.

The Analysis

Vertical Mergers and Competition Law

9. We are evaluating a transaction between two firms in a vertical relationship: SCHS, the acquiring firm, supplies candle wax to the target firm, PD, a candle manufacturer. We emphasise this at the outset because our analysis will proceed cognizant of, and in general sympathy with, the characteristically permissive approach taken by anti-trust to vertical mergers, indeed to vertical agreements generally.

10. It is relationships between competitors – that is horizontal mergers (and horizontal agreements generally) - that tend to attract the immediate attention of anti-trust enforcement. Vertical arrangements do not, on the face of it, lessen competition in either of the markets in which the contracting parties are active. On the contrary, a strong body of opinion holds that vertical arrangements are frequently competitiveness enhancing, that is, far from diminishing competition, these arrangements actually enable the contracting parties to produce or distribute a

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1 After the conclusion of the hearings into this matter, SCHS tabled an alternate structure for the post-merger decision. In terms of this structure a holding company would be incorporated in South Africa with SCHS and PD reporting to the holding company. Although briefly discussed at the hearing, the details pertaining to the post-merger structure of the companies have not influenced our decision in any material respect.

better or lower priced product or service. In general then, it is argued, anti-trust proscription of these arrangements confuses the requirement to defend competition, with action essentially designed to defend competitors.

11. However, the Competition Act, in common with competition statutes elsewhere, does cover vertical mergers. It does so because it is widely recognized that, under particular circumstances, vertical mergers may impact negatively on competition. Alarm bells will sound where one or both of the parties to the transaction dominate the markets in which they operate.[2] We shall elaborate the reasons underlying these concerns below. Suffice to note that while a vertical transaction involving a dominant firm portends a variety of potentially anti-competitive outcomes, for the purposes of the present transaction it is the prospect of increased entry barriers[3] as well as the possibility of market foreclosure[4] and the related ability to raise rival's costs[5] that are of most immediate concern.[6]

12. It is frequently pointed out that the decision to integrate vertically is a business decision generally made to enhance the efficiency, the competitiveness, of the product or service brought to market. A manufacturer may, in order to secure a reliable source of input, or an improved input, freely elect to provide the input itself. By the same token, a manufacturer anxious to ensure effective distribution of its product, may freely elect to handle distribution itself rather than entrusting it to a third party. This argument is, for the most part, unimpeachable, but it still does not eliminate the necessity for regulating vertical mergers. By analogy, firms are encouraged to expand horizontally in their chosen markets through the pro-competitive provision of superior products but may nevertheless be restrained from expanding through merging with their competitors. By the same token, although a firm's, even a monopolist's, pursuit of 'internal' vertical integration may excite little anti-trust concern, there may nevertheless be solid anti-trust

2 William G. Shepherd, *The Economics of Industrial Organization*, 4th Edition, 1996, page 388 and on page 277 Sheppard states that "high market shares raise a presumption that the social costs of a vertical merger exceed the benefits."
3 The ease with which new firms can enter has been recognized as an important consideration in evaluating the ability of existing firms in a concentrated industry to increase prices above competitive levels. See Antitrust Law Developments Volume I (third edition) page 307.
4 Traditional foreclosure theory posits that a vertical merger may foreclose new entry at one level of production or service by eliminating potential purchasers or suppliers for a potential entrant and thereby making it necessary to enter at two levels in order to succeed – Antitrust Law Developments, fourth edition, Chapter IIIC, page 352.
5 Raising rivals' costs is described as a form of non-price predation carried out by raising rivals' supply cost, rather than the traditional predatory tactic of reducing their output price by flooding the market - *Understanding "raising rivals' costs"* by Timothy J. Brennan, Antitrust Bulletin Spring 1988.
6 For a summary of the economic consequences of vertical mergers and possible substantial impairments of competition arising from these transactions see Areeda, Hovenkamp and Solow – Antitrust Law Vol. IVA pp 142-144. In addition to foreclosure, price discrimination and increased entry barriers, they identify the following possible threats to competition arising from a vertical merger: supply preemption in times of shortage, the facilitation of horizontal collusion, the elimination of a large, aggressive buyer, and raising the cost of rivals

grounds for proscribing an attempt to integrate vertically through the merger process. Anti-trust scholars, Areeda, Hovenkamp and Solow, identify several reasons for adopting a less sympathetic approach to vertical integration through mergers than through internal expansion.[7]

13. What the literature does clearly reveal is that, as with much of anti-trust adjudication, the impact of a vertical merger on competition is acutely sensitive to the facts of the case. At the level of general principle, it is fair to say that vertical mergers raise fewer competition concerns and generates larger pro-competitive gains than their horizontal counterparts. On the other hand, it may be credibly claimed that vertical transactions in which one or both of the parties dominate their respective markets are liable to raise greater anti-trust concerns than those involving firms with relatively small market shares. But this does not take us very far – clearly the evaluation requires a detailed examination of the facts of the case in question and it is to this that we now turn.

The Relevant Markets

14. SCHS and PD are in a vertical supplier/customer relationship and the two relevant markets with which we are concerned in this merger are the supply of medium wax to the candle industry in South Africa (the 'upstream market'), and the production and marketing of household candles in South Africa (the 'downstream market'). Both SCHS and PD sell their products throughout the Republic. Note that both the Commission and the merging parties agree that the relevant product markets affected by this transaction are the market for candle wax and the market for household candles. They also agree that the relevant geographical market is South Africa.

The upstream market

15. SCHS produces and markets *hard waxes*, that are used in the hot melt adhesive, polymer processing and printing inks industries; *medium waxes*, that are mainly used in the candle manufacturing industry; and *paraffins*, that are used in the oil exploration, synthetic rubber and solvents industries.

