total of $ million on advertising and promotion.[77] Dulux therefore spends around cents per litre of paint (million litres per annum)and up to per cent of its sales on advertising ($ million per annum)

Bristol

6.139. Bristol indicated that in 1995 they spent $ million on television advertising alone, $ on radio advertising and $ on print media advertising. Bristol thus spends around cents per litre of paint (million litres per annum) on advertising. With sales figures for paint at $ million this is equivalent to per cent of sales revenue.

6.140. It is evident from the above figures that there is a minimum level of advertising required to promote a brand nationally. As this is essentially a fixed cost, the viability of establishing a national brand depends upon the size of the manufacturer. As such, the need to undertake extensive advertising and promotion in order to establish and maintain a nationally recognised brand is a significant barrier to expansion in the architectural and decorative paint market.

6.141. Advertising and promotional expenditure is a sunk cost that can not be recouped if entry is not successful. A new entrant often has to spend more than an incumbent to generate the same level of sales if the incumbent's previous advertising has generated brand loyalty.

6.142. Wattyl claims that advertising educates consumers and stimulates interest in the product. The Commission agrees that advertising can assist consumers in their purchasing decisions if it provides information about the product's attributes and availability. At least some advertising of paint is likely to serve this purpose given consumers' imperfect knowledge of paint characteristics. However, advertising can also be used to develop brand loyalty by enhancing product differentiation. As a result, the sensitivity of demand to changes in price is reduced. This impedes the ability of new entrants to gain market share by undercutting incumbents' prices.

6.143. It is evident from the discussion above, that much of the advertising of architectural and decorative paint is persuasive in nature. In particular, advertising and promotion establishes brand recognition and loyalty which differentiates the various manufacturers' products. This differentiation is especially high between nationally recognised brands and their regional counterparts and has two effects. First, it lowers the price elasticity of demand for the three large manufacturers' paints and thereby reduces the degree to which smaller manufacturers' products are competitive substitutes. This enables the major manufacturers to maintain price premiums relative to the smaller manufacturers and dilutes the ability of the smaller manufacturers to constrain the large manufacturers' conduct. Secondly, it increases the difficulties that smaller manufacturers face in seeking to expand their operations.

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[77] Dulux confidential submission.

6.144. Wattyl agrees that advertising a particular brand might attract a consumer into a store. However, it claims that consumers can be directed to other brands, particularly high-margin house brands, by retailers. This would reduce the impact of brand awareness as a barrier to entry and expansion. The Commission acknowledges market studies that suggest that consumers often seek assistance from retailers when purchasing paint. In providing such assistance, retailers might attempt to switch a consumer to a higher margin housebrand. There is, as discussed, some consumer resistance to housebrands because of their perceived lesser quality. Furthermore, housebrands' share of the market does not support the argument that retailers' influence over consumers' paint purchase decisions are sufficient to fully undermine the impact of brand loyalty. In addition, performance targets contained in trade depot agreements and the availability of rebates from list price in return for achieving sales targets reduces the incentive for retailers to engage in so-called 'bait and switch' activity.

Access to shelf space

6.145. The success of a new entrant is dependent upon its ability to access retail shelf space. Most paint resellers have limited capacity to stock a new brand without discontinuing or reducing a brand currently stocked. Resellers incur substantial costs if they switch from one supplier of paint products to another. Similarly, many resellers have reduced the number of brands stocked. These factors limit the ability of new entrants to access shelf space. This trend was noted by Schafer Business Services in their report dated May 1996 where it is stated:

> For any smaller manufacturer or new entrant to seriously challenge the national market shares of Dulux or Wattyl they have to convince national retailers to stock their range. As Taubmans have found over the past few years national retailers are critically reviewing their shelf space productivity and their cost of doing business and this process has resulted in a reduction in the number of suppliers to these retailers. Both Big W and K Mart have reduced down to a full range of Dulux product supported by Wattyl timber finishes and Solagard exterior paint with their own Housebrands to provide the price point choice. The Bunnings group are major stockists of Dulux product carrying the Dulux, Berger and Walpamur brands along with a select range of Taubmans and Wattyl products. BBC has continued to be a full line stockist of Dulux and Taubmans along with selected Wattyl and smaller manufacturers products.
>
> The point here is that the trend has been very clearly to reduce ranging down to one only full range national brand. Taubmans has been losing out because it is seen by the national retailers to only have a premium image in the interior broadwall paint market. The following table illustrates the national market leadership position of the major product segments.

	Interior	**Exterior**	**Timber**
No 1	Dulux	Dulux	Wattyl
No 2	Taubmans	Wattyl	Cabots (Dulux)

Source: SBS

6.146. The importance of brand awareness is reflected in resellers' choice of stock. A high degree of national brand recognition is the most important factor[78] when

78 Markowitz & McNaughton Report, op. cit.., p. 14, for details see their customer opinion report.

selecting which paints to stock and devote shelf space to.[79] Resellers prefer to purchase products which have a nationally recognised brand and seek to ensure that products can be purchased on a national level.[80]

6.147. The mass merchants, for example, stock almost exclusively the major manufacturers' brands. K Mart sources most paint from Dulux and Target sources almost exclusively from Taubmans. Mass merchandisers primarily support the leading national brands because their stores are located throughout Australia and their customers are typically brand sensitive.[81] Such merchandisers offer little if any technical advice to assist customers in their choice of paint. They therefore rely on the product to 'sell itself'. As consumers cannot evaluate the quality of paint before purchasing it, the product will only 'sell itself' if it has a widely recognised brand which conveys information about the paints' characteristics.

6.148. Although hardware stores provide a higher level of customer service, this segment is still mainly concerned with brand awareness and brand strength. This is one reason why nationally recognised brands are sourced.[82]

6.149. Similarly a national brand is important for the paint specialists to carry as such brands attract customers to the store.[83]

6.150. Large hardware retailers such as BBC or Bunnings or mass merchants such as K Mart organise both television and catalogue advertising for their network of stores on a national basis. They need nationally recognised brands to feature in this advertising.[84] Those resellers have been increasingly rationalising the number of suppliers and product lines held.[85] In some cases, only a high volume, strongly supported brand is carried. Unless a manufacturer has a major recognised brand in the marketplace, it could face deletion from such stores.[86]

6.151. Access to retail shelves might be gained by a new entrant if it is able to win tenders to supply house brands. Such tenders are generally called for every one or two years by resellers. House brands are not generally supported by advertising and promotion. Therefore, their supply is attractive to smaller manufacturers who do not have the resources to engage in extensive marketing activities. However, housebrand contracts will generally be offered to suppliers who offer the lowest price. The larger manufacturers enjoy cost advantages arising from economies of scale. Consequently, most of the major housebrand accounts are held by either Dulux, Wattyl or Taubmans. Furthermore, smaller manufacturers might be constrained in their ability to supply the volume of paint required by a particular housebrand contract. White Knight, for example, supplies housebrand paints to the

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79 Ibid., p. 30.
80 Ibid, p.14.
81 Ibid., p. 12.
82 Ibid., p. 11.
83 Ibid.
84 BBC - Confidential Submission.
85 Schafer Report, op. cit., p.14
86 Ibid.

Paint Place and Mitre 10. It is not, however, the sole supplier of housebrands to either of these resellers.

6.152. Production of housebrands might lower the entry threshold. Ultimately, however, a new entrant would need to develop a recognised brand in order to be a significant competitor. As discussed above, loyalty to existing brands is an additional barrier to entry and expansion.

6.153. A further obstacle to securing shelf space is the need to provide promotional material such as colour cards and to provide on-site technical support to non-specialist paint resellers. Smaller suppliers find it difficult to match the full range of promotion and support services currently provided by the major manufacturers. This point was discussed in relation to advertising costs.

Vertical arrangements between paint manufacturers and paint resellers

6.154. As discussed in Chapter 3, each of the major manufacturers have entered into trade depot agreements with a substantial number of independent specialist stores. In addition, each of the three majors operate company owned trade stores.

6.155. These arrangements, and the vertical ownership lines, are a substantial barrier to the entry of new suppliers and to the expansion of the small suppliers of architectural and decorative paint. This is discussed in some detail separately in the section on Vertical Integration which appears later in the Chapter.

Countervailing power: s.50(3)(d)

6.156. Countervailing power exists where a supplier (buyer) faces a buyer (supplier) with market power or a credible threat of vertical integration or direct importing. In such cases the ability of the merged firm to increase (decrease) prices may be constrained and the likelihood of a substantial lessening of competition diminished.

6.157. The Commission recognises that mass merchandisers, corporate hardware and other buying groups may be able to exert some counterweight to the market power of the major manufacturers. It appears, for example, that such groups are able to negotiate higher discounts from list price than independent resellers. However, none of these groups are sufficiently large in their own right to provide a significant constraint on the large manufacturers.

6.158. The parties claim that the top nine resellers of architectural and decorative paints account for approximately 90 per cent of all retail paint sold, (which is less than half of all such paint sold when trade sales are considered). The market shares by volume and value of architectural and decorative paint for the five main categories of paint resellers are shown in Tables 6.10 and 6.11.

Table 6.10.: - **Market share by volume, %, decorative or retail paint**

Corporate Hardware e.g. - BBC, Bunnings, Hudson Hardware, Hardware & General	18
Hardware Groups and Independent Hardware e.g. - Mitre 10, Home Hardware, Thriftilink	30
Mass Merchants e.g. - Kmart, Big W, Target	11
Manufacturer Owned Stores e.g. - Dulux, Wattyl, Taubmans, Bristol	11
Paint Specialists e.g. - 3D Group, Your Local Paint Place	30

Source: Schafer Report[87]

Table 6.11 - **Market share by volume, %, architectural and decorative paint**

Corporate Hardware	6.5
Independent Hardware	14.0
Mass Merchants	6.4
Manufacturer owned stores	50.0
Paint Specialists	11.6
Dealers[a]	11.7

a Most dealers supply paint on the account of the major paint manufacturers
Source: Taubmans' submission, Attachment 9
NB: Figures do not total 100 due to rounding

6.159. While hardware stores and paint specialists are the largest resellers of decorative paint; not even the largest paint reseller would account for more than 5 per cent of architectural and decorative paint sales. The demand side of the paint industry is highly fragmented when contrasted with other industries, for example, groceries, where four companies account for nearly all grocery sales in Australia. Furthermore the major paint manufacturers also have a significant presence in the direct sale of paint through their trade centres. Trade sales represent around 55 per cent of the architectural and decorative paint market. The stores owned by Wattyl, Taubmans and Dulux sell only to trade buyers. On this basis, it can be estimated that these stores represent between 60 and 70 per cent of trade sales.

6.160. The Commission also considers it unlikely that resellers would import paint in significant quantities given the impediments to imports discussed above. Furthermore, while the applicants' economic advice suggests retailers could

87 Ibid., p. 10.

possibly enter the industry in their own right,[88] no evidence has been provided to suggest that resellers would integrate backwards into manufacturing, particularly where many paint resellers sell a range of products in addition to paint.

6.161. Similarly, as paint resellers must stock a widely recognised brand in order to be competitive, they would be unable to switch to alternative suppliers other than Wattyl or Dulux for substantial quantities of their paint requirements.

6.162. Therefore, the Commission does not consider countervailing power to be sufficiently strong in the market for architectural and decorative paint such that the acquisition would not lead to a reduction in competition.

Impact on prices and profit margins: s.50(3)(e)

6.163. The parties claim that the merger will generate efficiency gains from rationalisation and economies of scale which will be passed on to consumers because of the strengthening of competition with Dulux. In support of this view, Wattyl points to the acquisition by Dulux in 1993 of the Cabots range of clear and wood stains from Kenbrock Timber Finishes Pty Ltd. Wattyl claims that since the acquisition Cabots' products have been marketed aggressively by Dulux. As a result, Wattyl has been forced to reduce the price differential between its own range of clear and wood stains and the Cabot's alternative. Therefore consumers have benefited from this acquisition.

