Australian
Competition &
Consumer
Commission

22 April 2009

Statement of Issues — Rheem Australia Pty Ltd - proposed acquisition of Aqua-Max Pty Ltd

1. Outlined below is the Statement of Issues released by the Australian Competition and Consumer Commission **(ACCC)** in relation to the proposed acquisition of Aqua-Max Pty Ltd by Rheem Australia Pty Ltd **(proposed acquisition)**.

2. A Statement of Issues published by the ACCC is not a final decision about a proposed acquisition, but provides the ACCC's preliminary views, drawing attention to particular issues of varying degrees of competition concern, as well as identifying the lines of further inquiry that the ACCC wishes to undertake.

3. In line with the ACCC's *Merger Review Process Guidelines* (available on the ACCC's website at www.accc.gov.au) the ACCC has established a secondary timeline for further consideration of the issues. The ACCC anticipates completing further market inquiries by **13 May 2009** and anticipates making a final decision on **27 May 2009**. However, the anticipated timeline can change in line with the *Merger Review Process Guidelines*. To keep abreast of possible changes in relation to timing and to find relevant documents, market participants should visit the Mergers Register on the ACCC website at www.accc.gov.au/mergersregister

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 also intended to provide the merger parties and other interested parties with the basis for making further submissions should they consider it necessary.

Background

5. On 23 February 2009, the ACCC commenced a public informal review of Rheem Australia Pty Ltd's proposed acquisition of Aqua-Max Pty Ltd.

The parties

Rheem Australia Pty Ltd

6. Rheem Australia Pty Ltd (**Rheem**) is a wholly owned subsidiary of the Japan-based firm, Paloma Industries Ltd, a leading international producer of gas-powered water heaters, boilers, and other consumer appliances.

7. Rheem began manufacturing and supplying water heaters in Australia in the late 1930's, and is currently the largest manufacturer and supplier of water heaters in Australia. Rheem manufactures, imports and supplies a complete range of water heaters for residential and commercial use, including electric storage water heaters, gas storage water heaters, instantaneous gas water heaters, solar water heaters and heat pump water heaters. The water heater brands distributed by Rheem include *Rheem*, *Solahart*, *Edwards*, *Vulcan*, *Raypak*, *Paloma*, and *Everhot*.

8. Rheem distributes its water heater products to retail customers through plumbing and building supply merchants, energy retailers and plumbing supplies buying groups. Rheem's Australian manufacturing sites are located in Rydalmere New South Wales, Welshpool Western Australia and Scoresby Victoria.

Aqua-Max Pty Ltd

9. Aqua-Max Pty Ltd (**Aqua-Max**) is a wholly owned subsidiary of the Australian investment firm, Sietel Ltd, which is listed on the Australian Stock Exchange (**ASX**).

10. Aqua-Max began manufacturing and supplying water heaters in Australia in the early 1990's. Aqua-Max manufactures and supplies a limited range of water heaters mainly for residential use, including electric storage water heaters, gas storage water heaters (in the 5-star rated product range only) and a small volume of solar water heaters under the *Aqua-Max* brand.

11. Aqua-Max distributes its water heater products to retail customers through plumbing and building supply merchants, energy retailers and plumbing supplies buying groups. Aqua-Max's only Australian manufacturing site is located in Moorabbin, Victoria.

Other industry participants

Dux Pty Ltd

12. Dux Pty Ltd (**Dux**) is a wholly owned subsidiary of the Australian firm GWA International Ltd (**GWA**), which is listed on the ASX and is one of Australia's largest designers, manufacturers, importers and distributors of household consumer products.

13. Dux has been manufacturing water heaters in Australia since 1915, and is currently the second largest manufacturer and supplier of water heaters in Australia. Dux manufactures, imports and supplies a complete range of water heaters for residential and commercial use, including electric storage water heaters, gas storage water heaters, instantaneous gas water heaters, solar water

heaters and heat pump water heaters. Dux distributes water heater products under the *Dux* and *Radiant* brands.