16. Waxes may be divided into different groups based upon the oil content of their respective products with the lowest, fully refined paraffin wax, having an oil content of 0,5% and the highest, slack wax, with an oil content of 5-20%. The

7 These include, firstly, the relative ease of identifying and controlling mergers as opposed to internal expansion; secondly, the fact that even if a vertical merger is prohibited it remains open to the firm to achieve the same benefits through internal expansion; thirdly, internal expansion introduces new capacity and competition. This is likely to generate greater efficiencies because this new capacity will have to win its way in the market. Fourthly, a vertical merger, as opposed to internal vertical integration, is less likely to generate immediate economies in production because the plants are unlikely to be combined. (Areeda, Hovenkamp and Solow – Antitrust Law, Vol. IVA p.141)

higher the oil content, the softer the wax and the less suitable for producing candles.

17. Of the different waxes that can be distinguished in the industry, that is, fully refined paraffin wax, semi-refined wax, SCHS medium wax and slack wax, only a wax blended from a combination of slack wax and a better quality semi-refined wax, could be regarded as reasonably substitutable for the medium wax produced by SCHS, in order to produce candles. The medium wax produced by SCHS, which is used for candle manufacturing, is allegedly of a lower quality than the imported semi-refined wax. When the higher quality imported wax is used for candle manufacturing it is first blended with lower quality slack wax.[8]

18. The medium wax manufactured by SCHS is manufactured at Sasolburg, using raw material purchased from Sasol Ltd in Boksburg and slack wax from Shell, BP and overseas suppliers. This is a continuous process and the output, which is immediately suitable for use in the manufacture of household candles, must be removed from the factory because candle wax cannot be stored economically. If the wax cannot be sold to candle manufacturers, it must be "cracked" into fuel and sold at a lower realisable value.[9]

19. The estimated market shares of participants in the medium wax supply industry are SCHS 75%, Masterrank 8%, G Zabel 6%, Reach Industrial 6%, BP 5% and Shell 2%. Although some submissions claimed that SCHS's current share of the domestic market for household candle wax was considerably in excess of 75%, it is common cause that its share is no less than 75%.

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8 Although there is a price differential of approximately 11-15% between imported semi refined wax and medium wax, it was confirmed at the hearing that the former is of a higher quality than the latter and that, before use in candle production, the imported wax was 'extended' by blending it with slack wax, which is cheaper – thus the effective price of the imported wax that goes into local production (that is, after it has been blended with the less costly local slack wax) is not significantly above medium wax. Unless the costs of production of local medium wax, on the one hand, and the blended imported wax, on the other hand, are identical this would indicate that SCHS is pricing at import parity, a pricing strategy available only to monopolists (or, what is the same thing, colluding oligopolists).

9 It appears that this feature of the product dictates SCHS's preference for long term supply contracts with its principal customers in the downstream market. It has enjoyed such an arrangement with PD since 1995, the year in which SCHS sold PD to the Goodman family trust. It has a supply agreement in place with Willowton, the second largest candle producer – with a 13% market share – in South Africa. Note however, that contrary to the impression sometimes created, there is an alternate use for the wax – it may be 'cracked' into fuel– but it is a less commercially attractive use.

(i) Note that most of the competitors mentioned above – all, with the exception of BP and Shell – do not produce wax.[10] They import it and distribute it and account for approximately 20% of the local market. Imported, unprocessed medium wax is not subject to import duties. It appears that, for the most part, the share of imported wax used in the domestic candle market is a residual of that available from SCHS, that is, when SCHS does not have supplies of wax available candle manufacturers resort to the higher priced imported wax which they then 'extend' by blending with cheaper (because inferior) South African produced slack wax. Manufacturers of decorative candles – not part of the relevant market - use imported wax, the South African product not being suitable for this segment of the candle market.

The downstream market

20. PD produces and markets household candles, which consist of a pack of six white candles each weighing 75g or 450g in total. This candle market must be distinguished from decorative candles. . Candles may not be sold as household candles unless they comply with the specifications laid down in SABS Standard No. CKS60.

21. Although possible substitutes for candle-use include oil lamps (paraffin) and electricity the fact of the matter is that, at present, a large portion of the South African population, especially the very poor, still rely on candles for primary lighting purposes.

22. The estimated market shares of the five largest participants in the market for the manufacture and distribution of household candles are PD with 42%, Willowton and Cake Mills 13%, Morlite Industries (Buffalo) 11%, Boardman Brothers, t/a Newdons[11] 9% and Sealake Industries 7%. SCHS currently is the only supplier of wax to PD, Willowton and Cake Mills and Morlite Industries, which covers 66% of the household candle market.

23. South African manufacturers – both decorative and household candles - are protected from imports by a standard duty of 20% on imported candles. According to the parties imported candles, both decorative and household,

10 BP and Shell actually sell some of their slack waxes to SCHS as well as to the importers of wax for blending purposes.

11 However it alleges that it does not compete with PD because it is operates in a niche market -it uses higher quality imported wax, the candles have a smoother appearance and the packaging differs slightly.

account for only 8% of the candles distributed in South Africa.

24. The parties estimate that candle manufacturers are operating at 60% of their capacity.

The Act

25. The Act requires us to consider mergers in terms of section 12A, which states in subsection 12A(1):

‘Whenever required to consider a merger, the Competition Commission or Competition Tribunal must initially determine whether or not the merger is likely to substantially prevent or lessen competition, by assessing the factors set out in subsection (2), and –

a) If it appears that the merger is likely to substantially prevent or lessen competition, then determine -

i. Whether or not the merger is likely to result in any technological, efficiency or other pro-competitive gain which will be greater than, and offset, the effects of any prevention or lessening of competition, that may result or is likely to result from the merger, and would not likely be obtained if the merger is prevented; and

ii. Whether the merger can or cannot be justified on substantial public interest grounds by assessing the factors set out in subsection (3); or

b) Otherwise, determine whether the merger can or cannot be justified on substantial public interest grounds by assessing the factors set out in subsection (3).’

26. Section 12A(2) reads:

‘When determining whether or not a merger is likely to substantially prevent or lessen competition, the Competition Commission or Competition Tribunal must assess the strength of competition in the relevant market, and the probability that the firms in the market after the merger will behave competitively or co-operatively, taking into account any factor that is relevant to competition in that market, including –

a) the actual and potential level of import competition in the market;
b) the ease of entry into the market, including tariff and regulatory barriers;
c) the level and trends of concentration, and history of collusion, in the

market;

d) the degree of countervailing power in the market;
e) the dynamic characteristics of the market, including growth, innovation, and product differentiation;
f) the nature and extent of vertical integration in the market;
g) whether the business or part of the business of a party to the merger or proposed merger has failed or is likely to fail; and
h) whether the merger will result in the removal of an effective competitor.'