6.164. The Commission accepts that the acquisition by Dulux of the Cabots range has made that range a more effective competitor to the Wattyl alternative. This is because Kenbrock was not an effective competitor prior to the acquisition. In particular, as a small manufacturer it would not have been able to afford the considerable amount needed to develop a well recognised brand. As a result, Wattyl was able to maintain a high market share despite charging a price premium of around 20 per cent. Following the acquisition, Dulux had the resources to devote to developing the Cabots brand name. As a consequence, its substitutability with the Wattyl product rose and Wattyl was forced to reduce its price premium in order to retain market share.

6.165. A key difference between the current acquisition and that of Dulux/Cabots is that both Wattyl and Taubmans are currently effective competitors to Dulux and with each other. Therefore there is no reason to expect that price competition will increase following the acquisition. Indeed, a reduction in price competition is more likely to be the case. Furthermore, competition limited to one product type is unlikely to have the dramatic consequences for profits that would flow from aggressive competition across a full product range between two large suppliers of equal market share. Finally there is a large share of sales of clear and woodstains which is not accounted for by Dulux and Wattyl.

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88 Dr. Cousins, op.cit., paragraph 14.6.

6.166. As is well recognised in antitrust assessments, as Wattyl/Taubmans more closely replicate the market position, cost structure, product range and strategies of Dulux, the two are more likely to recognise their interdependence and their interest in not entering into costly price competition. Cooperative behaviour reduces economic efficiency. Thus there is a trade-off between the potential efficiency gains arising from rationalisation, and the potential efficiency losses arising from a reduction in competition.

6.167. The expectation of less price competition after the merger is consistent with market evidence discussed in Chapter 5 which indicated that all paint manufacturers believe there will be no price war following the acquisition. Many thought the merged firm and Dulux would raise prices.

6.168. Mr Boshell's internal report to the Board of Wattyl, dated 14th July 1995 (provided by Wattyl through discovery) also indicates clearly that one of the reasons for Wattyl's acquisition of Taubmans is to restore or at least not erode margins:

> ..In theory the use of the established TT brand would give Wattyl credibility as a broad wall paint supplier and the shelf space it otherwise would have to buy, almost certainly at low margins. ...
>
> In many ways this cost of advertising has limited the number of competitors and enabled Dulux and TT to achieve reasonable margins. With Wattyl becoming increasingly prepared to finance its entry into this large market sector, margins have begun to erode. If Wattyl did not acquire TT this situation would continue as a non Wattyl ownership of TT would retain the status quo. ..

6.169. The applicants' economic advice suggests the proposed acquisition will enhance competitive pressure on Dulux. This assessment is rather equivocal. Furthermore it relies, in part, on the expectation that retailers could be expected to exploit new opportunities to extract lower prices from manufacturers and would in turn pass these savings on to the final consumer to ensure that end-users benefit from any such rise in competition at the manufacturing level.[89] This view seems at odds with the evidence. In particular, as discussed in Chapter 5, a number of retailers contacted were in favour of the merger because they believed it would help stabilise prices. None saw it reducing prices. Furthermore, most retailers contacted stated that they would pass any price increase on and several trade painters advised that any price increase or diminution in terms would have to be passed onto the customer.

6.170. It is interesting to note that some retailers favour the merger because they expect it to stabilise prices, an outcome which is likely to be to the detriment of consumers and inconsistent with the argument that competition will rise after the merger. Such stabilisation would enable retailers to increase their own margins and thus benefit directly from the reduction in competition at the manufacturing level. Higher margins, would in turn be passed on to end-users.

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[89] Ibid., paragraph 21.

6.171. Already, there are indications of attempts by manufacturers to stifle price competition. For example, in August 1995, Taubmans introduced a new advertising policy which is outlined below:[90]

1. Customers of Taubmans agree that they will not advertise (outside of the premises of in any media) any Taubmans branded products in such a way that the price can be determined. If a Taubmans branded product is to be advertised, then the price being charged or any discounts applicable must not be included. Any advertising of Taubmans branded products that displays a price at which the product is offered must be restricted to within the premises of the customer.

2. Our customers agree not to display Taubmans' names nor the names of any Taubmans branded products in such external advertisements than in any way may give the impression that paints being advertised at a certain price are Taubmans branded products.

3. Our customers agree that neither Taubmans' name nor the names of any of Taubmans branded products will be featured in advertisements as a free offer or reward for certain minimum quantities purchased. For example, while it is in order to offer "a free roller with every four tins of Living Proof purchases", it would conflict with our policy to offer "a 4L tin of Living Proof free with every four tins purchased".

4. This policy is not intended to exclude the use of statements such as "We are the cheapest in town for Taubmans" or "Our prices for Taubmans are too low to quote" or similar. It simply excludes mention of specific prices or discounts in advertisements featuring our products.

5. In order for this policy to be successful, it must be universally applied by all of our customers. Therefore, we would not be in a position to continue to supply any customer who is unable to operate within the terms of the policy.

6.172. Taubmans Advertising Policy was brought to the Commission's attention in September 1995 after was denied supply of Taubmans' products for advertising in the .

6.173. Courtaulds provided the Commission with the following rationale for the advertising policy:[91]

> Courtaulds Australia has for some time been concerned that our Taubmans branded product has been consistently advertised by retailers at prices cheaper than competitive brands of equal or lesser quality. It is our belief that this practice has the effect of denigrating our brand and creating a false impression than Taubmans products are of lower quality than our competitors' brands. We therefore decided to adopt a policy of requiring our resellers not to advertise prices for Taubmans products, except in-store. This policy is being supported by an advertising campaign intended to promote consumer awareness of the quality of the products sold under the Taubmans brand. We believe that an increased awareness of the quality of Taubmans products will result in an increased demand for our products, enabling resellers to increase their sales.

6.174. Advertising prices is one way of informing consumers of the availability of paint and is conducive to price competition. However, it is clear that Taubmans' advertising policy is aimed at removing discounting of Taubmans' paint by resellers. In this manner, it reduces price competition and enables retail margins to stabilise to

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90 Taubmans Advertising Policy, Effective August 1, 1995.

91 Letter from Mr David Forder, Business Manager, Taubmans Architectural Coatings to Mr Patrick Jeffers, Commission, dated 6 October 1995.

the detriment of consumers. As discussed previously, market stabilisation is an outcome that many retailers expect post-merger. An extract of a facsimile dated 18 July 1995 from Barrier Reef Mini Zone Members to Leon Kurop Mitre 10 (Northern) regarding Taubmans' new pricing policy highlights the pricing benefits that retailers expect to flow to them from stabilisation of the market, in this case from Taubmans' advertising policy.

> The Mitre 10 and True Value members of the Barrier Reef mini-zone would like to go on the record as fully endorsing and supporting the recent decision taken by Taubmans with regards to their policy of non-advertisement of price on their paint range. .....We believe that this is a brave step for Taubmans but that ultimately the Mitre 10 and True Value members will benefit immensely from it. Whilst the primary reason given by Taubmans, for this policy, is to curb what they perceive to be a diminishing acceptance of the quality of their product, bought about by the low pricing policy of some retailers in the market place, the benefits of the policy in terms of the increased prices which will now be able to be achieved in store is quite obvious. In fact, the way we see it, the only losers in this will be the mass merchants that get in and prostitute the price on any item, quality or not, and thereby ruin our market.
>
> If all retailers agree to the policy and adhere to it then we believe that other paint manufacturers will follow suit in due course. In the meantime, Taubmans has lead the way in taking positive steps to regain some profit margins on their product, ultimately benefiting themselves and us, the retailers, and combating the category killers and discounters, whilst at the same time regaining consumer confidence in the quality of their product. ...

6.175. Taubmans' internal correspondence also provides support for the view that the advertising policy reduces price competition and increases retail margins. For example in a letter from Taubmans to Mitre 10 Southern Region, Mr Dubb, General Manager of Taubmans stated:

> I believe that our advertising policy will prove to be of great benefit in regard to driving up margins in the retail market.[92]

6.176. Not all of Taubmans' customers were initially willing to implement the advertising policy. Some customers were concerned that it may constitute a breach of the Act whilst others claimed that the policy was contrary to their company's policy of always advertising prices in catalogues. However the Commission's inquiries indicate that all customers, with the possible exception of , have implemented the policy.

6.177. The Commission also believes that other paint manufacturers have adopted, or are considering adopting, similar policies. In a Taubmans' memorandum it was stated that:[93]

> ...whereby Dulux field sales people wanted to make trouble for Taubmans in the market place because of (the) new advertising policy on price...the official direction from senior Dulux management is to do and say nothing here. They intend to see if (Taubmans) can enforce this policy and if it works for us they will do the same.

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92 Memorandum from Mr Richard Dubb to Mr Lew Celle, Mitre 10 Southern Region dated 18 September 1995.

93 Memorandum from Mr John O'Neill, Retail Sales Manager to Mr Richard Dubb, General Manager, Taubmans Architectural Coatings dated 8 August 1995.

6.178. A further Taubmans' memorandum reports that Dulux implemented a similar type of advertising policy with the Paint Place Group.

6.179. The following extract from Wattyl Sales Representative Monthly Sales Report-Retail Division, September 1995 (provided by Wattyl through discovery) also suggests that Wattyl recognising the desirability of stabilising retail prices:

> Amazing Paints strike again - $40.95 and a FREE 1 litre. What can you do-you talk to store to keep pricing at a sensible level and this sort of thing lands in you lap-why should my stores believe me-I am afraid the days of me talking pricing re Solagard are over-I give up, the blame lies solely at the feet of the retailer and I will not keep beating my head against the wall until it bleeds!

6.180.

However, Taubmans is vertically integrated into the sale of architectural and decorative paint through its company owned trade centres and trade depots. Therefore a contract, agreement or understanding between Taubmans and other paint retailers which would have the purpose, or be likely to have the effect, of fixing controlling or maintaining the price of architectural and decorative paint would prima facie be in breach of section 45.

6.181. The Commission's views as to the likely effect of the proposed acquisition on prices is reinforced by the lack of effective import competition and the height of barriers to entry to the market. Furthermore, there is little evidence that existing suppliers or resellers would be able to constrain the exercise of Wattyl/Taubmans' and Dulux's market power; indeed this conclusion would be contrary to the weight of evidence and the implications to be drawn from Wattyl's stated reasons for acquiring Taubmans. For example, as outlined in Chapter 5, the more significant of the smaller manufacturers indicated that their activities had little prospect of restraining a price increase by Wattyl and Dulux post-merger. The smaller manufacturers also indicated that they do not believe they could constrain Wattyl's or Dulux's pricing post-merger, as they do not effectively do so now. Furthermore, most market inquiry participants thought that in the event of a post merger price rise, all lesser manufacturers would follow the price rise.

6.182. In addition, the proposed merger will lead to a reduction in industry excess capacity, and in particular, for Wattyl. The Commission has previously expressed concerns about price movements that followed the 1988 merger between ICI and Berger/British paints. The applicants' economic advice stated that:

> These movements as measured by the Australian Bureau of Statistics data, followed a period when prices had been reduced to unquestionably low levels as companies sought to retain market share in a market subject to substantial excess capacity.[94]

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[94] Dr Cousins, op. cit. paragraph 14.8.

6.183. One of the stated aims of the proposed acquisition is to rationalise excess capacity. Furthermore, it has been stated that Taubmans' current position is unsustainable. Thus the current merger has similarities with the 1988 merger. The applicants' economic advice provides no reassurance that the outcome of this merger, in terms of pricing, will not be similar to the earlier merger.

