



1 November 2006

Statement of Issues - Hexion Specialty Chemicals Pty Ltd's proposed acquisition of Orica Australia Ltd's formaldehyde resins business

1. Outlined below is the Statement of Issues released by the Australian Competition and Consumer Commission (ACCC) in relation to the proposed acquisition of Orica Australia Ltd's (**Orica's**) formaldehyde resins business by Hexion Specialty Chemicals Pty Ltd (**Hexion**) (**the proposed acquisition**).
2. A Statement of Issues published by the ACCC is not a final decision regarding a proposed acquisition, but provides preliminary views, and draws attention to particular issues of varying degrees of competition concerns of the ACCC, as well as the lines of enquiry that the ACCC wishes to undertake.
3. The ACCC anticipates completing market inquiries by 15 November 2006 and expects that it will make a final decision on 6 December 2006. However, the anticipated timeline can change in line with the *Merger Review Process Guidelines*. To be kept abreast of possible changes in relation to timing and to find relevant documents, market participants should visit the ACCC's website at www.accc.gov.au/mergers/register.
4. A Statement of Issues provides an opportunity for all interested parties (including customers, competitors, shareholders, and other stakeholders) to ascertain and consider the primary issues identified by the ACCC. It is intended to also provide both the merger parties and other interested parties with the basis for making further submissions should they consider it necessary.

The transaction

5. Hexion propose to acquire the formaldehyde resin business of Orica.

Background

6. On 31 August 2006, Hexion sought informal clearance from the ACCC with respect to the proposed acquisition pursuant to the ACCC's Merger Review Process Guidelines.

The parties

Hexion

7. Hexion is headquartered in Ohio USA and has significant experience in the production of formaldehyde based resins. In Australia, Hexion manufactures amino and phenolic resin from production plants in Laverton, Victoria and Brisbane, Queensland. The

resins are primarily used in the manufacture of wood based products (eg particle board, MDF, plywood) and to a lesser degree in the production of foundry and glass fibre insulation.

Orica

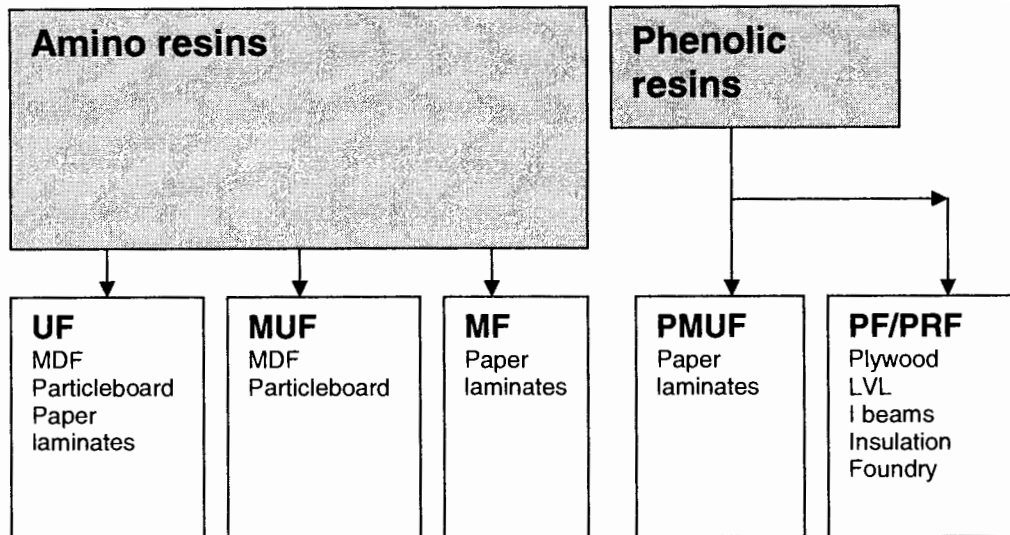
8. Orica is a publicly listed company on the Australian Stock Exchange. Orica's formaldehyde resins business manufactures and supplies amino and phenolic resin products to the wood panels, timber, foundry and fibre insulation industries in Australia, New Zealand, Indonesia and China. Orica's Australian manufacturing facilities are located at Deer Park in Victoria.