14. Dux distributes its water heater products to retail customers through plumbing and building supply merchants, energy retailers and plumbing supplies buying groups. Dux's only Australian manufacturing site is located in Moss Vale, NSW.

Rinnai Australia Pty Ltd

15. Rinnai Australia Pty Ltd (**Rinnai**) is a wholly owned subsidiary of the Japan-based firm, Rinnai Corporation, which is a significant international manufacturer and supplier of gas appliances, including water heaters.

16. Rinnai has been supplying water heaters in Australia since 1990. Rinnai manufactures, imports and supplies a limited range of water heater products for residential and commercial use, including instantaneous gas water heaters (which comprise the majority of its overall sales), as well as small volumes of electric storage water heaters and solar water heaters. Rinnai distributes water heaters under the *Rinnai* brand.

17. Rinnai previously only supplied imported water heater products, but recently acquired small-scale manufacturing facilities in Australia, which are focused on the production of stainless steel storage tanks for solar water heaters.

18. Rinnai distributes its water heater products to retail customers through plumbing and building supply merchants, energy retailers and plumbing supplies buying groups. Rinnai's only Australian manufacturing site is located in Devon Park, South Australia.

Robert Bosch (Australia) Pty Ltd

19. Robert Bosch (Australia) Pty Ltd (**Bosch**) is a wholly-owned subsidiary of the German-based firm, Robert Bosch GmbH, which is a significant international manufacturer and supplier of products and services to a range of industries (including the automotive, industrial and building sectors), and is a significant international manufacturer and supplier of commercial and consumer goods, including water heaters.

20. Bosch has been supplying water heaters in Australia since the 1950's. Bosch imports and supplies a limited range of water heaters for residential and commercial use, including instantaneous water heaters (which comprise the majority of its overall sales) and a small volume of solar water heaters. Bosch distributes water heaters under the *Bosch* brand.

21. Bosch distributes its water heater products to retail customers through plumbing and building supply merchants, energy retailers and plumbing supplies buying groups. Bosch currently has no manufacturing facilities in Australia.

Chromagen Solar Australia Pty Ltd

22. Chromagen Solar Australia Pty Ltd (**Chromagen**) is a wholly-owned subsidiary of the Israel-based Chromagen Ltd, which is a significant international manufacturer and supplier of solar water heaters.

23. Chromagen has been supplying imported solar water heaters in Australia since 2004, and a small volume of instantaneous gas water heaters (typically for use with their solar water heater systems) since 2005, mainly for residential use. Chromagen distributes water heaters under the *Chromagen* brand.

24. Chromagen distributes a significant proportion of its water heater products directly to retail customers, typically through large volume builders and direct-to-public retail stores. Chromagen currently has no manufacturing facilities in Australia.

Peter Sachs Industries Pty Ltd – trading as Saxon

25. Peter Sachs Industries Pty Ltd (trading as Saxon)(**Saxon**) is a private Australian company involved in the manufacture and supply of water heating products for residential, commercial and marine applications.

26. Saxon currently manufactures and supplies a limited range of water heaters, including electric storage water heaters, solar water heaters and heat pump water heaters. Saxon distributes water heaters under the *Saxon* brand.

27. Saxon distributes its water heater products to retail customers through plumbing and building supply merchants, energy retailers and plumbing supplies buying groups. Saxon's only Australian manufacturing site is located in Zillmere, Queensland.

Industry background

General background

28. Approximately 700,000 water heaters are supplied and sold in Australia per annum. Total sales revenue for water heaters nationally around $600 million per annum.

29. An overview of the water heaters currently available in Australia is provided as follows:

    - Electric storage water heaters: consist of a storage tank (with variations in water holding capacity) and heating element. These water heaters have tended to be the lowest up-front cost option available to end-customers. Historically, these types of water heaters were the most commonly purchased by consumers and currently account for around 50% of existing water heater sales. However, existing and anticipated regulatory changes (see below) appear likely to result in declining sales of electric storage water heaters as they are phased out over time.