6.184. Indeed, the reduction in excess capacity reduces one of the key obstacles to coordinated behaviour. Furthermore, Dulux will retain its existing excess capacity. This means that it has the capacity to retaliate if Wattyl attempts to reduce prices following the merger. By removing Taubmans as an effective competitor, prices and profits are likely to be higher than they would be absent the merger.

6.185. The Commission's concerns about the effect of the merger on prices are highest in the retail sector. Customers in that market are brand sensitive and more reluctant to switch to an alternative supplier if their preferred supplier exercises market power by raising price. While trade customers may have a higher willingness to switch suppliers they are still influenced by brand awareness. Therefore, this group is also likely to face higher prices. Furthermore, if either category of customer is dissatisfied with their previously preferred supplier, they will have an effective choice of only one other national supplier post-merger rather than the existing two.

Availability of substitutes: s.50(3)(f)

6.186. The elasticity of supply, either in terms of alternative products that may be used or the capacity of existing suppliers to quickly expand output , will have a material impact on the extent to which prices may be raised post-merger if Wattyl or Dulux seek to exercise market power.

6.187. In this regard, the applicant's economic advice concludes that:

> There are many alternative materials to paint ranging from wallpaper and timber to bricks and glass. These provide some element of competition which should be recognized even if they are not sufficiently close to include in the same market.[95]

6.188. However, no evidence has been provided of the extent to which such products are substitutes for paint; nor does the advice indicate in what way such products might impose a relevant competitive constraint. The Commission considers the weight of evidence in respect of the product market is that there are no close substitutes for architectural and decorative paints.

6.189. More importantly the advice also refers to the potential for existing producers to increase output due to the excess capacity in the market:[96]

> Excess production capacity, exacerbated by on-going improvements in productivity, is another significant characteristic of the industry which acts to enhance competition. When excess capacity exists, output can be increased at relatively low cost as many of the plant costs will not change. This provides an incentive for firms to cut prices to encourage sales especially when their profitability is low. (see F.M. Scherer, Industrial Market Structure and Economic Performance, Second Edition, 1980 page 208 for discussion of the impact of excess capacity on competition). Capacity rationalisation has been assisted by frequent mergers in the paint industry.

6.190. The anti-competitive consequences of a concentrated market structure might be undermined if the supply elasticity of smaller manufacturers is high. Some regional paint manufacturers do have the capacity to expand production. This suggests that post acquisition, such smaller players may have a limited capacity to expand production, which may tend to defeat any attempted exercise of market power. While these participants have the physical capacity to expand quickly, their success in doing so is likely to be limited by the brand recognition of existing players. Difficulties in accessing retail shelf space combined with the network of company owned stores and trade depot agreements also places significant constraints on the ability of smaller market participants to expand output quickly. On the demand side, the significant differentiation of products between the minor and major manufacturers also reduces the ability of the small manufacturers to defeat an exercise of market power. Furthermore, several other producers, including Bristol, are in fact operating at near full capacity.

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[95] Ibid., paragraph 14.5.
[96] Ibid.

Dynamic characteristics: s.50(3)(g)

6.191. The total volume of paint products sold in Australia has not increased significantly since 1992. Future growth is expected to largely parallel the growth in the economy.

6.192. As mentioned previously, some resellers have rationalised the number of brands that they stock. If this trend continues, it will exacerbate the barrier to entry arising from difficulties in gaining access to shelf space.

6.193. It is also expected that the warehouse hardware concept will continue to develop in Australia. Current examples are BBC's Hardwarehouse and Bunnings Warehouse. Such resellers have a preference for national brands in order to convey a price/quality image to their customers. If this expected outcome eventuates, the importance of brand recognition will be highlighted. This will raise the already high barrier to expansion caused by the need to supply a well recognised brand.

Removal of a vigorous and effective competitor: s.50(3)(h).

Taubmans

6.194.

6.195.

Its market share has declined slightly but is still at a level which suggests that it is an effective and vigorous competitor. Furthermore, while Taubmans has recently lost market share, its current share is not at an historically low point (see above discussion on market concentration). This suggests that Taubmans remains a viable business and that its current difficulties are attributable to management decisions rather than competitive pressures.

6.196. The Commission's recent inquiries indicate that most retailers consider Taubmans to be an effective competitor because of its strong brand and quality product. Many also indicated that service levels and promotional support had improved. In addition, Taubmans supplies paint across the entire range of architectural and decorative paint products.

6.197. The Commission has reviewed Taubmans' strategic direction over the past few years.

6.198.

6.199. While there is substantial evidence that Taubmans has undergone a slide in its competitive profile over the past few years, the above analysis, and the market place perception, suggests this is more to do with strategic settings and Courtaulds desire to exit a non-core business than any lack of ongoing viability of the business.

6.200. Even over the past few years, Taubmans has continued to be an effective and vigorous competitor, although not supported by strong promotion. Furthermore, and contrary to the submission of Wattyl and Taubmans, much of that competition has been head to head with Wattyl. A few examples from the evidence are useful to illustrate the point.

6.201. In September 1995, Mitre 10 Southern Region made a decision to de-range Taubmans products from the majority of its stores in Victoria and Tasmania after a long association with Taubmans spanning many years. The Taubmans range of products was replaced with the Wattyl range of interior and exterior products. Wattyl's Ceramacoat replaced Taubmans Living Proof Silk as one of the core range products.

6.202. In a letter dated 12 December 1996 Mitre 10 Southern Region made the following observations:

> You would be aware that we called for tenders from Dulux, Wattyl and Taubmans and after much analysis and deliberation we have decided to run with Dulux and Wattyl as our two major National Premium Paints to be complemented by Accent and Viva in our own brands (NB: Accent is currently manufactured by Taubmans whilst Viva is manufactured by Wattyl).
>
> Unfortunately this will result in Taubmans products being de-ranged in the majority of our stores and no longer being supported by this Region's marketing programme.
>
> However with our outlook fixed firmly on the long term future, we believe that Wattyl can provide the impetus required to support our already substantial efforts to project Paint Shop and Mitre 10 as a major player in this difficult market. Your brand has not experienced real growth in this Region for a number of years and we were certainly disappointed with its performance in the last year in comparison to the overall growth we achieved in all our other brands.
>
> It is therefore even more difficult for us to accept that there will be a major turnaround which we require in the short term as your overall advertising spend on projecting the brand to the market will not be substantial in comparison to other brands. Coupled with this has been the withdrawal of $100 000 in marketing allowance support to this Region, together with your new "non priced" advertising policy. All these factors left us believing that we would have a real challenge in trying to gain the growth which we required out of the brand.
>
> As we look back on the history of the management of the Taubmans organisation in recent years, it has certainly been chequered with a long line of different personnel appointments, especially at senior management level. Unfortunately this has resulted in a Stop/Start effect

> on the company's direction and outlook which in turn has not installed a great deal of confidence in the people at this office or at store level.
>
> As part of the overall review process we conducted an extensive survey of our stores in which we asked them to assess the performance of our major paint companies and brands. The results of this survey highlighted to us that our then current core range strategy which included Taubmans was not being fully supported. Stores strongly reported that the product was not readily selling due to poor customer demand. This low customer demand is coupled with a reluctance on behalf of many of the store to actually push the product and create sales for the brand.

6.203. In late 1994, Taubmans won the account to supply the Target chain nationally from Wattyl. Wattyl had previously supplied Target with the full range of premium, three quarter and budget lines of architectural and decorative paints. Taubmans Proof products replaced the corresponding Wattyl products in all Target stores. Taubmans' range of wood stain products also replaced Wattyl's woodstain products. Taubmans agreed to replace all Wattyl woodstain stock in Target stores with Taubmans Timber Proof and Clear Proof Range on a two for one deal. Taubmans also agreed to take back the remaining Wattyl stock from Target stores after a run-out sale on the product by Target. Taubmans acquired the remaining Wattyl stock from Target and sold it on their own account in the market place. The value of the account in terms of litres of paint was approximately   litres per year in the 1994/95 financial year. The Target account remains one of Taubmans' largest accounts.

6.204. An internal Taubmans memorandum, dated 7 August 1995 (which was provided to the Commission through discovery) outlined the views of Dulux towards Taubmans as communicated to Mr John O'Neill, a Taubmans Sales Manager.

6.205. Mr O'Neill stated that previously Dulux had believed that Taubmans had 'lost the plot' in the market place as regards to both trade and retail activity, as well as appearing to be 'going under'.

6.206. Mr O'Neill asserts that Dulux had since revised its view of Taubmans and now saw the company 'as a serious threat'. The main areas of concern were Taubmans':

- increased national media coverage;
- colour selector offer, cheat sheets, colour cards, POS (point-of-sale), etc.;
- better margins than equivalent Dulux products; and
- success with its product Evencover which was 'hurting' Dulux's share of the budget market place.

6.207. Mr O'Neill also reported that Dulux believes that Taubmans are the 'ones to beat in the market place' because of Taubmans' media advertising, which 'is creating a demand that retailers can meet' and better margins.

6.208. Mr O'Neill's personal belief was that Taubmans was slowly gaining ground at the expense of Dulux and other companies and he could not see any reason why this should not continue.

6.209. Furthermore, Taubmans has remained throughout the uncertainty of the last few years, one of the strongest competitors in the trade sector.

6.210. By way of example, an internal Taubmans' document, reviewing its position in the supply of paint in the trade sector, contained an assessment of the top 25 trade accounts in Canberra. Twelve of those accounts were as follows:[97]

Table 6.13.: **Assessment of the top 25 trade accounts**

Rank	Painter	Comments
1.		Supports Taubmans well
2.		Share with Dulux
3.		Share with Wattyl
5.		Dulux trying on prices
6.		Share business with Wattyl and Dulux
8.		Share with Dulux
10.		Share with Wattyl
16.		Armawall Products. Share with Wattyl
17.		Share with Bristol
18.		Share with Dulux and Wattyl
22.		Share with Dulux
24.		Share with Dulux