Market background

9. Formaldehyde resins come in a variety of forms to suit different applications. Broadly these different varieties of resin can be placed in two groups:
 - Amino resins – include; urea formaldehyde (UF); melamine urea formaldehyde (MUF) and melamine formaldehyde (MF); and
 - Phenolic resins - include; phenol melamine urea formaldehyde (PMUF*) and phenol formaldehyde (PF/PRF).

*PMUF is a hybrid amino/phenolic resin product.

10. Resins are adhesive agents that have a variety of applications, particularly in the wood based products industry and the foundry and fibreglass industries.
11. In Australia, Hexion and Orica manufacture and supply both amino and phenolic resins to customers who are typically manufacturers of wood based products such as particleboard, paper laminates, plywood, laminated veneer lumber (LVL), engineered lumber and structural beams. The supply of resin typically involves the provision of additional on-site or local after sales services and technical support to customers to ensure compatibility of the resin to raw wood materials which may be subject to regional and seasonal variations.
12. The diagram below illustrates the end uses of amino and phenolic resins.



13. In Australia, Hexion and Orica are the only manufacturers of phenolic resins. There are also limited volumes of imported phenolic resins.
14. Hexion and Orica are manufacturers of amino resin as are Woodchem in Oberon, NSW, and Dynea in Dardanup, Western Australia.

Market inquiries

15. The ACCC has conducted market inquiries with a range of interested parties and notes that a number of market participants expressed concerns in relation to the proposed acquisition.

Areas of overlap of the operations of Hexion and Orica's formaldehyde resins business

16. Hexion and Orica both manufacture amino and phenolic formaldehyde based resins.
17. Hexion submits that the proposed acquisition would not substantially lessen competition for the following reasons:
- Hexion will continue to face vigorous and effective competition from low cost competitor Woodchem, and from global rival Dynea;
 - barriers to entry to the formaldehyde resin market are and will remain low post merger;
 - Hexion will continue to sell resin to a highly concentrated customer base which:
 - has strong countervailing power due to customer's ability to by-pass, or credibly threaten to by-pass, Hexion by either vertically integrating themselves or sponsoring new entry by other manufacturers; and
 - has detailed knowledge of input pricing and resin manufacturing costs;
 - post merger Hexion will continue to have strong economic incentives to price competitively in order to:

- maximise utilisation of its plants;
 - support its independent (ie non-vertically integrated) customer base; and
 - support its customer base to remain competitive against imports of end use products in domestic markets and in export markets; and
- in the phenolics segment, Hexion will also face continued direct competition from imported resins.

Market definition

18. The ACCC invites submissions regarding the relevant markets appropriate to its assessment of the proposed acquisition.
19. The ACCC understands that there is limited demand side substitutability between amino and phenolic resins. That is, customers of resins would be unable to switch between amino and phenolic resins in their manufacturing processes in response to small but significant increase in price of either product. In addition, the ACCC understands that amino resin and phenolic resin have important distinguishing characteristics such as price, properties and uses.
20. The ACCC also recognises that while there may be some degree of supply side substitutability between amino and phenolic resins, it is not clear that remaining amino resin manufacturers could easily expand their existing facilities in response to a small but significant price increase in phenolic resin by the merged firm.
21. The ACCC also understands that there is limited, if any supply (as a primary result of the lower value of amino resins relative to transport costs) of amino resins from NSW to customers in South Australia, but there is supply from Victoria to South Australia, and from NSW to Victoria.
22. For the reasons set out above, the ACCC considers that the relevant markets for the purposes of assessing the proposed acquisition under section 50 of the *Trade practices Act 1974* (the Act) may be as follows:
- two possibly overlapping markets:
 - a regional market (including eastern South Australia and Victoria) for the manufacture and supply of amino resin;
 - a regional market (including Victoria and extending to mid New South Wales) for the manufacture and supply of amino resin; and
 - a national market for the manufacture and supply of phenolic resin.
23. The ACCC invites comment on the market definitions outlined above and in particular on the issues set out below:
- (i) the extent to which customers of amino resin in one region identified above source product from another region;