The Impact of the Transaction on Competition in the Relevant Markets

27. By any measure of concentration both SCHS and PD enjoy powerful positions in their respective markets. The Herfindahl-Hirschman index (HHI) that measures concentration and which guides anti-trust investigation and adjudication indicates significant market power in each of the markets in question with an HHI in the upstream market of 5786 points and in the downstream market at 2222 points.[12]

28. Furthermore, in the upstream market the single-firm concentration ratio (the C1 ratio) is exceptionally high at 75%. In the downstream market, the C1 ratio is also notably high at 42% and the C3 ratio (the three firm concentration ratio) is 66%.

29. Antitrust scholars Areeda, Hovenkamp and Solow observe that in the USA vertical mergers are unlikely to be challenged unless the HHI in the upstream market exceeds 1800, and a large percentage of the upstream product would be sold through vertically integrated retail outlets after the merger.[13] In this case SCHS, in 2000-2001, sold approximately [*this evidence is claimed confidential*] of its domestic wax supply to PD with whom it has a supply agreement.[14]

30. However, as with all vertical transactions, these measures of concentration and indicators of market power do not increase in consequence of the transaction and, hence, by these measures alone, competition cannot be said to have lessened.[15] The question that must rather be asked is whether the transaction allows the parties or one of the parties to prevent competition in the relevant market(s) thus maintaining or extending the anti-competitive structure of both or one of the markets[16].

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12 According to the U.S. Department of Justice and the Federal Trade Commission Horizontal Merger Guidelines HHI values below 1000 involve no significant monopoly power, whereas those above 1800 clearly do.

13 Areeda, Hovenkamp and Solow: Antitrust Law, Volume IVA p.168

14 It also sold, in the same year, approximately [*confidential information*] of its product to Willowton, its second largest customer, with whom it has a supply agreement.

15 See footnote 13 above.

16 Areeda, Hovenkamp and Solow, Antitrust Law Vol. IVA, p.137: "A vertical merger, standing alone, does not alter concentration … Accordingly, any anticompetitive effects of a vertical merger must arise from other structural or behavioral consequences such as increased entry barriers, the elimination of

31. As we shall elaborate, we find that the transaction prevents or lessens competition in the candle wax market, the upstream market, by raising barriers to entry in respect of that market. Furthermore, the transaction significantly increases the capacity of the merged entity to consolidate and extend PD's already powerful position in the downstream market. We will show that dominating the downstream market allows SCHS to protect its monopoly position in the upstream market for candle wax.

The Impact on Competition in the Candle Wax (upstream) Market

32. SCHS are major international producers of candle wax. The company clearly dominates the local market in the product. SCHS insists that its overwhelming interest is in the production of wax. It does not, it says, have a primary interest in the production of candles or in the price of candles except insofar as these impact on its ability to sell wax. In fact in 1995 it exited the local candle market when it sold Price's Candles to the Goodman family precisely, it avers, to avoid the conflict with its other candle manufacturer customers that was generated by SCHS's presence in both upstream and downstream markets.

33. SCHS's normal commercial interest in ensuring that its wax enjoys widespread support in the market is intensified by the nature of the product. Firstly, as already noted, wax cannot be economically stored. Secondly, it is a by-product of a larger chemical production process thus constraining, it appears, SCHS's ability to adjust, in the face of changes in demand, the supply of wax that it brings to market.[17] This has, it appears, dictated a particularly close relationship between supplier and customer manifest in, inter alia, exclusive supply relationships with its major customers, notably, in South Africa, with PD.

34. The security and stability of SCHS's relationship with its market has been disturbed by a conflictual relationship with PD, its major customer. A supply agreement between the parties has been in force since the sale of Price's to the Goodman family trust in 1995. The agreement essentially provides that PD shall procure the lion's share of its wax input from SCHS. It is permitted to source a small amount of wax from suppliers other than SCHS.

35. It appears, however, that relations between the parties have been fraught with

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non-integrated rivals by foreclosure, or the raising of rivals' costs".

17 Dr. Barth, the Chairman of SCHS, put it thus to the panel: "…I'm not so much interested as Schumann Sasol what happens to the candle price. I'm interested to my supply in wax and as we have stated earlier it's a continuous process and if we would say we reduce the manufacturing of wax for whichever period by even only 20% or 30% then that would have an immediate effect on the whole production of our Sasolburg plant because it's a continuous process and it's a process with complementary products, you either produce or you do not produce. You cannot produce only one product and not produce the others." (Transcript of hearing, 28 June 2001 pp.48-9)

conflict. The upshot is that PD has run up a significant trading debt with SCHS. SCHS has secured its debt by concluding a pledge agreement with the Leo Goodman Family Trust.[18] Moreover, it appears that there has been significant conflict between the parties regarding the terms of the contract and the performance of the contract. These conflicts had been referred to arbitration. The Tribunal has not been provided with details of this conflict. Suffice to say that immediately prior to arbitration SCHS offered, in exchange for settlement of all disputes between the parties and outstanding debt, to acquire PD from the Goodman Family Trust.

36. This, as outlined above, is the origin of the transaction before us, one that has been presented by the parties as the inevitable outcome of a commercial relationship gone sour and of a company, SCHS, attempting to settle a conflict with its contracting partner and to exercise its security rights. From the perspective of a major creditor, this presentation of the transaction is perfectly plausible. However, from a competition perspective, it must be given a somewhat different cast, one supported by other concerns articulated by the parties.[19]

37. From a competition perspective the transaction is to be viewed as the action of a producer intent upon defending or extending its market share. This motivation is unimpeachable at competition law. Indeed it is, or may be, the very stuff of competition *as long as the mechanism for achieving that objective is the provision of a superior or lower-priced product.* Our task is to ensure that this otherwise laudable objective is not realized through an anti-competitive mechanism.