Source: Taubmans submission

6.211. The remaining 13 accounts were all noted as held by Taubmans on its own account.

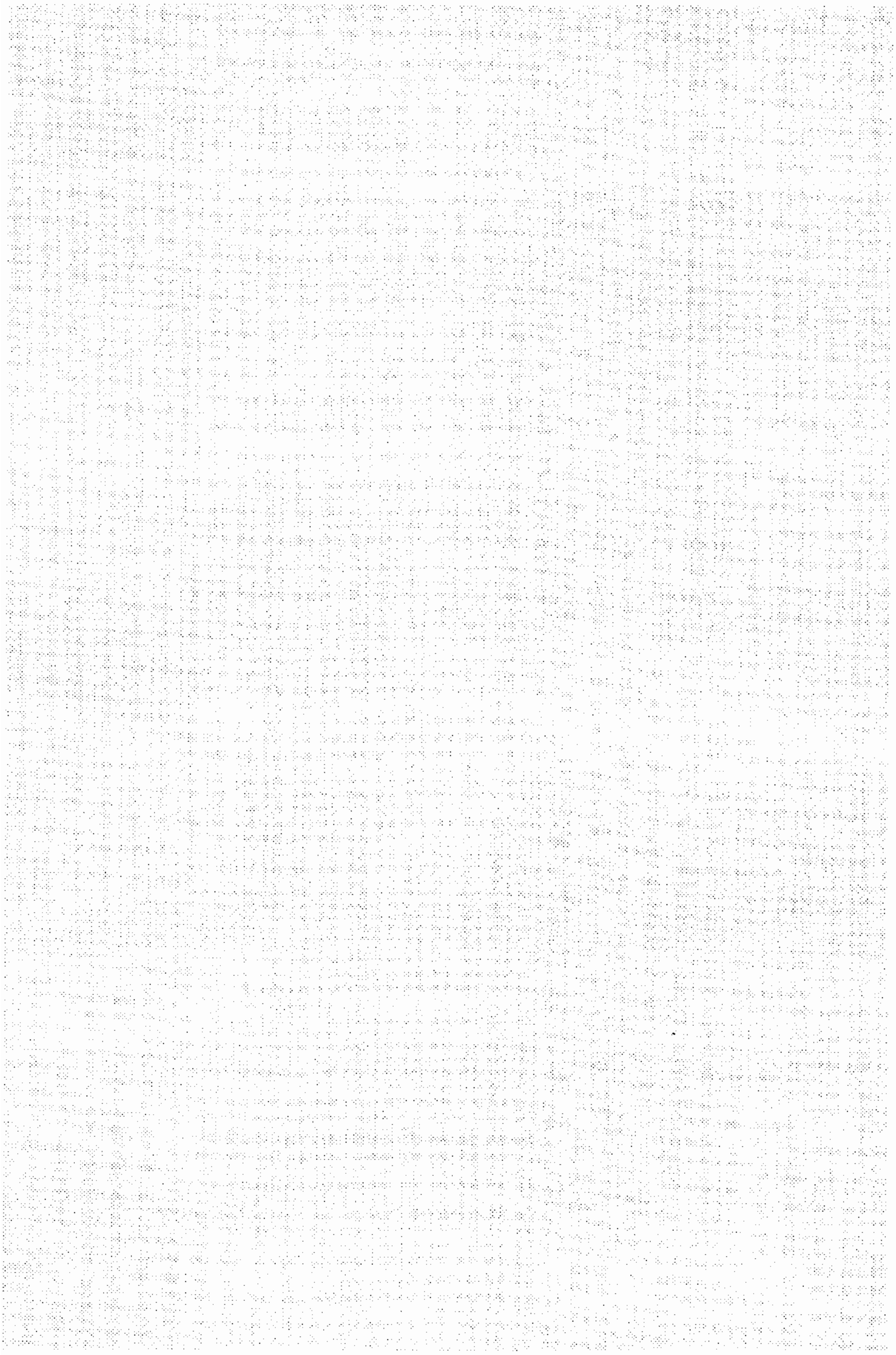
6.212. Of Taubmans 25 top customers, six were shared with Dulux and five were shared with Wattyl. Only one customer was shared with Bristol. None of the top 25 customers were shared with any other paint manufacturer.

6.213. As noted earlier, the internal records of Wattyl and Taubmans reveal a continual assessment of the competitive position of the top three suppliers, ie: Dulux, Wattyl and Taubmans, also with references to Bristol but with relatively few references to any other suppliers.

6.214. For example the following section contains extracts from Taubmans' NSW Residential strategy document. This appears to be a major annual strategy review document. All references in this document to competitors and their products have been extracted:

97 NSW Contractor Services, April 1994-March 1995, Business Plan.

6.215. Set out below are some selected, but fairly typical, extracts from internal records of Taubmans which demonstrates its ongoing competitiveness.



[redacted]

6.216. The Commission considers that the evidence clearly demonstrates there is direct and apparently vigorous competition between Taubmans and Wattyl and its subsidiaries, particularly Solver and Pascol paints.

6.217. In addition, a Taubmans' internal memorandum was sent to all Queensland staff on 8 December 1995 concerning the proposed acquisition by Wattyl. This memorandum shows not only that Taubmans considers Wattyl to be its competitor but also that Taubmans remains a strong and vigorous competitor in the market.

[redacted]

6.218. The conclusion that Taubmans remains an effective competitor is somewhat supported by a comparison of the bids received by Courtaulds for the Taubmans business. Wattyl's bid was considerably higher than that of Bristol. This suggests Wattyl recognises the viability of the Taubmans business (see the earlier comments of Mr Boshell) and is prepared to pay a price premium for the market share and power that it would acquire from such an acquisition. A combined Bristol/Taubmans would have considerably less market power. This is reflected in Bristol's lower bid.

Wattyl

6.219. As noted earlier, Wattyl have claimed that they do not compete head to head with Taubmans but rather their respective product lines are complementary. Set out below are some selected, but fairly typical, extracts from the internal records of Wattyl (provided by Wattyl through discovery) which demonstrates its competitiveness across the full product range.

Wattyl Group WA Division: GSM Report Feb 1996
'Mitre 10 WA's acceptance of Wattyl Premium paint as a preferred supplier is exciting, not only for WA but for Wattyl Australia. Wattyl now have the vehicle to promote broadwall paint to the consumer across Australia.'

Wattyl Trade Division: Monthly Report Feb 1996
'Dulux must be under pressure to maintain market share, they are the latest company to join in the silly prices race.'
'Bristol seems to be in disarray at the present time.'

Wattyl Sales Manager - Architectural and Decorative, Monthly Report Dec 1995
'Taubmans Trade pricing continues to be extremely damaging to our margins.'
'Dulux promotion is again on 8 litres, while ours has concentrated on a 4 litre give-away. They have launched their 5 litre Olympic Silk. Their POS is as usual good, but so is ours.'
'It is rumoured that Benjamin Moore have bought into White Knight and are preparing to launch into the trade area.'

Wattyl Retail National Account Customer Activity Report November 1995
'Amazing Paints: Concluded the deal to remove all remaining stocks of Berger Solascreen and replace with Wattyl Weather Guard.'
'Amazing Paints: Ceramacoat sell-in went well in all stores with better acceptance since Dulux Wash'n'Wear prices have increased to $40+.'

Wattyl Group Queensland Branch Retail Division Sales Report Jan 1996:
'Mitre 10 Beaudesert have removed Dulux and replaced with Wattyl Decorative Paints.'
'Bretts South Brisbane have removed Dulux, to now become totally Wattyl.'

Extract from Wattyl Master Painter Division Monthly Sales Report October 1993:
'Our new sales consultant, Rod Lawson (ex-Taubmans) is performing well, gaining new business from Taubmans, which will benefit Wattyl in the long term.'

Wattyl Sales Rep Monthly Sales Report - Retail Division September 1995
'Amazing Paints strike again - $40.95 and a FREE 1 litre. What can you do - you talk to stores to keep pricing at a sensible level and this sort of thing lands in your lap - why should my stores believe me - I am afraid the days of me talking pricing re Solagard are over - I give up, the blame lies solely at the feet of the retailer and I will not keep beating my head against the wall until it bleeds!'

6.220. The evidence before the Commission clearly suggests that without this merger, Wattyl will continue to make a concentrated effort to establish a stronger market share in interior paints.

Vertical integration: s.50(3)(i)

6.221. Vertical arrangements in the market for architectural and decorative paint were discussed in detail in Chapter 3. The terms of the major manufacturers' trade agreements vary considerably. However, many of them restrict the ability of the trade depot operator to sell competing trade or retail brands by imposing:

- minimum sales targets;
- minimum floor space requirements;
- restrictions on stockholdings;

- restrictions on entering other trade depot agreements with other paint manufacturers;
- a prohibition on competition for the existing trade customers of the paint manufacturer; and/or
- a prohibition on the sale of competitive trade brands.

6.222. In addition, a number of trade depot agreements seek to commit the trade depot operator to selling certain volumes of paint in the retail or decorative side. For example a number of the agreements of the major manufacturers contain clauses imposing a condition that a certain percentage of total sales must be of the paint manufacturer's products. Therefore the trade depot operator is in many cases committed to selling 100 per cent of the paint manufacturer's trade products and 80 per cent of its retail products. Such clauses restrict the possibility of expansion of existing manufacturers and entry of new paint manufacturers as they are unable to access many stores to sell their retail paint products.

Vertical arrangements: Taubmans

6.223. As noted earlier Taubmans has 33 trade centres and at least 83 trade depots or dealerships. Taubmans' internal correspondence indicates the underlying policy of the dealership arrangements. This is shown by the following memorandum dated 8 November 1994 where it was stated:

6.224. The following extract from a Dealership Agreement with Crokers Paint and Wallpaper shows the above policy in operation:

6.225. Taubmans has a 'Dealer Policy' which outlines the terms upon which it will grant a dealership to a retail outlet. The terms include the following:

1. Franchise dealers can only be approved by the National Service Centre Manager after consultation with the Retail Division and in line with strategy.

2. B. Franchise can only be set up where there is no Service Centre currently offered through an Owned Service Centre or another Franchise Dealer.

   C. Where the contractor sales potential will exceed $ per annum and where strategic advantage can be taken.

   I. The proposed Franchise Dealer must be a stockist and Taubmans must be the primary retail brand.

   J. The Franchise Dealer must not carry a competitive trade paint range.

   N. Franchise Dealership to purchase the stock, including the initial stock order.

3. Franchise dealers will provide the following service:

   C. Stock holdings to be formerly reviewed bi-annually by the Courtaulds Representative and appropriate increases/decreases to be effected.

   I. All customers introduced by Courtaulds to be serviced on Courtaulds paperwork.

   J. Franchise Dealership will only be offered or renewed as long as minimum performance criteria have been met.

6.226. The above terms appear contrary to the assessment contained in the applicants' economic advice that the existence of vertical arrangements 'partly reflects the strong bargaining power of retailers'.[98] Taubmans does not, on this material, appear to consider that retailers have any bargaining power in whether they are granted a dealership; the discretion lies entirely with Taubmans.

6.227. For example, clauses 2. (B) and (C) above indicate that Taubmans select the dealers according to their location and total sales potential. However the potential dealership must also offer Taubmans a 'strategic advantage' before a dealership agreement will be offered.

6.228. The policy appears designed to limit the dealer's product range to Taubmans' paint as the only trade brand and the primary retail brand. It should be noted that whilst all paint products must be purchased by the dealer, Taubmans appears to retain pricing control over the trade products sold to professional contract painters.

6.229. Taubmans' internal records indicate the implications of clause 3.(C) above. For example a letter addressed to Tempe Paint Specialists, dated 4 August 1994, sets out how one dealer had fulfilled the agreement by de-ranging competitors products from its stores:

[98] Dr Cousins, op. cit., paragraph 31.

6.230. Clause 3.(I) shows that a dealer is not permitted to service customers which have been introduced to the dealership by Courtaulds. Therefore under the terms of the agreement, the customers are treated as the property of the paint manufacturer.

6.231. Finally, clause 3.(J) shows that Taubmans is in control not only of which paint retailers obtain dealerships but also on their termination. Therefore this clause provides for enforcement of the dealership agreements.

6.232. Other Taubmans documents indicate that stock support levels required of dealerships are as high as   per cent of trade sales and   per cent of retail sales ('Criteria for Selection of Dealer Partners')

Vertical arrangements: Wattyl

6.233. In recent months Wattyl has been increasing its number of trade depots and, according to Taubmans internal correspondence, actively targeting Taubmans trade depots.

6.234. Whilst the Wattyl trade depot agreements differ considerably in their terms, the following represents an outline of the types of clauses contained in such agreements.

- The trade store will use its best endeavours to ensure that at least 80 per cent of all trade and retail paint sales are of the manufacturer's products;

- The Trade store will display the manufacturer's retail products in a prominent position;

- The trade store will not conduct a trade depot facility for any other paint manufacturer; and

- The trade store will not compete, directly or indirectly, with the manufacturer by marketing, selling or distributing trade products of the manufacturer's competitors to persons who have a trade account with it or who are licensed painters, builders or owner builders.

6.235. Wattyl retains the discretion over which retailers are offered trade depots. Therefore as stated above in relation to Taubmans vertical arrangements, the Wattyl trade depot arrangements also appear contradictory to the assessment contained in the applicants' economic advice that the existence of vertical arrangements "partly reflects the strong bargaining power of retailers".