- (ii) the extent to which amino resin manufacturers in mid New South Wales (ie Woodchem) would be able to constrain Hexion post merger;
- (iii) the price increase that would be incurred by amino resin customers located in South Australia to source their resin from NSW; and
- (iv) current prices of amino resins for customers located in South Australia and Victoria.

Overview of competition issues

24. In the course of its assessment of the proposed acquisition, the ACCC identified the potential areas of concern which are outlined below. The ACCC now invites comment (preferably supported by examples and quantitative data) by market participants to:

- Hexion's arguments above;
- the specific concerns identified in relation to the markets identified in this Statement of Issues; and
- any other issue which may be relevant to the ACCC's assessment of the proposed acquisition.

25. The ACCC considers that the proposed acquisition may raise certain competition concerns under section 50 of the Act and therefore further consideration is required.

Concerns in relation to markets for the manufacture and supply of amino resin

The acquisition will increase concentrations in the relevant markets for the manufacture and supply of amino resins

26. The ACCC understands that the proposed acquisition will result in Hexion being the only manufacturer and supplier of amino resins in the geographic area of eastern South Australia and Victoria and it will have a higher market share in the geographic area of Victoria and extending to mid-New South Wales. The ACCC understands there are virtually no, or very limited, imports of amino resins.

The likelihood of sponsored entry

27. The ACCC has formed the preliminary view that barriers to entry into the manufacture and supply of amino resin may be relatively high. The ACCC considers that amino production facilities require government licensing and planning approvals, there are significant capital costs associated with establishing a new facility and there appears to be some excess capacity in the market which may serve to discourage new investment.

28. While there is evidence to suggest that new entrants seek sponsorship from customers to enter, the minimum customer 'base-load' or volume requirement of a customer required for sponsored entry is unclear.

29. The ACCC seeks further information to determine whether customers located in eastern South Australia and Victoria would be willing and likely to sponsor new entry. In particular, the ACCC seeks further information on the following issues:

- (i) the minimum level of demand to enable a new entrant to enter the market and constrain the merged entity (preferably in kmt per annum);
- (ii) whether there is sufficient levels of demand in the relevant geographic markets to meet the minimum level of demand identified in (i) above;
- (iii) availability of candidates for sponsorship;
- (iv) the effect of a new plant on prices in the region;
- (v) whether a new plant would be restricted to supply to the sponsoring customers (or would offer supply to buyers in the region more broadly); and
- (vi) any other issues that may assist in the ACCC's assessment of the likelihood of sponsored entry.

Constraints posed by competition in downstream markets

30. As noted above, amino resins are used in the production of wood-based products, such as particleboard and MDF. These wood-based products are traded on international markets (for instance, the ACCC understands that approximately 45% of Australian production of MDF is exported). The demand for amino resins produced in Australia depends on the competitiveness of Australian producers of wood-based products in domestic and overseas markets. If the merged entity increased the prices of amino resins, arguably Australian producers of particleboard and MDF will become less competitive in domestic and overseas markets.

31. The ACCC invites comments on whether the international competition faced by domestic producers of wood-based products will constrain the prices of amino resins charged by the merged entity. The ACCC seeks information on:

- (i) the cost component of amino resins in relevant downstream products (eg MDF, particleboard);
- (ii) the likely effect on sales volumes of domestically-produced wood-based products resulting from a 10% increase in the price of amino resins (i.e. if domestic producers passed on the higher price of amino resins in the price of wood-based products would they lose sales in domestic and overseas markets – and if so how much)

Concerns in relation to the national market for the manufacture and supply of phenolic resin

The acquisition will increase concentration in the market for the manufacture and supply of phenolic resin

32. The ACCC understands that the proposed acquisition will result in Hexion being the only manufacturer and supplier of phenolic resins in Australia.