38. Consider, again, the background: the dominant player in a market is faced with, what appears to be endemic conflict with its major customer. At stake is the potential loss of that customer – it may seek an alternate supplier or it may exit the market altogether. The normal commercial concern that would inevitably accompany that threat is exacerbated by the nature of the product, by, in other words, the imperative to maintain the level of output and to ensure that the output is consumed as soon as it is produced.

39. This situation is ripe for competitive entry into the candle wax market. And there

18 The Leo Goodman Family Trust pledged its shareholding in PD to SCHS as security for amounts owing under the wax supply agreement.

19 The parties have effectively suggested that the financial ties between the parties – dominated by PD's debt to SCHS – necessitate subjecting this transaction to a lower competition standard than that accorded another transaction. This plea has no merit. We must naturally base our decision on the competition perspective, on the impact of the transaction upon competition. The transaction may make perfect sense from a private commercial perspective but we must still confine ourselves to the competition perspective and to the other factors – efficiency gains and public interest - specified in the Competition Act. Expressed otherwise the Competition Act does not permit us to suspend or dilute our standards of evaluation because one of the parties to a proposed transaction seeks relief, through merger, from the consequences of an imprudent or unfortunate business decision.

are potential competitors on the horizon. There are no tariff barriers and international competition, particularly in the form of Chinese imports, already has a toehold in this market. Moreover, it appears that Shell, a potential alternate supplier of a competing wax product, has recently resolved some significant technical problems at its Malaysian refinery and is eyeing the local market. This is, quite understandably, a situation in which any producer would feel acutely vulnerable, all the more so one with the technical constraints faced by SCHS.

40. In the event that PD survives, there exists the real possibility that it may change its allegiance to another supplier, the more so if the arbitration allows it to escape its obligations under the supply agreement. If, on the other hand, PD fails then a large portion of the candle market is unaccounted for. It may be taken up by imports, by new entrants or by producers currently active in the market, producers who have not entered into supply agreements with SCHS. Both of these scenarios are immensely threatening to SCHS's interests, a threat significantly exacerbated by the nature of the product. As Dr. Barth, the Chairman of SCHS, eloquently expressed it at the Tribunal hearing: "Please imagine just for a moment that the candle industry would decide for 2 months period to buy Chinese wax instead of Schumann Sasol wax."

41. From a competition perspective it is this consideration that has driven SCHS's decision to acquire its largest customer. When PD's custom is secured, it, together with the supply agreement with Willowton, secures for SCHS the lion's share of the South African wax market. There are other mechanisms for achieving SCHS's objective, but they carry a greater risk of failure. The pro-competitive mechanism preferred by competition law is through the provision of a better or less expensive product. Supply agreements along the lines of that between SCHS and PD is another option. However, as Mr. Barth expressed it "the experience which we made with the selling the business in '95 to the Goodman family, would not be an argument in favour of trying to do that again."[20]

42. From SCHS's perspective then the immediate virtue of the acquisition – its narrower financial considerations aside – is that it secures a share of the candle wax market that is not subject, as in the PD situation, to the vagaries of a disputed contract and to the possibility of hold-up by its largest customer. However, from a broader competition perspective it ensures that SCHS's competitors are reduced to the role of bit players participating at the fringes of the market. They are excluded from the largest part of the market in an area of production subject to scale economies and in which the respective participants – the supplier and customer – place a high premium on certainty of supply and demand. Their only way of entering the upstream candle wax market would be to enter, simultaneously, the downstream candle market. But this is unlikely to happen.

20 There are also indications in the SCHS submission to its supervisory board that it feared that the supply agreements would not pass muster with the competition authorities.

Like SCHS, they are not candle manufacturers and, in a market where there is already one dominant candle producer, one owned, moreover, by the dominant competitor in the candle wax market, this approach is fraught with risk. Under the circumstances the competitors are likely to accept their bit player status.

43. Confined to the fringes of a monopolized market, the presence of competitors does not represent a threat to SCHS. Quite the contrary, they perform a useful function, and this is precisely why the supply agreements permit the candle manufacturers to purchase a small share of their candle wax from alternative suppliers. As already noted at length, SCHS's technical constraints do not permit it to fine tune its production levels, to adjust output to short run spikes and troughs in demand. In this circumstance the presence of fringe suppliers is useful – they can be competed with in demand troughs for the fringe of the market; and they can help order the market when demand spikes thus allowing SCHS to avoid having to introduce additional capacity that may not find available demand in down periods. In response to Shell's re-entry at the fringes of the market Dr. Barth noted that its presence "will then also balance the supply and demand situation so that situations as we had in the past (where) we are not able to meet additional demands for product will then not be repeated." The entry of a competitor, even a potentially formidable competitor, is welcomed in the firm knowledge that SCHS's acquisition of the largest candle manufacturer ensures that its competitor remains confined to the fringes. [21]

44. We must, in concluding our finding on entry barriers in the candle wax market, respond to one other argument advanced by the parties. It is argued that SCHS already has its dominant position secured by the supply agreements with PD and Willowton. Hence, the argument continues, the acquisition does not disturb the *status quo*; it does not raise already high entry barriers. We are not persuaded by this argument. A contractual agreement is not immutable. The very proof of that - if any is needed – is provided by the relationship between PD and SCHS. Moreover, even well functioning contractual relationships provide for termination and are subject to re-negotiation and this at least allows a potential entrant to contemplate a substantial presence in this market. As important, it forces the incumbent to contemplate a competitor entering the market. This potential is precluded by the acquisition. Accordingly, the acquisition lessens the potential for competition; it indeed prevents competition, by raising entry barriers above those present as a result of the supply agreement.