Vertical arrangements: Dulux

6.236. Dulux's trade depot agreements are similar to those being implemented by Taubmans. Dulux also have a range of agreements which are directed more to the retail sale of architectural and decorative paint.

6.237.

6.238. The Dulux agreements are the subject of separate Commission consideration.

Assessment of Vertical Links

6.239. The vertical links between manufacturers and resellers are a substantial barrier to the entry and expansion of new suppliers of architectural and decorative paint. A new manufacturing entrant's ability to access paint outlets and, in particular, trade painters would be restricted by these arrangements. Typically, trade depot agreements require the reseller to make minimum purchases from the manufacturer and to achieve sales targets for that manufacturer's products. The reseller's ability to deal with other manufacturers is often limited by clauses in the agreements.

6.240. While Bristol entered the market at both the manufacturing and retail level it must be recognised that this was of course some time ago under a quite different market structure. Furthermore this might suggest that this form of entry is viable for other potential entrants and might reduce the barriers to entry that existing vertical links otherwise represent. However, if the new entrant sought to also enter at the retail level, it would encounter additional difficulties, especially in accessing trade customers. The vast majority of trade sales are made through trade depots or company owned stores (see Chapter 3). The prices charged to trade painters for trade paint sold from trade centres and trade depots is significantly less than the prices charged to retail DIY customers through retail outlets. The price difference in some cases is as much as 40 per cent of the wholesale price of the retail paint suppliers. The magnitude of these discounts is such that trade painters will generally purchase only from trade centres and trade depots. Trade painters are highly unlikely to switch to a small manufacturer's products purchased from a retail outlet. Effectively, then, the trade sector has a choice of three manufacturers; Dulux, Wattyl and Taubmans. Following the merger, the choice would be reduced to two.

6.241. These agreements also represent a barrier to entry at the retail level for independent resellers. A new entrant seeking to establish a retail or trade outlet would have difficulty in accessing competitively priced paint from Dulux and Taubmans and to a lesser extent Wattyl for sale to trade customers unless they entered into a trade agreement with one of the majors. Even if the entrant wished to enter into such an agreement it may be unable to do so. The agreements often prevent the manufacturer from entering into another agreement with a store located within the geographic catchment of a store with whom an existing agreement is held. A new entrant would therefore have to source much of its paint requirements from a smaller manufacturer whose brands are not widely recognised. Without a nationally recognised brand, the new entrant's ability to compete with established resellers would be impaired because it is recognised that resellers must stock at least one widely recognised brand to be an effective competitor.

6.242. The agreements which exist between manufacturers and resellers restrict to varying degrees the freedom of resellers of trade paint to stock or act as trade resellers for any other manufacturer of paint and receive discounts if they sell paint from a manufacturer other than the manufacturer with whom they have entered into such an agreement. The effect of these agreements is to restrict access by any other supplier of paint to retail outlets which have entered into one of these agreements.

6.243. The agreements also restrict retail price competition to various degrees by restricting the reseller's ability to stock competitors' products. Furthermore, by setting sales targets, the agreements appear to limit the extent to which resellers would seek to direct customers to alternative comparable products. In some cases, such actions are prohibited by the agreements. This undermines to some extent, the parties' claims that the effects of brand loyalty are offset by the influence of retailers over consumers' purchase decisions. Sales targets based on revenue also reduce the incentive to engage in price competition.

Anti-competitive detriment

6.244. The Commission considers that if the merger proceeds, the combination of substantial barriers to entry and the rise in concentration, will increase the ability of Wattyl/Taubmans and Dulux to exercise market power to the detriment of competition. The combination of the requirement for a new manufacturer to spend substantial sums on advertising and promoting a new brand together with the vertical arrangements between manufacturers and resellers creates a substantial barrier to a new manufacturer of architectural and decorative paints establishing itself as an effective competitor.

6.245. Neither retail or trade stores, nor existing or potential entrants, will be able to constrain the pricing and production policies of Wattyl and Dulux. Taubmans will cease to be a vigorous and effective competitor. In the absence of Taubmans, price competition is likely to be reduced and Wattyl and Dulux are substantially more likely to engage in parallel rather than competitive behaviour.

6.246. In reaching this view, the Commission has carefully assessed Wattyl's and Courtauld's arguments as to why they believe the proposed merger will be pro-competitive rather than anti-competitive. As discussed above, this is based on the argument that a merged Wattyl/Taubmans would be a more effective competitor for Dulux. The underlying assumption is that wholesale prices would fall with the resulting reduction being passed onto consumers through lower retail prices.

6.247. In the case of *Re Howard Smith Industries Pty Ltd*[99], the Tribunal said:

> We consider that there is no substance in the claim that a strengthening in the capacity of a competitor ... would of necessity constitute a benefit to the public.[100]

Furthermore, Corones notes that:

> A common misconception is to confuse, or invalidly equate, the "competitiveness" of individual buyers or sellers with the "competitiveness" of the market. The Act, as a principal objective seeks to foster competitiveness in markets. The courts reject, in general, the suggestion of any necessary correlation between competition in the market and individual competitive strength.
>
> Arguments based on the individual competitive ability or the "vigour" of competitors were advanced in the *QCMA* case,[101] *Top Performance* case,[102] and in the *Howard Smith* case.[103] In all cases they were rejected and most firmly in the *Ford* case where the Tribunal stated that:
>
> "We reject the argument that an enhancement of competitive strength of a major participant in the market necessarily increases competition."[104]
>
> The Full Federal Court in *Outboard Marine Australia Pty Ltd v Hecar Investments (No 6) Pty Ltd*[105] has also rejected the fallacy that the competition test is concerned with the fate of individual competitors rather than the level of rivalrous behaviour in the market.[106]

6.248. The parties' view of the likely competitive effects of the merger seems to contradict the argument that smaller market participants are able to constrain the pricing and production decisions of the majors. If this were the case, it does not follow that a full range of recognised brands is necessary to provide effective competition to Dulux. Instead, effective competition could be achieved by the competitive restraint offered by the competition of the various suppliers of the 'partial range' of products. These, in combination, would amount to a 'full range' of products. The parties' view suggests that firms that offer a less-than-full range of products are not able to constrain firms that do. In this sense, competition among a number of firms that offer a full range of products may be beneficial.

6.249. However, there are strong reasons for doubting that such competition would exist following a merger. The more likely outcome is that the two major firms would

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99 (1977) ATPR ¶40-023.
100 Ibid., p. 17,342.
101 (1976) ATPR ¶40-012, p. 17,244.
102 (1975) ATPR ¶40-004, p. 17,118.
103 (1977) ATPR ¶40-023, p. 17,341.
104 *Ford Motor Co of Australia Ltd & Ford Sales Co of Australia Ltd* (1977) ATPR ¶40-043, p. 17,498.
105 (1982) ATPR ¶40-327.
106 Corones SG, 'Restrictive Trade Practices Law', 1994, The Law Book Company Limited.

cooperate rather than compete. This would be to the detriment of competition and efficiency. The probability of cooperation emerging rather than competition is substantial given the structural features of the architectural and decorative paint market.

6.250. In reaching this conclusion, the Commission has considered the factors that are conducive to the exercise of both unilateral and coordinated market power. One such factor is a reduction in the number of firms in the market. This raises the likelihood that remaining firms will engage in cooperative behaviour because it is easier to reach and monitor agreements (both explicit and tacit). In this matter, the number of substantial effective competitors falls from three to two. Thus this factor is clearly present in the current matter.

6.251. High concentration also facilitates the exercise of unilateral and coordinated market power. In this case, concentration will be very high after the merger.

6.252. Coordination is also facilitated if firms have similar cost structures as each firm has a similar view as to the appropriate price. One of the aims of the merger is to produce cost efficiencies. Thus the combined costs of Taubmans/Wattyl are likely to be lower than the sum of their current costs. However, costs are unlikely to be as low as the existing Taubmans plant because some decentralised production will remain. The net effect is that cost structures between Taubmans/Wattyl and Dulux are likely to be similar.

6.253. Furthermore, if there are few close substitutes, such that the price elasticity of demand is low, it is easier for firms to maintain price near monopoly levels. There are no close substitutes for paint.

6.254. The ability to exercise market power is enhanced if there is not a competitive fringe of sellers that can readily expand output. Although there are a large number of small manufacturers, the Commission considers that this group would be unable to readily expand output to deter or defeat the exercise of market power by the merged firm. Although smaller manufacturers may have some physical capacity to expand output, their success is likely to be limited by brand awareness of existing players, difficulties in accessing shelf space, the network of company owned stores and trade depot agreements and trade painter requirements for service, distribution and availability.

6.255. Cooperative behaviour is easier to sustain if there is an even flow of frequent and small sized sales because the potential payoff from undercutting a rival is smaller than if sales are in large lots and occur infrequently. This condition is generally satisfied in this case. Some sales, however, are made through tender; for example housebrands. Tender markets tend to reduce the likelihood of cooperative behaviour. However, for tender markets to be fully effective it is necessary that there be a large number of bidders. This situation is unlikely to arise in the paint market.

6.256. Of course, the ability to exercise unilateral or coordinated market power might be constrained by effective import competition or low barriers to entry. However, the Commission considers the potential for significant expansion in imports is low and that there are high entry barriers.

Conclusion on competitive effects

6.257. The Commission has examined the competitive effects of the proposed merger on the basis of its statutory obligations and in the framework of its Merger Guidelines. It is of the view that if the merger proceeds there are significant concerns about the effect on competition.

7. Commission's assessment of public benefit

Assessment of Public Benefit

7.1. As noted in Chapter 4, Wattyl and Taubmans have argued that the proposed acquisition will generate a number of public benefits. The Act does not define the meaning of 'public benefit'. However, the Commission is required to take account of all relevant matters relating to international competition and to consider significant increases in exports or import replacement as public benefits (s.90(9A)). The explanatory Memorandum to the 1992 amendments to the Trade Practices Act states that:

> Changes in international competitiveness may be attributed to a wide range of matters which it is impossible to list exhaustively, but could include matters such as changes in the quality of inputs, improvements in technology, or better work practices. The range is qualified by the requirement that the matters looked at be 'relevant', which indicates that they should be attributable to the merger in question.

7.2. The Tribunal provided some guidance on the meaning of 'public benefit' by suggesting that the term should be given its widest possible meaning to include:

> ... anything of value to the community generally, any contribution to the aims pursued by the society including as one of its principal elements (in the context of trade practices legislation) the achievement of the economic goals of efficiency and progress.[107]

7.3. The Tribunal also pointed out that the concept of public benefit is not limited to a benefit to consumers. A private benefit can also be considered of value to the wider community.[108] However, the interests of the public are of primary importance in considering the public benefit.

7.4. The Tribunal also provided guidance as to the assessment of the likely public benefits:

> The benefit must be 'substantial'. It must be 'considerable', 'large' or 'weighty'. It need not, it is plain, be necessarily capable of quantitative assessment; but it should be sufficiently definable - have sufficient substance- as to permit some factual judgement of its relative importance.[109]

7.5. In the same case, the Tribunal concluded that it is appropriate to start the assessment of public benefit with an examination of the competitive implications of the merger.[110] This was undertaken in the previous chapter. The enhancement of competition is a substantial public benefit.

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[107] Re: QCMA and Defiance Holdings, , (1976), ATPR, 40-012, p. 17,242.
[108] Ibid, p. 17,242.
[109] Ibid, p. 17,243.
[110] Ibid, p. 17,244-17,245.