    - Gas storage water heaters: consist of a storage tank (with variations in water holding capacity) and heating element. They appear to account for around 20% of existing water heater sales. Gas storage water heaters are rated from 3-star (least energy efficient water heater of this type) to 6-star (most energy efficient). As with electric storage water heaters, existing and anticipated regulatory changes (see below) appear likely to result in declining sales of 3-star rated gas storage water heaters as they are phased out over time.

- Instantaneous gas water heaters: consist of a heating element (with variations in the volume of water able to be heated per minute) in a small heating unit. These water heaters do not have a storage tank. All such water heaters are imported and are rated between 5-stars (least energy efficient water heater of this type) and 6-stars (most energy efficient water heater of this type). Instantaneous gas water heaters appear to currently account for around 20% of existing water heater sales.

- Solar water heaters: consist of a storage tank (with variations in water holding capacity) and a heating element (which may be powered by either attached solar panels and, where there is insufficient solar energy, by a gas or electric booster element. Government subsidies are currently available for these types of water heaters to offset their significantly higher upfront cost. Solar water heaters appear to account for around 10% of existing water heater sales (in combination with heat pump water heaters), and have been capturing a growing share of sales in recent years.

- Heat pump water heaters: consist of a storage tank (with variations in water holding capacity) and a heating element (which comprises a reverse air-conditioning unit). Government subsidies are currently available for these types of water heaters to offset their significantly higher upfront cost. Heat pump water heaters appear to account for around 10% of existing water heater sales (in combination with solar water heaters), and have been capturing a growing share of sales in recent years.

Anticipated regulatory changes in relation to water heaters

30. The ACCC notes that there have been a large number of regulations, and proposed regulatory developments at both the national and state level, which have, and will, directly impact the national water heater market.

Phase out around 2010 of 3-star gas storage water heaters

31. During the second half of 2009, the Ministerial Council on Energy will consider a proposal to impose Minimum Energy Performance Standards on gas water heaters. The new regulation proposes to phase out 3-star rated gas storage water heaters by imposing a minimum 4-star rating standard, which will impact both new and established homes. It is proposed that the regulation will take effect during the second half of 2010.

32. At the state level, the installation of all gas storage water heaters with a rating of less than 5-stars has already been prohibited in Queensland, South Australia and Western Australia in relation to new and established detached, semi-detached, row and terrace homes (**class 1 homes**) in areas with access to reticulated gas.

Phase out around 2010 of electric storage water heaters in areas with access to reticulated gas

33. During 2010, the Ministerial Council on Energy proposes to begin phasing out electric storage water heaters in all new homes, and established class 1 homes

with access to reticulated gas. This will apply to all jurisdictions except Tasmania.

34. At the state level, the installation of electric storage water heaters has already been prohibited in Queensland, Western Australia and South Australia in relation to new Class 1 homes in areas with access to reticulated gas. In Victoria, all new Class 1 homes are required to have either a water tank or a solar water heater.

Phase out around 2012 of electric storage water heaters in areas with no access to reticulated gas

35. During 2012, the Ministerial Council on Energy proposes to phase out electric storage water heaters in all established Class 1 homes without access to reticulated gas. This will apply to all jurisdictions except Tasmania.

36. During 2012, electric storage water heaters are to be phased out in all new flats and apartments (**class 2 homes**) in areas which have access to gas reticulation. This will apply to all jurisdictions except Tasmania. Class 2 homes without access to gas reticulation will be exempt from these proposed phase outs. Market inquiries

37. On 23 February 2009, the ACCC commenced market inquiries regarding the proposed acquisition. A range of interested parties provided responses, including other suppliers of water heater products, plumbing and building supply merchants, energy retailers, plumbing supplies buying groups, industry associations and government bodies.

Areas of overlap and market definition

38. Rheem and Aqua-Max overlap in relation to the manufacture and supply of electric storage water heaters, gas storage water heaters (in relation to 5-star rated gas storage water heaters only) and to a less significant extent, solar water heaters.