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21 Note that participants who are compelled to operate in this manner at the fringes of the market are compelled to absorb most of the risk of market fluctuation. As Areeda et. al observe "A risk is a kind of cost, and a firm that faces higher risk must customarily pay more for capital, and must charge higher prices during strong demand periods to make up for increased losses during weak periods of shortage. To that end, the ability to shift the risk to rivals effectively raises their costs" (Areeda et al p. 181). Note too the evidence of considerable 'churning' (that is rapid entry and exit) of firms at the fringes of the market. This of course increases the risk assumed by wax producers reliant upon this end of their market for their custom.

45. The Commission has proposed that this transaction be approved subject to the imposition of certain conditions. None of the conditions proposed will overcome the heightened entry barriers in the market for candle wax. In fact, the Commission confined its considerations and concerns to the candle market and it does not appear to have considered the transaction's impact on the candle wax market despite having identified this as one of the markets affected by the transaction. We have not been able to devise conditions designed to cure the effect of the transaction on entry barriers in the candle wax market.

The Impact on Competition in the Household Candle (downstream) Market

46. The Commission expressed the view that the proposed deal would diminish competition in the household candles market should the transaction be approved unconditionally. An unconditional approval, in the Commission's opinion, would lessen the number of participants in the candle production and distribution market in future in what is already a concentrated industry. Future competition, i.e. new entry, could be adversely affected if not totally eliminated. In addition, the Commission provide evidence establishing that, in the past, many new entrants found it impossible to survive in the market place. In the Commission's view the proposed transaction would not only make new entry highly unlikely, but the potential restriction on competition and anti-competitive practices that could flow from this transaction could also force existing participants, mostly small to medium-sized firms, from the candle production and distribution market.

47. As already indicated, SCHS insists that its overriding interest is in the candle wax market. It denies that it has primary designs on establishing a dominant position in candle manufacturing. Far from that being the case, it insists that it is cognizant that its interests as a manufacturer of candle wax (the upstream market) are in potential conflict with a presence in the downstream candle market and that this will temper any prospect of anti-competitive behaviour on its part in that latter market. In support of this contention it points to its withdrawal from candle manufacturing in 1995 and insists that its re-entry into the business of manufacturing candles was forced upon it by its fraught relationship, concretely including its financial relationship, with PD and the likelihood of that company's imminent demise.

48. We will however demonstrate that, from the perspective of the interests of SCHS, the wax producer, there is, nevertheless, considerable incentive for the merged entity to extend its powerful position in the downstream market, the candle market. And we will then show that this transaction provides the wherewithal for an anti-competitive response to that incentive. In other words, we have demonstrated above that, despite its powerful position in the candle wax market, SCHS has strong grounds for feeling vulnerable to potential entry into this

market. The acquisition by SCHS of PD, its largest customer, is, we have found, a mechanism for shoring up its dominance of the upstream market by raising barriers to entry in that market. By the same token, SCHS's imperative to defend its dominance in the upstream market provides the incentive for anti-competitive behaviour in the downstream market and the transaction provides the means for pursuing that conduct.[22] We emphasize that SCHS is not hereby discouraged from defending its market share in candle wax provided it achieves this through the pro-competitive mechanism of a superior product. We are simply enjoining a mechanism – the merger – that will permit the realization of this objective through anti-competitive practices in either of the affected markets.

49. SCHS has consistently maintained that it has no interest in favouring its prospective subsidiary, PD, over its other customers. It points out that although PD consumes approximately [*confidential information*] of SCHS's medium wax supply, it must still, particularly given SCHS technical constraints, ensure the loyalty of the remainder of its customer base. This imperative, it avers, predisposes it against anti-competitive practices directed at PD's competitors who remain important customers of SCHS.

50. The Commission has sought to bolster this assurance by recommending the imposition of the following conditions on the transaction, designed to prevent SCHS from discriminating in favour of PD relative to that of its competitors in the candle market:

    (i) *The primary acquiring firm is reminded that at all times it shall comply with the provisions of Section 8 and Section 9 of the Competition Second Amendment Act;*
    (ii) *SCHS must at all times adhere to the principles of transparency and non-preference in supplying candle manufacturers with wax;*
    (iii) *SCHS will not refuse to sell wax directly to any potential purchasers. However, if a single transaction is in respect of less than 100kg, SCHS may refer such potential purchaser to a retailer of wax;*
    (iv) *In the event of production shortages, the available wax would be proportionally supplied to all customers. SCHS must apply generally accepted trade standards (i.e. an equitable method of supply) that would not give preference to Daelite in these periods of shortages;*
    (v) *SCHS shall not give any confidential rebates or other advantages to Daelite;*
    (vi) *SCHS may only apply price differentiation and other differential treatment as provided for in Section 9 of the Competition Second*

22 Although at opposite ends of the technology spectrum, this is remarkably similar to the conclusion of the US Appeals Court in its much quoted recent decision in the Microsoft case: "Microsoft's efforts to gain market share in one market (browsers) served to meet the threat to Microsoft's monopoly in another market (operating systems) by keeping rival browsers from gaining the critical mass of users necessary to attract developer attention away from Windows." - U.S. v. Microsoft Corp. decided on 28 June 2001.

Amendment Act, and then only if such differential treatment is economically justifiable.

51. We are, however, not persuaded by this recommendation. In our estimation, should SCHS believe that its share of the candle wax market, the upstream market, is threatened by a possible tie-up between an alternative supplier of wax and one of the smaller producers of candles, its dominance of the upstream market combined with its powerful position in the downstream candle market will enable it to consolidate its position in the latter market precisely in order to maintain the already significant barriers in the upstream market that have, as we have demonstrated above, been consolidated and extended by this transaction.