7.6. Efficiency is also a public benefit and has been recognised as such in numerous matters considered by the Commission and the Tribunal. Indeed, the Tribunal has stated that:

> ..the encouragement of competition and competitive behaviour and the achievement of the economic goals of efficiency and progress will commonly be paramount.[111]

7.7. Rationalisation of industry which results in lower or contained costs of production improves resource allocation and is also a public benefit. However, if rationalisation costs are not passed through to the wider community, they will be given less weight than if such savings, or a proportion of the savings were passed through in lower supply costs.[112] It is relevant, therefore, for the Commission to assess whether such savings, either in whole or part, will be passed through. Furthermore, if the benefits will not be passed on, it is worthwhile also to consider whether such savings are likely to be dissipated through managerial slackness, or by firms seeking to maintain their market power.

7.8. The phrase 'not otherwise available' previously formed part of the public benefit test. This is no longer an absolute requirement. Nevertheless, there must be a nexus between the claimed public benefit and the proposed merger. Furthermore, the Commission considers that it is still relevant to consider whether the benefit may be available otherwise than by the proposed merger when comparing the situation which is likely to prevail with and without the merger. If a benefit may be otherwise available, it is likely to be given less weight in the Commission's analysis.

Efficiencies

7.9. Wattyl claims that the merger will generate efficiency gains through rationalisation and the exploitation of economies of scale. The recurrent savings are estimated to be $ million per annum. Wattyl estimates current total cost to Wattyl and Taubmans of individual manufacturing and selling an assumed 46 per cent of the market is $ million. This represents a reduction of per cent of the current combined total costs of manufacturing and marketing Wattyl's and Taubmans' architectural and decorative paints.

7.10. The Commission asked KPMG to advise whether the claimed savings would be achievable, attributable to the acquisition and correctly described as recurrent savings.

7.11. KPMG advised that, in general, the estimates provided by Wattyl were not supported by detailed substantiation as much of the information required to provide such substantiation is confidential to Taubmans. Overall, KPMG estimated that there are approximately $ million of potential recurrent savings to Wattyl from the proposed acquisition and rationalisation. However, much of this could be achieved

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[111] *Rural Traders Co-operative (WA) Ltd & Ors*., ATPR, 1979, 40-110, p. 18,123.
[112] *Howard Smith Industries and Adelaide Steamship Industries*, 1977, ATPR, 40-023, p. 17,334.

otherwise. This represents a reduction of per cent of the current combined costs of manufacturing and marketing of Wattyl's and Taubmans' architectural and decorative paint. Further, these savings must be considered in relation to the overall market.

7.12. The Commission considers that only real savings in resources be should be treated fully as public benefits for the purpose of this application. Pecuniary savings which would accrue to Wattyl as a result of increased buying power simply represent a transfer of income from one party to another rather than a reduction in resources used. The Commission has excluded any pecuniary benefits from its assessment of public benefits arising in this case.

7.13. Only limited cost information has been provided to the Commission. On the basis of this information, the Commission understands that raw materials and packaging costs are the main cost components and represent between 40 to 50 per cent of costs.

7.14. Marketing and promotional costs, including the costs of a sales force, are between 20 and 30 per cent of costs. Warehouse and distribution costs represent a further 10 to 15 per cent, as do factory overheads and administration.

7.15. The cost of manufacturing and promoting trade paint is usually less than paint for the retail sector. This is reflected particularly in lower material and packaging costs for trade paints compared with retail but also in lower advertising costs.

Rationalisation of manufacturing sites

7.16. The estimated efficiency savings from

7.17. The increased capacity available at follows a recent factory upgrade. The decision to upgrade the factory was made prior to the proposed acquisition and therefore any estimated improvement in production efficiency should be excluded from an analysis of the proposed benefits of any rationalisation arising from the proposed acquisition. Furthermore, the plant, in the main, produces industrial paints and on that basis alone should be excluded from the proposed benefits of rationalisation.

7.18. The proposed upgrade of was also proposed prior to the decisions to acquire Taubmans' architectural and decorative paint business. Accordingly any proposed efficiency benefits from the new plant at should be excluded from the analysis as it is not the direct result of the proposed rationalisation.

7.19. KPMG advise that the proposed savings from rationalisation of manufacturing sites is limited to the Villawood site and valued at around $. This compares with $ estimated by Wattyl.

7.20. Wattyl claims that to date there has been no easy solution to the problem of implementing any rationalisation within the Wattyl Group because of capacity problems which would result from temporarily closing down one of the major manufacturing sites.[113] The Commission accepts that the acquisition of Taubmans' Villawood plant will enable Wattyl to more readily rationalise its manufacturing sites. However, it appears that rationalisation could also proceed absent the merger, albeit at a slower pace. Therefore some of the savings identified by KPMG could be achieved regardless of the merger proceeding.

Raw materials

7.21. Wattyl estimated potential savings of $ million in reduced cost of raw material purchases based on an estimated saving of per cent of raw material costs. KPMG advise that Wattyl were unable to properly substantiate the use of a per cent figure. KPMG also noted that the $ million savings is based upon total raw material purchases and thus includes inputs into the production of products other than architectural and decorative paints.

7.22. On this basis, KPMG estimated that if the per cent savings is correct, the total savings would be $ million rather the $ million estimated by Wattyl. Whether the per cent figure is accurate will depend ultimately on negotiation with the suppliers. However, for the purposes of this exercise, it appears to KPMG to be reasonable.

7.23. The Commission has some concerns that the per cent saving has not been substantiated. More importantly, any reduction in raw material costs will simply reflect the merged firm's superior buying power. As such, it represents a transfer of income to Wattyl/Taubmans from its raw materials' suppliers; there is no suggestion that raw material usage per litre of production will decline following the merger. Therefore the Commission is inclined to discount as a public benefit the cost savings arising from better buying power for raw materials.

Rationalisation of warehouse and distribution facilities

7.24. Wattyl operates full warehousing and distribution facilities at each of its factories. Taubmans make the majority of its deliveries from its Villawood warehouse. It is intended that the distribution of architectural and decorative paint will be split between western Australia (encompassing Western Australia, South Australia, Northern Territory, and parts of Victoria) and eastern Australia (encompassing parts of Victoria, Tasmania, New South Wales and Queensland). There will be major warehousing sites in South Australia and New South Wales with small distribution warehouses in each State to carry backup stocks. Wattyl

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[113] Wattyl submission, p. 2.

anticipates that by reducing the amount of warehousing and distribution facilities, stock holdings will be reduced in the order of per cent or approximately $ million. The working capital benefit of the reduction in stock holdings and conversion to cash, assuming a rate of return of per cent, would be $ per annum.

7.25. Wattyl was unable to provide an estimate of stock holdings of architectural and decorative paints but estimated that of its total stock holdings, per cent relate to architectural and decorative paints. On this basis, KPMG calculated total savings based upon a per cent reduction would be $ per annum rather than $.

7.26. KPMG also examined whether a per cent reduction is reasonable. This depends upon the current stock turnover ratios. There is considerable variation in the stock turnover ratios at the various Wattyl plants and Taubmans facility. After examining these ratios KPMG concluded that a per cent reduction is reasonable. Therefore, according to KPMG, the total potential savings from a rationalisation of warehouse and distribution facilities are $ rather than $ as claimed in Wattyl's submission.

7.27. As with the rationalisation of manufacturing sites, the Commission is not convinced that the rationalisation of warehouse and distribution facilities envisaged by Wattyl could not be achieved without the merger. Therefore, the Commission is disinclined to give full weight to the public benefits arising from rationalisation of warehouses and distribution facilities.

Rationalisation of trade depots

7.28. Wattyl intends to close approximately trade depots because of duplication in areas where both Taubmans and Wattyl currently have depots.

7.29. KPMG advise that the total potential savings from the closure of the Taubmans' depots alone is $ which compares favourably with Wattyl's estimate of $ million. However, some of the sites earmarked for closure have relatively long leases. For the potential cost savings to be realised it will be necessary for Wattyl to negotiate the release of its liabilities under the lease agreements or to extract a transfer or purchase of the depot to mitigate their liability. The longer the period required to transfer each store, the longer before the potential savings will be derived.

Administration and office sites

7.30. Wattyl calculates total savings of $ million from rationalisation of administration and office sites. This appears to relate primarily to a merger of management information systems (MIS) and consequential savings in duplication of services. KPMG advise that these savings appear to relate to the defraying of costs by Courtaulds. However, the mere fact that the two MIS will merge will lead to cost savings over time. The actual amount of those savings can not be determined from the information provided and consequently, KPMG have included only per cent of the savings estimated by Wattyl.

Advertising and Promotion

7.31. Wattyl assumes it can achieve potential savings of approximately $ per annum via a reduction of rates charges for advertising of per cent of total combined advertising expenditure of $ million. This appears reasonable to KPMG given the high advertising costs of both businesses.

7.32. Again, the Commission is concerned that Wattyl has not substantiated its claimed savings. However, as with savings in raw materials costs arising from superior purchasing power, any reduction in advertising rates is a pecuniary benefit to Wattyl rather than a saving of resources. There has been no suggestion that advertising levels will fall post-merger. Indeed, given Wattyl's view that Taubmans' brand needs to be re-established, it is quite feasible that Wattyl will increase advertising post-merger. Furthermore, if the Commission's views as to the impact of the merger on competition are realised, it is possible that advertising will rise as Wattyl and Dulux seek to maintain and expand their market power.

Reduction in employee numbers

7.33.

7.34. Reductions in labour usage are a real resource saving and thus improve static allocative efficiency if the freed resources can be more productively employed elsewhere. However, a reduction in the number of employees does not have these effects if the employees who lose their job can not quickly find new employment elsewhere that utilises their skills. Whether this occurs is dependent on the employees' skills and the general state of the macro-economy. Nevertheless, it is likely that the post-merger outcome would be a reduction in labour usage.

7.35. The Commission also notes that there are a range of employment outcomes that could arise if the merger does not proceed. This is because of the likelihood that Wattyl would pursue alternative rationalisation plans. Thus it is difficult to compare the situation absent the merger with the likely post-merger outcome.

Courtaulds' overhead charge, other cost savings and cost of interest on new plant at and

7.36. Wattyl estimate savings of $ million arising from the elimination of Courtaulds' overhead charge. KPMG advised that it considers that charge has already been included in the potential cost savings outlined above, in particular, staff reductions, and should thus be excluded to avoid possible double counting.

There is no substantiation whatsoever for the other claimed cost savings of $. These savings have therefore been excluded.

7.37. Wattyl provide for a charge of $ million relating to interest on the financing costs for the new plants at and . As these upgrades are not related to the acquisition, the charge has been excluded.

Conclusion

7.38. KPMG estimate the potential benefits from the proposed rationalisation to be $ million per annum compared with Wattyl's estimate of $ million per annum. Of the difference, approximately $ million does not relate directly to the proposed acquisition. That amount is the efficiency gains from the plant upgrades at and . The decision to upgrade those plants was made prior to the proposed acquisition.

7.39. Efficiency gains of this magnitude would, if realised, be a substantial public benefit arising from the merger. However, as discussed, the Commission is not satisfied that the entire $ million should be considered to be a public benefit. In particular, the savings from advertising and raw material purchases are pecuniary benefits and should not be counted; especially when a reduction in competition may not see these savings passed through in lower prices. On this basis alone, the potential efficiency gains are reduced to $ million. There may be possible public detriment arising from labour shedding. The Commission also considers the likelihood that some of the claimed savings from rationalisation would occur absent the merger.

7.40. The Commission considers, therefore, that the upper-limit of potential efficiency gains is per cent of the current combined costs of manufacturing and marketing Wattyl's and Taubmans' architectural and decorative paints rather than the per cent estimated by KPMG and the per cent claimed by Wattyl. Given the comments in the previous paragraphs, it appears appropriate to discount the figure further.