The likelihood of sponsored entry and the likelihood of expansion into phenolic resin manufacture by existing manufacturers of amino resin

33. As with amino resins, the ACCC has formed the preliminary view that barriers to entry into the manufacture and supply of phenolic resin may be relatively high. The ACCC seeks further information on the likelihood of sponsored entry into the manufacture and supply of phenolic resins, taking into account the factors outlined in paragraph 29 above.

34. The ACCC also seeks further information on the likelihood of existing amino resin manufacturers expanding into the production of phenolic resins. In particular, the ACCC seeks further information on the following:

- (i) the time required to commence operations for the supply of phenolic resins taking into account acquisition of relevant equipment and establishing relevant facilities;
- (ii) the cost of such expansion; and
- (iii) the circumstances under which amino resin manufacturers would expand, taking into account, for example, the level of demand required, securing customer contracts etc.

The threat of imports of phenolic resin as a constraint against the merged entity

35. The ACCC has formed the preliminary view that independent imports of phenolic resin, especially phenolic resin relevant to the wood products industry, may not be a viable constraint on Hexion post merger due to difficulties associated with logistics (including shipping and storage) and shelf life (the ACCC understands that the relevant shelf life for a large amount of phenolic resin used in Australia is approximately 2 – 7 weeks).

36. It has been suggested that there is import parity pricing in phenolic resins although this appears to be in respect of imports from countries with low production costs as opposed to imports from countries such as New Zealand.

37. The ACCC seeks further information on the likely effectiveness of independent imports to constrain Hexion post merger including reference to any issues associated with the importation of phenolic resins such as:

- (i) logistical and shelf life issues; and
- (ii) price competitiveness with phenolic resin in Australia.

Constraints posed by competition in downstream markets

38. As noted above, phenolic resins are used in the production of wood-based products, such as plywood and LVL. These wood-based products are traded on international markets (for instance the ACCC understands that approximately 50% of Australian consumption of plywood is imported). The demand for phenolic resins produced in Australia depends on the competitiveness of Australian producers of wood-based products in domestic and overseas markets. If the merged entity increased the prices of phenolic resins, arguably Australian producers of plywood and LVL will become less competitive in domestic and overseas markets.
39. The ACCC invites comments on whether the international competition faced by domestic producers of wood-based products will constrain the prices of phenolic resins charged by the merged entity. The ACCC seeks information on:
- (i) the cost component of phenolic resins in relevant downstream products (eg plywood, LVL);
 - (ii) the likely effect on sales volumes of domestically-produced wood-based products resulting from a 10% increase in the price of phenolic resins (i.e. if domestic producers passed on the higher price of phenolic resins in the price of wood-based products would they lose sales in domestic and overseas markets – and if so how much).

ACCC's Future Steps

40. The ACCC will finalise its decision on this matter subsequent to considering the further market responses invited by this Statement of Issues.
41. The ACCC now seeks submissions from market participants on each of the issues that have been raised in this Statement of Issues and on any other issue that may be relevant to the ACCC's assessment of this matter.
42. Submissions must be received by the ACCC no later than 15 November 2006. The ACCC will consider the submissions received from the market and the merger parties in light of the issues that have been identified above and will, in conjunction with information and submissions already provided by the parties, come to a final view as to the appropriate course of action to take to resolve any competition concerns that remain.
43. The ACCC intends to publicly announce its final view on 6 December 2006. However, the anticipated timeline may change in line with the *Merger Review Process Guidelines*. A Public Competition Assessment for the purpose of explaining the ACCC's final view may be published following the ACCC's public announcement.