52. Note that this does not necessarily presuppose that the upstream firm engages in unlawful restrictive practices of the sort contemplated by the Commission's proposed conditions. PD in the downstream market is accorded a massive anti-competitive advantage by the mere fact that SCHS, its parent in the upstream market, has intimate, direct and immediate knowledge of the production capacities and output levels of all PD's competitors in the downstream market, including knowledge of fluctuations in their demand for wax (which, in turn, is directly derived from the demand for their candles). In other words, SCHS may behave quite lawfully in relation to its customers – it may refrain from discrimination, from withdrawals of supply, or from foreclosure. However, its vantage point as the dominant supplier of the critical input in candle manufacturing accords it privileged insight into the capacities and strategies of its downstream subsidiary's competitors. The conditions proposed by the Commission do not restrain this and nor do we believe that it is possible to achieve this through the creation of artificial 'fire walls'.[23]

53. Moreover, while the conditions may limit the ability of SCHS to engage in discriminatory practices that favour PD they clearly do not limit PD's ability to engage in other anti-competitive practices. One example is predation. A number of submissions suggest that PD has already engaged in this practice. A counter-

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23 The US Federal Trade Commission recently considered a vertical transaction between the Ingram Book Group and Barnes & Noble, respectively the largest wholesaler and retailer of books in the United States. The transaction appears to have been withdrawn at the 11th hour while the FTC was considering behavioural remedies broadly similar to those proposed by the Commission in this matter. Richard Parker and David Balto, two FTC officials, comment as follows: 'The only remedy that might have addressed the situation is a set of behavioral rules—essentially a set of non-discrimination or 'fair dealing' provisions. But those kinds of rules can be problematic. They are susceptible to evasion and difficult to monitor, particularly in a transactional setting where discrimination could be exercised in subtle ways on several different variables. While the (Federal Trade) Commission has on occasion accepted some form of behavioral relief in mergers, those approaches may not have worked in this context. Recall the Supreme Court's admonition in *DuPont* (United States v. E.I. du Pont de Nemours & Co., 366 U.S. 316 (1961)) that "the public interest should not in this case be required to depend upon the often cumbersome and time-consuming injunctive remedy" to enforce behavioral rules "- *The Evolving Approach to Merger Remedies by Richard G. Parker & David A. Balto, published in Antitrust Report (May 2000)..*

argument, and one that is borne out by the allegation that predation has already occurred, is that the transaction does not enhance PD's ability to predate – its ability to predate was given by its pre-merger market power and this has not increased in consequence of the merger. However, there is little question that the ability to predate is substantially enhanced by the deep pockets of a powerful shareholder, particularly one that may be willing to take significant losses downstream in order to defend its dominance in an important upstream market.[24]

54. Our concerns in this regard are confirmed by submissions that indicate that enhanced domination of the candle industry is already part of SCHS's game plan. In a submission made by Morelite, PD's largest competitor in Gauteng, it was averred that in a meeting held in September 2000 between representatives of SCHS and Morelite, the former outlined his company's intention to acquire PD and then to transform the other candle manufacturers into distributors of PD manufactured output. This claim was denied by SCHS at the hearing. Moreover, on the morning of the hearing Morelite informed us that it had reached an accommodation with SCHS – the precise nature of which was not placed before us – and that it accordingly withdrew its objection to the transaction. However, the submission to SCHS' Board of Directors confirms the Morelite account.[25] We should add that this interpretation was not denied by SCHS (although the meeting with Morelite was denied). It sought rather to downplay the significance of this (confidential) statement by suggesting that it simply reflected discussions regarding the long-term future of the candle industry.

55. It was also pointed out that entry barriers into candle manufacturing are relatively low. We accept this – it is borne out by evidence of new entry. . We note however the extremely high rate of attrition or exit. It appears then that while entry requires relatively little technological sophistication or capital, it is nevertheless difficult to sustain. This is not surprising. Simply put it is difficult to sustain a presence in a market in which the largest participant has a 42% market share and the three largest share 66% of the market. The fact that the largest player is owned by the dominant supplier of the key input renders this market particularly inhospitable. It suggests that, at best, new entrants into the candle market will, as with new entrants into the candle wax market, have to content themselves with the fringes of their market thus posing no competitive threat to the dominant players.

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24 The parties have insisted that they have not been found guilty of restrictive practices in the past and that we cannot make our decision on the basis of an inference of future conduct. We cannot, it is insisted, engage in speculation about the future; we must rather concern ourselves with evidence from the present. We do not understand this argument. Merger regulation is, in significant part, inherently speculative - it is pre-emptive insofar as it designed to ensure that the merger proposed does not give rise to a market structure that lends itself to restrictive practices. It is our view that the market structure that will emerge from this transaction does lend itself to a number of restrictive practices, including predation, not all of which can be forestalled by the imposition of conditions.

25 This evidence is borne out by a confidential statement.

56. In sum then, we conclude that the transaction before us enables SCHS to maintain and extend its dominant position in the market for candle wax. Furthermore, should SCHS deem it necessary to further secure its position in the upstream market by extending its powerful position in the downstream market then this too is facilitated by the transaction. Accordingly we find that the transaction will substantially lessen or prevent competition in both markets in question.

A failing firm

57. Section 12A(2)(g) of the Act enjoins us to consider "whether the business of part of the business of a party to the merger or proposed merger has failed or is likely to fail." The parties have raised the failing firm defense.[26] In effect, they argue, as they are entitled to do, that the prospective failure of PD, the target firm, justifies the application of a lower anti-trust standard to this transaction. The merger, they claim, is necessary to ensure PD's continued presence in the market. Absent the merger, PD will fail. In that event, a significant competitor will have been removed from the market - competition will have been diminished in consequence of the failure of this competitor, more particularly if the productive capacity represented by PD's material assets exits the market altogether. Under these circumstances – that is, if the firm (and, more so, its assets) exits the market - competition will actually have diminished thus exerting upward pressure on candle prices.