7.41. The Commission recognises that it is difficult to quantify the appropriate discount. Therefore the following discussion will proceed on the basis of the estimated upper-limit. If the per cent reduction in costs is reflected fully in retail prices, then an indicative reduction in retail prices is $0. for a four litre can of paint. This represents a per cent reduction in the retail price of a $40 can of premium paint.

7.42. However, given the Commission's concerns about the likely effect of the merger on competition, there is reason to doubt whether such savings, if achieved, would be passed through to end users. If competition is lessened as a result of the merger, it is likely that some of the efficiency gains will instead be distributed to shareholders through higher profits and/or employees through higher wages than would be achieved in a more competitive market. In this regard, it is instructive to note the price rises that followed the Dulux/Berger/British merger in 1988. Retail prices in some cases increased by a reported 20 per cent.[114] If price rises follow this merger then the public benefit arising from efficiency gains would be very small, at best. Although there will be gains to shareholders and/or employees, the Commission considers that the weight attached to such gains should be reduced.

7.43. As the merger would effectively create a duopoly, there is a real possibility that the two major parties would act cooperatively, rather than competitively in order to increase profits. Under such a scenario, there would be two conflicting pressures on prices. On the one hand, the exercise of joint market power by Wattyl and Dulux would enable prices to be raised above competitive levels to an extent determined by the height of barriers to entry and import competition. There will be, however, an incentive to reduce prices if efficiency gains are achieved in order to gain maximum profits. Whether, the combination of increased market power and lower costs would result in higher or lower prices after the merger depends on the extent of cost savings and the elasticity of demand. The Commission considers that prices are more likely to rise.

7.44. It is also possible that the envisaged efficiency gains will be dissipated if the merger results in a lessening of competitive pressures. For example, the pressure to avoid cost increases and/or to avoid management inefficiency is reduced as competitive pressures decline.[115]

7.45. Alternatively, Wattyl and Dulux may recognise that price competition will result in a reduction in industry profits. Consequently, non-price competition such as advertising and promotion may rise in an attempt to maintain and extend market power.

7.46. In conclusion, the Commission considers that there are cost savings that are likely to result from the merger and constitute a benefit to the public. There is a strong likelihood, however, that these will not be reflected fully in lower prices to end users.

Research and development

7.47. As a result of the acquisition, Wattyl anticipates an increase of around $ million per annum in its research and development (R&D) expenditure. This is based on the assumption that current level of R&D expenditure (per cent of turnover) is maintained and that the merger increases turnover by $ million per year. The net increase in industry R&D is $ million.

7.48. The magnitude of the additional funds available for R&D rests on the assumption that Wattyl will continue to devote around per cent of turnover to R&D. The Commission understands that this figure is consistent with Wattyl's historic R&D expenditure. However, R&D must compete with other potential investments for scarce investment funds. Therefore, whether Wattyl continues to

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114 Salesmakers, op. cit, p. 6.
115 These cost inefficiencies are termed 'X-inefficiencies'.

devote per cent of turnover to R&D will depend upon the expected returns on available investment opportunities. In addition, there are likely to economies of scale in R&D which could enable the a given level of R&D to be undertaken without spending per cent of turnover.

7.49. Courtaulds make the additional claim that the merger will enable the two leading companies (Wattyl and Dulux) to challenge each other in leading technology which will produce a healthier level of competition in the market. Courtaulds claim that its commitment to R&D has been tempered by its lack of profitability in its architectural business.

7.50. According to Courtaulds, the merger will not only increase the level of R&D but will also lead to more comprehensive, focused and forward looking R&D than either of the separate companies can justify or sustain.

7.51. The expected increase in industry R&D may improve dynamic efficiency. This would occur if it leads to the development of new products, and the expansion of consumer choice. Any such gains to dynamic efficiency are of benefit to the public. However, in this instance there is a potential trade-off between dynamic efficiency and allocative efficiency. The trade-off arises because dynamic efficiency might be enhanced by the proposed acquisition whereas allocative efficiency is likely to be reduced because of a reduction in competition. This trade-off needs to be evaluated in assessing the public benefit claim.

7.52. The proposed acquisition will lead to a one off transfer to Wattyl of technology currently employed by Taubmans. There will also be a loss of direct access to the results of future R&D by Courtaulds UK. The Commission accepts that Courtaulds UK does not undertake R&D on architectural and decorative paints. Therefore, a loss of direct access to its research does not appear be a significant detriment. However, research in one field, especially one that is closely related, can lead to spin-offs in other areas. Consequently there is likely to be a reduction in the knowledge base available to the architectural and decorative paint industry.

7.53. Two assumptions implicitly underlie the arguments made with respect to R&D and illustrate the nature of the potential tradeoff between allocative and dynamic efficiency: that innovation increases more than proportionally with firm size; and that increases in market concentration facilitate innovation.

7.54. The economic literature which examines the relationship between market structure and innovation is somewhat inconclusive. The balance of evidence on the relationship between firm size and innovation has shifted over the past decade. By the early 1980s, there was a tentative consensus that a positive relationship existed between firm size and research and development. However, recent studies have cast doubt on this consensus.

7.55. The majority of studies that examine the relationship between concentration and R&D have found a positive relationship but negative relationships have also been found. A persistent finding is that the effect of concentration on R&D intensity depends on industry-level variables.[116] Once these variables are taken into account, the evidence does not support the hypothesis that concentration and firm size are significant determinants of R&D intensity.[117]

The Commission has concerns about the likely impact of the merger on the incentive to engage in R&D. If, as the Commission has argued, the merger leads to a reduction in competition, then the incentive to engage in R&D might be correspondingly reduced. To use the words of Scherer and Ross:[118]

> Schumpeter was right in asserting that perfect competition has no title to being established as the model of dynamic efficiency. But his less cautious followers were wrong when they implied that powerful monopolies and tightly knit cartels had any stronger claim to the title. What is needed for rapid technological progress is a subtle blend of competition and monopoly, with more emphasis in general on the former rather than the latter, and with the role of monopolistic elements diminishing when rich technological opportunities exist.

7.56. The Commission accepts that the proposed acquisition may lead to an increase in domestic R&D to the benefit of the public.

International competitiveness

7.57. Wattyl claims that international experience in the paint industry has shown that there is a direct correlation between domestic size and international success. This is one of the general arguments used to justify the 'dominance test'.

7.58. Wattyl claims that the merger will increase exports because:

- royalties and dividends returning to Australia from its overseas subsidiaries which supply products incorporating Australian technology will increase because of an increased ability to focus on those subsidiaries and because of increased R&D in Australia.

- viability of exporting finished product to foreign markets, particularly New Zealand will increase because of the efficiency gains arising from the merger.

7.59. Wattyl does not quantify the extent of the claimed increase in exports.

7.60. Wattyl claims that it will be in a better position to compete with low cost imported product because of the merger.

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[116] Cohen WM and Levin RC, 1989, "Empirical Studies of Innovation and Market Structure", Chapter 18 of Schmalensee R and Willig R (eds), *Handbook of Industrial Organisation*, Vol.2, North Holland.

[117] Hay DA And Morris DJ, 1991, *Industrial Economics and Organization, Theory and Evidence*, Oxford University Press.

[118] Scherer FM And Ross D, 1990, Industrial Market Structure and Economic Performance, 3rd. ed., Houghton Mifflin Company, p. 660.

7.61. Courtaulds claims that the benefits of expanding exports and combating imports can only be achieved if the merger is allowed to proceed. However, it concedes that both Dulux and Taubmans already have the capacity to enter export markets. The argument appears to rest, therefore, on the assumption that Wattyl is more motivated to enter export markets.

7.62. The volume of total paint exports from Australia in 1995 was 6.9 million litres.[119] In the three years since 1992 the total volume of paint exports have grown by 29.8, 73.9 and 23.5 per cent respectively from a very low base. Prior to 1992, paint exports were reasonably static, exhibiting an average annual compound growth rate of 2.0 per cent between 1988 and 1992. Despite the strong growth in paint exports in the last three years, paint exports as a percentage of domestic production are still very small. New Zealand is the main destination for paint exports, accounting for 42 per cent of paint exports by volume in 1995.

7.63. The Commission is aware that Wattyl is currently exporting architectural and decorative paint to Papua New Guinea and New Zealand. These exports, however, are of a short term nature.

7.64. The only other existing Australian market players with meaningful export capability are ICI and Courtaulds. Courtaulds have not exported architectural and decorative paints for two reasons. First, Courtaulds' world-wide coatings strategy does not place any significance on architectural coatings. Secondly, Courtaulds' policy is that local subsidiaries are not subject to competition from Courtaulds' subsidiaries in other countries. ICI have a similar policy. It does not export architectural and decorative paints except for isolated and insignificant instances.[120]

7.65. Exports of architectural and decorative paint are low. This is likely to be because the costs of freight mean that exports from Australia are unattractive. If large scale exports are currently feasible, it is difficult to understand why Dulux, which is a low cost manufacturer, is not using its excess capacity to supply overseas markets. It may be Dulux's policy not to compete with its overseas subsidiaries. However, if exports from Australia could be landed at a lower cost than domestic production in overseas markets, it would be in Dulux's interest to pursue such a strategy rather than establish overseas production facilities. Furthermore, Wattyl has expanded into overseas markets by establishing domestic production facilities rather than exporting from Australia. This suggests that transport costs from Australia and any other barriers to entry to overseas markets exceed any cost advantages arising from economies of scale. The presence of these overseas plants suggests that Wattyl may, like Dulux and Courtaulds, be more likely to expand its overseas presence through establishing foreign production sites. Furthermore, New Zealand seems to be the most likely destination for Australian paint exports. However, Wattyl has recently acquired a manufacturing plant there which reduces the likelihood of significantly expanded exports to that market.

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119 Australian Bureau of Statistics.

120 Taubmans submission, p. 7.

7.66. If Wattyl does expand internationally, it could engage in licensing of technology which would, as claimed, generate royalties to be credited as exports in the current account of the balance of payments.

7.67. As Wattyl has not been able to quantify the extent to which exports are expected to rise following the merger, the Commission is not able to assess the magnitude of any associated public benefit. Given the current low levels of exports any such gains are likely to be small, at least in the short run. Furthermore, the Commission considers it more likely that Wattyl will seek to expand its presence in overseas markets by establishing manufacturing plants in those markets, as it has done in the past. This would represent capital outflow from Australia and is in contrast to the 'buying back the farm' arguments which are discussed below in relation to Australian ownership.

7.68. Imports of architectural and decorative paint are also low. There are substantial barriers to imports arising from the costs of transport and the advantages of brand loyalty. Wattyl appears to be already combating imports and does not make explicit claims of import replacement. Even if such replacement occurs, its extent would be small given the current contribution of imports to market share.

Australian ownership

7.69. There are many dimensions to national benefit or detriment arising from foreign ownership of Australian assets. To assist in its assessment of the public benefit arguments raised by Wattyl and Courtaulds in relation to Australian ownership, the Commission engaged the Centre for International Economics and Dr Tony Makin of the University of Queensland to advise on the benefits and detriments arising from foreign ownership of Australian assets.

7.70. The Commission recognises that Australian ownership may be a social benefit if Australians place a value on the Australian ownership of assets located in Australia. In this case, domestic acquisition of a foreign owned asset must, other things being equal, be a public benefit. The Commission considers that it is likely that Australians do place a value on Australian ownership of assets. However, no evidence as to the significance of this point was put before the Commission. Accordingly the extent of such a benefit is difficult to quantify.

7.71. The economic benefits of Australian ownership are also difficult to quantify. Foreign investment has many macroeconomic consequences, most of which are interrelated. The arguments that foreign ownership is detrimental to national welfare relate primarily to its impact on the current account deficit and foreign debt. Foreign investment worsens the current account deficit. Like any debt, however, a critical question is whether it can it be serviced. If not, then buying back the farm is likely to be a macroeconomic benefit. What matters for the public interest question is the ultimate source and use of the funds used to finance the domestic acquisition of the foreign owned asset. There is often no definitive answer to that question.[121]

7.72. The level of net foreign investment depends on the level of domestic national savings compared with the level of domestic investment. Only if domestic savings rise relative to investment will our net foreign debt and current account deficit fall. With the free movement of capital between countries, it is difficult to see how the acquisition of Taubmans by Wattyl will increase the level of national private savings relative to investment.[122]

7.73. Another commonly expressed concern about private foreign investment in Australia relates to the loss of control of established domestic firms through foreign takeover. Whenever this happens we are seen to be 'selling off the farm'. By implication, Australian acquisitions of foreign owned Australian assets is seen as a good thing, or as 'buying back the farm'.[123] This is one of the arguments used by the parties to justify a public benefit arising from Australian ownership. While the acquisition may result in profits from the use of Taubmans' assets being returned to Australian shareholders, the funds used by Wattyl to purchase Taubmans' assets could alternatively be used to acquire other assets located with domestically or abroad to raise Wattyl's profitability, and to enhance the income of Australian wage earners and shareholders.[124]

7.74. Even if Australian control is a benefit in this sense the benefit would be offset by Courtaulds' reinvestment of the sales proceeds in Australia as they have indicated they intend. This could have the possible effect of increasing foreign control in another industry.

7.75. However, there are economic benefits which accrue to residents who dispose of their assets to foreigners. Whenever domestic assets are purchased by non-residents the quantum of funds available to residents for additional spending is supplemented as a result of their assets sales. Furthermore, when foreigners buy existing Australian assets at higher prices than other resident buyers would be willing to pay, the Australian residents who sell such assets make capital gains that they would not otherwise have made. As a general principle, the greater the international trade in assets, the greater the potential economic welfare gains.[125]

7.76. The economic impact of foreign investment can be further considered at the industry or firm level. The general arguments in support of foreign investment focus

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121 Centre for International Economics, 1996, *Macroeconomic benefits/detriments of Australian versus foreign ownership of Australian based assets,* Prepared for Australian Competition and Consumer Commission. ('CIE Report')

122 Ibid., p. 6.

123 Dr Tony Makin, 1996, *The Macroeconomic Effects of Foreign Investment,* Report prepared for Australian Competition and Consumer Commission, April. p. 4.

124 Ibid, p. 11.

125 Ibid, p.7.

on the package of differentiated product, technical know-how, management expertise and market access.[126]

7.77. An argument can be made in support of transferring ownership from a foreign firm to a domestically based firm because the latter will not repatriate profits back to the foreign based firm. This argument needs to be examined on a case by case basis. Courtaulds has expressed its desire to sell Taubmans because the latter is not very profitable. This means that there will not be large gains from retaining profits.[127]

7.78. The other issue regarding repatriation of profits is how ownership affects the disbursement of profits and tax revenue. Wattyl claims that the acquisition of Taubmans by Wattyl could increase tax revenue for two reasons. One is an expected rise in Wattyl's profits post-acquisition. As an improvement in profit performance is a key motivation for the merger, it is likely that the expected rise in profitability will occur. However, this rise in tax revenue can not be considered a public benefit in this case as it has already been factored implicitly into the expected efficiency gains from the merger. To also count increased tax revenue would be to double-count the benefit.

7.79. The second source of increased tax revenue is the retention of profits locally and the subsequent taxation of those profits. Generally, however, profits earned by any company in Australia are taxed in Australia at the same rate, irrespective of whether it is domestically or foreign owned. However, a foreign company's after-tax dividends do not receive a franking credit to offset the foreign shareholders' tax liabilities. Thus there may be an incentive to shift profits back to the parent country. Whether this occurs will depend on the relative tax laws and rates. If profits are artificially being shifted out of Australia, welfare will rise with the acquisition of the foreign firm by the local firm.[128] The Commission is not in a position to evaluate whether this is the current situation and thus attaches no weight to this potential source of increased tax revenue.

7.80. Wattyl suggests that it will use retained earnings for further investment in Australia. However, quarantining earnings for purposes of domestic asset accumulation may not necessarily be in the interests of resident shareholders who seek maximum return from their investment, and indeed may not be the outcome if the company has multinational objectives, which Wattyl appears to have.[129] Because any public benefits are therefore tenuous, the Commission attaches reduced weight to them.

7.81. Wattyl claim that the proposed acquisition will provide increased opportunities for Australians to be promoted to senior executive positions in an enlarged Wattyl and provide enhanced career opportunities for Taubmans' employees who transfer to Wattyl. This argument does not appear to rest on the

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[126] Ibid, p.7.
[127] CIE Report, op.cit, p.6.
[128] Ibid, p.7.
[129] Makin, op.cit, p.11.

issue of foreign ownership. Furthermore, the issue of whether there are increased opportunities for promotion to any level will depend upon the nature of any restructuring of management positions that occurs following the merger. It is possible that overall senior executive positions will decline rather than increase. It is likely, therefore, that the effect on employment in this regard as a result of the transfer of ownership will be minimal.[130] Furthermore, domestic employees of foreign owned firms are often exposed to international management practices. [131] Therefore the Commission attaches little weight to this argument.

7.82. As well as considering the social and economic implications of foreign ownership for the public interest, it is also necessary to have regard to permissive foreign investment policy trends in Australia as well as global trade liberalisation programs and trends.

7.83. The trend has been to relax controls over foreign investment. Governments have also declared their intent to liberalise these controls further through the APEC process of negotiating a move to freer trade.[132]

7.84. In summary, the Commission does consider it likely that there will be some social benefit from the post-acquisition transfer from foreign to domestic ownership of the Taubmans' brand although there is no evidence of that. The Commission considers that the economic arguments as to the benefits of foreign ownership are at best equivocal and that the parties have not demonstrated any substantial public benefit in this regard sufficient to outweigh the Commission's concerns about the adverse effects on consumers of higher prices.

7.85. Wattyl also claims that the Australian paint market is becoming of increasing interest to foreign multinational manufacturers who desire access to the Australian and Asian region. Wattyl alleges that it would be a target for takeover by foreign interests if it was not able to continue its history of profitable growth thereby improving its share price and market capitalisation. The implication is that its growth and profit potential would be constrained absent the proposed acquisition. The Commission engaged KPMG Corporate Finance to assist in the Commission's assessment of this proposition. The following discussion is based on KPMG's advice.[133]

7.86. Wattyl's shareholders are primarily professional investment funds managers. It has no major shareholder that would add stability to the shareholder register. Therefore, its best means of defence from hostile takeover is the performance of its share price on the Australian Stock Exchange.

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[130] CIE Report, op. cit, pp. 11-12.
[131] Makin, op. cit. p.8.
[132] CIE Report, op. cit. p.7.
[133] Letter from Tim Monger, Director of Corporate Services, KPMG Corporate Finance, to Mr M Terceiro, Australian Competition and Consumer Commission, re: Wattyl's claims that it may become the target of a foreign takeover if the proposed acquisition does not proceed, 6 May 1996.

7.87. On the basis of the present market and its favourable views of Wattyl, it would be reasonable to expect that the acquisition of Taubmans would ensure that the Wattyl share price continues to perform well. Nevertheless, if Wattyl stumbles in the acquisition, there is potential for the share price to fall and correspondingly leave it more open to takeover.

7.88. A foreign buyer is likely to be interested in acquiring Wattyl only if the acquisition would provide synergistic benefits to the acquirer. Such benefits may arise in research and development or in gaining access to the retail market in Australia. It is unlikely that a foreign buyer would be interested in Wattyl purely for its research and development.

7.89. The over-riding conclusion is that, if the merger proceeds, it does not preclude the possibility of a foreign takeover of Wattyl. The likely performance of Wattyl's share price is to some extent a natural barrier to potential takeover. However, if a foreign competitor was sufficiently interested, a foreign takeover may still proceed after the merger. Furthermore, if Wattyl continues to grow in the international market, it is likely to becoming more attractive to a foreign buyer.

7.90. Even so, such a foreign take-over may not be contrary to the public interest to the extent that it ultimately conferred capital gains on Australian owners that would not otherwise be available.[134]

7.91. In conclusion, the Commission considers that the evidence does not support Wattyl's submission that if the proposed acquisition does not proceed then Wattyl will be more susceptible to foreign takeover.

Environmental benefits

7.92. The Commission accepts that rationalising the number of paint manufacturing plants as a result of the acquisition will reduce actual and potential environmental damage to the benefit of the public.

7.93. Taubmans' Villawood plant currently makes extensive use of recycling so that little waste is removed from the site. Wattyl, on the other hand, spends close to $ per year removing industrial waste from its manufacturing sites. Wattyl envisages that the environmental standards and practices adopted by Courtaulds at Villawood will be adopted at Wattyl's manufacturing sites thus providing a public benefit.[135]

7.94. The Commission accepts that improvements in environmental standards and practices are a benefit to the public. However, the Commission is not convinced that this benefit can only be achieved if the merger proceeds. Wattyl could independently raise its environmental standards and practices, albeit at a possibly higher cost and within a longer time frame than if the merger proceeds.

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[134] Makin, op. cit. p.12.
[135] Wattyl submission, p. 17.

7.95. In summary, the Commission accepts that the environmental benefits arising from the proposed acquisition are benefits to the public and that some would not be available absent the merger.

Health and safety

7.96. The Commission accepts Taubmans' claim that its lost time injury rate is less than one third of the paint industry average whereas five years ago it was higher than the industry average. This reduction is likely to the result of the implementation of Courtaulds Health Environment and Safety Services (CHESS).

7.97. A reduction in lost time injury rates is a benefit to the public. The Commission is unable to establish whether the implementation of the CHESS system to Wattyl plants following the merger would reduce lost time injury rates, although this is likely to be the case. The extent of such reductions is also impossible to assess. The Commission doubts, however, that reductions in lost time injury rates at Wattyl plants can be achieved only through a merger with Taubmans. In particular, it appears that Wattyl is currently unrestricted in its ability to implement programs aimed at improving health, environment and safety standards.

7.98. Any public benefits arising under this heading do not appear to be dependent on the merger and hence are likely to be available if the merger does not proceed.

Pro competitive benefit

7.99. This claimed public benefit is discussed in detail in the previous chapter. The Commission has formed the view that the proposed merger is likely to reduce rather than enhance competition

Conclusion

7.100. The Commission has considered the likely implications for the industry with and without the merger and has concluded that the public benefits do not outweigh the public detriment, particularly the detriment arising from possible anti-competitive effects of the proposal. On balance, and in the particular circumstances of this case, the Commission does not consider authorisation to be appropriate.

7.101. In making this assessment the Commission has weighed the benefits that flow from the acquisition particularly greater resource and cost reductions but considers that they are likely to be sufficiently outweighed by the anti-competitive detriment.

7.102. The Commission is not satisfied that in all the circumstances the acquisition of Taubmans' architectural and decorative paint business by Wattyl would result, or be likely to result, in such a benefit to the public that it should be allowed to proceed.

8. Commission determination

8.1 For the reasons contained herein, the Commission denies authorisation to application A 30175 made under s. 88(9) of the Act.

8.2 This determination is made on 17 May 1996. If no application for review of this determination is made to the Australian Competition Tribunal in accordance with s.101 of the Act, this determination will come into force on 8 June 1996.

8.3 If an application for review is made to the Tribunal, the determination will come into force:

(a) on the day on which the Tribunal makes a determination on the review and grants authorisation; or

(b) where the application for review is withdrawn - on the day on which the application is withdrawn.