58. We should, at the outset, indicate a plausible alternative scenario in the event of PD's demise. There is, it is common cause, considerable excess capacity – 40% is the figure given – in this industry. Moreover it is common cause that that there is relative ease of entry into candle manufacturing, the downstream market. It is, in our view, eminently plausible that, upon PD's exit, its existing competitors will, through utilizing their spare capacity, increase their output and compete for a share of PD's erstwhile market. Equally, new firms may enter the market, possibly availing themselves of those of PD's material assets that come onto the market. Indeed SCHS itself has insisted that it will enter the market should PD

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26 Anti-trust jurisdictions differ in the way in which they treat the failing firm defence. The concept originated in the United States where it provides an absolute defense to a finding that a merger will substantially lessen competition. It was first recognized in International Shoe Co. v. FTC, 280 U.S. 291 (1930). Because it provides an absolute defence its requirements are rigorous and difficult to meet. Also see the 1992 US Merger Guidelines. The EU in Kali-Salz/MdK/Treuhand, Case IV/M308 [1994] 0.J. L186 has broadly followed United States v. General Dynamics Corp., 415 U.S. 486 (1974) in dealing with the failing firm defence. With regard to Canadian merger law Paul S. Crampton in his book *Mergers and the Competition Act*, 1990 in footnote 59a on p.408 quotes the Competition Authority in the Wadair/PWA merger indicating that "In assessing the failing firm factor in mergers that are otherwise considered to be substantially anti-competitive, the Director requires information relating to two issues: 1) the extent to which failure is, in fact likely to occur; and 2) whether there are alternatives to the merger that would be less restrictive of competition."

fail.[27] On this scenario competition will actually intensify in the wake of PD's failure. Moreover, the relative resilience of PD's competitors will have been rewarded by the market share that they will gain as a result of the very process of competition.

59. However, the 'failing firm' is a term of art in merger regulation and it is incumbent upon us to examine the criteria commonly used in assessing the salience of the failing firm defence in this case. We do however insist that, as in most anti-trust assessments, the facts of the specific case will take precedence over the application of a derived formula. In our view the existence of considerable excess capacity is a salient fact that militates against the prospect of a shortfall in supply, and therefore upward pressure on price, in the wake of failure.[28] We nevertheless will reflect on the range of tests and criteria conventionally employed to assess the impact of potential firm failure on the competition implications of a merger.

60. First, is PD failing? According to the parties: " PD is demonstrably insolvent".[29]

61. There is little doubt that PD's financial predicament is dire. We should note that we do not understand, nor have the parties or the commission shed any light upon, how a firm with significant market share in a mature industry has landed in this sorry situation. It has not, after all, been derailed by a new innovation to which it has not had access. The Commission claims that the firm's auditors believe that the firm sold by SCHS to the Goodman family in 1995 was already in trouble. Others suggest that PD has been pricing below cost, presumably cushioned by a steady supply of loan capital from SCHS. The Goodman's allege that PD has been prejudiced by SCHS failure to adhere to the terms of the supply agreement. SCHS implies that management failure accounts for the firm's predicament.

62. None of these various allegations and explanations has been satisfactorily supported by evidence. However, an understanding of the causes of PD's failure is pertinent for two reasons: In the first place, it is not clear how SCHS intends post merger to address the cause of PD's possible failure and, as we shall

27 SCHS suggests that the fact that it will enter the market should PD fail is further evidence that prohibiting the transaction will make no difference to the competitive structure of the market. Regardless of whether the transaction is approved or prohibited, we will have a vertically integrated firm participating in the market. We do not accept this argument. SCHS is, of course, perfectly entitled to vertically integrate through internal growth because in order to do so it will have to compete for its share of the downstream market in much the same way as a firm is entitled to expand horizontally, even to monopoly, as long as it achieves this by competing. Merger regulation is meant to prevent the attainment of an anti-competitive position through means other than competition.

28 The parties have acknowledged this argument but insist that this will only take place with a considerable time lag – eighteen months was suggested. During the intervening period there will be a shortfall in demand. However with a large proportion of unutilised capacity already in place and relative ease of entry, we cannot understand why there should be such a slow response in a situation of excess demand.

29 This is substantiated by evidence, which is claimed confidential.

demonstrate below, this has bearing on the merger evaluation, particularly on the question of countervailing efficiency gains resulting from the transaction as well as its impact on public interest. Moreover, failure, if it is to occur, will happen at the behest of SCHS, immeasurably the largest creditor. It appears that PD's failure could have been triggered by SCHS at any time over the last several years.

63. Unless we understand why the firm has been unable to survive profitably, it is difficult to understand why SCHS should trigger liquidation now rather than 12 months ago or, indeed, rather than 12 months hence. One possible inference is that SCHS has chosen to subsidise a captive, though inefficient, customer in preference to instability (read, competition) in the market for its candle wax. If this is so then SCHS has reaped the consequences that protection so often begets: increasing inefficiency matched by increasing subsidy. It should not expect the competition authorities to rescue it by sanctioning the ultimate protective umbrella, namely full vertical integration, regardless of the impact on competition. In short, while we believe that PD is in dire straits, we are not certain whether its failure is necessarily imminent – that will depend upon SCHS's continued interest in protecting the company.

64. Secondly, has there been any attempt to find an alternative suitor for PD, one that raises fewer competition concerns than SCHS? SCHS makes the plausible argument that few buyers would be willing to assume PD's massive debt. However it appears that there has been a concerted attempt to find a buyer for PD. Note that this search has specifically excluded other South African candle manufacturers. SCHS avers that they have been excluded in part because it was calculated that a horizontal transaction would not have received competition approval. SCHS has also made it emphatically clear that it would not welcome a situation where it was beholden to a single large customer. The absence or presence of willing buyers is, for the most part, a function of price – this is after all not a new untested product; its market and mode of distribution is well known and relatively predictable. The price of PD is largely a derivative of the extent to which SCHS is willing to assume the target company's debt. SCHS is proposing to purchase PD for a nominal sum because it has effectively been willing to write off its massive debt in exchange for vertical integration. Should it be willing to do the same in respect of other purchasers then alternative offers may come to the fore.

65. Thirdly, is there any prospect of re-organising PD? That is, is there any prospect of PD surviving without the merger? As we shall elaborate when we discuss the prospect of countervailing efficiency gains, little has been said about the prospects of raising PD's performance. We are accordingly unable to answer this question. SCHS, though revealing few details, believes that it is capable of turning around PD. It is not clear why it cannot achieve this without first merging. SCHS has argued that it has been in effective control of PD since 1998 – if it is possible to

restore PD's fortunes through the adoption of pro-competitive strategies then surely SCHS should be able to achieve this from its present position without resorting to the expedient of an anti-competitive merger.

66. Fourthly, what will happen to PD's market share? The Commission errs by asking where PD's market share will go post-merger. Clearly, it will go to the acquiring firm, SCHS, or, technically, it will remain with PD now controlled by SCHS. However, what is pertinent is what will happen to its market share post-failure? If it can be shown that the acquiring firm (SCHS) will simply mop up the target firms (PD's) market share post-failure then there is, it is argued, little point in prohibiting the merger because the impact on market shares in the downstream market will be identical – either way, the acquiring firm will take the target's market share. However as we have demonstrated above the post-failure outcome is by no means clear because there will be several competitors contending for PD's market share including existing participants in the candle market and possibly new entrants, including SCHS itself.

67. Finally, what will become of PD's assets post failure? We have already suggested that the pertinence of this question is eroded by the existence of significant over-capacity. On the evidence the most likely outcome is that certain of the assets, to the extent that they are divisible, will be acquired by new entrants, while others may find their way out of the country. However, in the context of considerable excess capacity we do not believe that the market will be characterized by a significant supply shortfall post-failure.

68. In summary, we find that the failing firm defence does not support approval of this transaction. First, it is not clear that the firm will actually fail despite its parlous circumstances. Secondly, the extent of excess capacity in the industry and ease of entry suggests that the competitive situation will not deteriorate in consequence of the exit of PD (or its assets) – quite the contrary, we are likely to see an intensification in competition. Third, if SCHS has a pro-competitive strategy for reviving PD's fortunes it is not clear why this cannot be pursued through means other than the merger. Finally, while we are persuaded that SCHS and PD have sought alternative purchasers, the success of their search will, in a relatively stable industry, depend on price and that, in turn, will depend on the quantum of PD's debt that SCHS is willing to assume – it is the only purchaser because it has only been willing to write off its own debt in exchange for complete vertical integration. [30]

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30 Expressed conversely, through writing off its debt (that is, through assuming PD's debt) SCHS has effectively demonstrated its willingness to pay a premium price for PD – the inference is that it is willing to pay this price because, through vertical integration, it secures dominance of the markets in question. Other purchasers would not be willing to pay this price – or, assume this level of debt – because they would not be able to reap the anti-competitive benefits of vertical integration. However, at a more realistic price, one that reflected simply the cost of acquiring a significant candle manufacturer, alternative purchasers may well be available.

Pro-competitive Efficiency Gains

69. Are the anti-competitive consequences of the transaction countervailed by pro-competitive efficiency gains?

70. The Commission points out that SCHS has not specified efficiency gains arising from the transaction aside, that is, from a blanket assertion that these are assured by the injection of SCHS's superior management and financial resources. We have already pointed out that SCHS's financial resources have long been at PD's disposal and these have not apparently improved the latter's competitive position. We have also noted that SCHS's financial resources may plausibly give rise to anti-competitive predation rather than a pro-competitive resolution of PD's predicament.

71. SCHS has, in fact, only proposed one concrete strategy for alleviating PD's plight.[31] Note that there is no certainty that PD's competitors will respond to this strategy by taking market share from PD. Certain of PD's competitors have already intimated that PD has been pricing its output below cost. Under these circumstances a more plausible scenario is that they will accept price leadership from PD – in that event PD's competitors will similarly seek to enhance their profitability by hiking their own prices in a market in which the price elasticity for the product is, given the absence of ready substitutes, likely to be low.[32] Given a C1 ratio of 42% and a C3 ratio of 66% price leadership would be extremely likely.

Public Interest

72. There are three public interest factors that must be assessed in this transaction. These are export competitiveness, small business and employment.

73. SCHS has asserted that it will focus on penetrating export markets. However, we have not been told how this will be achieved and no further weight is given to this bland assertion. It is certainly not clear that a successful export strategy requires the merging of SCHS and PD.

74. We concur with the Commission that small business is, if anything, promoted by

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31 Evidence to this effect is born out by a statement in the Submission to the Board of Directors of SCHS for settlement with Goodman Family, which is a confidential document.

32 Refer to *The Economics of Industrial Organization*, fourth edition by William Shepherd, p.261 where the author points out that concentration, homogeneity of products, stable industry conditions, and long familiarity among firms favours tacit collusion, of which price leadership is one form. Also see Areeda and Turner, Antirust Law, Vol.V, p.230 where they mention the three grounds on which the largest firm might become a price leader, one being that the largest might be thought the wisest or at least the more knowledgeable about industry prospects and trends.

prohibition of the merger. Low entry barriers lend themselves to an active SME presence. Indeed this is a rare case where SMEs seem to have succeeded in maintaining and, it appears, extending their market share, while the only large firm in the industry has floundered. As we have outlined PD's travails may constitute a golden opportunity for SMEs already active in the industry to consolidate and advance their own interests. On the other hand, protecting PD by allowing it to integrate with SCHS may well be the route for realizing one of SCHS's stated alternative strategies of converting existing small and medium-sized candle manufacturers into distributors of PD product.

75. Finally, we must consider the impact on employment. SCHS avers that, absent the transaction, PD will fail and 315 workers will lose their employment.[33] As we have pointed out, there is no certainty that PD will fail despite its parlous circumstances. Second, if, in the event of failure, PD's assets are acquired by a new entrant, certain of these jobs may be restored. Thirdly, we are not told how SCHS will re-organise production in order to restore PD's competitive position – this process inevitably entails job loss and we have not been provided with estimates of this. Indeed, one of SCHS's expressed alternative re-organisation strategies is to relocate the PD operation to Sasolburg and this will, in all likelihood mean that the present employees, who are, for the most part, employed through a labour broker, will lose their employment.

76. We accordingly conclude that the impact on public interest does not outweigh the anti-competitive consequences of the transaction. It should be borne in mind that it is the poorest consumers who consume candles – accordingly, the public interest loss would have to be considerable and certain in order to justify us approving an anti-competitive merger.

18 July 2001

D.H. Lewis **Date**

Concurring: M. Holden and U. Bhoola

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33 This figure includes 45 full time employees, 1 temporary employee, 3 independent contractors involved in sale and 267 persons employed through labour brokerage.