39. In relation to the ACCC's review of the proposed acquisition, the ACCC considers that the relevant market is the national market for the supply of water heaters (**the national water heater market**).

40. Market inquiries indicated that consumers generally replace their hot water heater with the same type of hot water system, which led the ACCC to identify distinct water heater product segments. However, there was also evidence of some substitution occurring between these product segments. Therefore, while the proposed acquisition was considered in the context of a broad water heater market, the ACCC noted a degree of discrete demand for different product types within that market.

The ACCC invites market participants to comment on market definition

41. The ACCC welcomes any comments from market participants regarding the proposed market definition, including whether or not the different types of water heater (i.e. water heaters that use a storage tank as compared to

instantaneous gas water heaters that are tankless) should be considered in the same or separate product markets.

42. The ACCC welcomes any comments from market participants as to the geographic dimension of the proposed market definition, including whether there are any significant elements of state-based competition between water heater suppliers.

Statement of issues

43. For the purposes of this Statement of Issues, the issues in this matter are divided into three categories, 'issues that are likely to raise concerns', 'issues that may raise concerns' and 'issues unlikely to pose concerns'.

Issues that are likely to raise concerns

44. The ACCC's preliminary view is that the proposed acquisition is likely to raise competition concerns in relation to the electric storage water heater segment of the national water heater market.

Reduction in the number of available suppliers to the electric storage water heater segment of the national water heater market

45. The ACCC notes that, notwithstanding proposed regulatory developments, there is likely to be on-going demand for one to two years and potentially longer, particularly, but not exclusively to households without access to reticulated gas.

46. The ACCC notes that it appears likely that the following categories of consumers will continue to have the option of replacing an electric storage water heater with an electric storage water heater (i.e., like-for-like replacement):

- Established class 1 homes with access to reticulated gas (until around 2010);
- Established class 1 homes in areas without access to reticulated gas (until around 2012);
- Established Class 2 homes without access to reticulated gas (no phase out proposed); and
- Tasmania (no phase out proposed).

47. Rheem and Aqua-Max are currently the first and third largest suppliers of electric storage water heaters in Australia. The ACCC considers that the proposed acquisition by Rheem of Aqua-Max may have the potential to reduce competition for the supply of electric storage water heaters to customers, particularly as Dux (as the second largest supplier) will be the only remaining significant supplier of these types of water heaters post-acquisition.

48. The initial phase of the ACCC's market inquiries indicated that Aqua-Max is currently a strong competitor in terms of the pricing of its electric storage water heater product offering. In particular, market inquiries have indicated that aggressive price competition by Aqua-Max for the supply of electric storage

water heaters has resulted in increased price competition for these types of water heaters by all suppliers (particularly Rheem and Dux).

49. The initial phase of market inquiries also indicated that the removal of Aqua-Max may lead to a reduction in price competition for the supply of electric storage water heaters. There were indications during the initial phase of market inquiries that Dux would be likely to follow any price increases by Rheem.

50. The initial phase of market inquiries indicated that it was unlikely that instantaneous gas water heaters imported by Rinnai and Bosch would credibly constrain the merged entity due to their significantly higher upfront costs (unit price and installation).

51. In particular, on the available evidence, staff consider that it seems unlikely that manufacturers of instantaneous gas water heaters would credibly constrain the merged entity in areas that are not able to access reticulated gas (since these consumers would be required to use LPG as the fuel source for their gas-powered water heater, at a significantly higher cost).

52. On the available evidence, it is appears unlikely that solar and heat pump water heaters (supplied primarily by Rheem, Dux, Rinnai and Chromagen) will be considered as credible alternative options for consumers currently using electric storage water heaters. This is mainly due to the significantly higher up-front (unit price and installation) costs of these types of water heaters despite government rebates.

53. The ACCC invites further information and comments from market participants on this issue. In particular, the ACCC seeks further information and comments in relation to the:

- relative costs of other types of water heaters (e.g. gas storage water heaters, instantaneous gas water heaters, solar water heaters and/or heat pump water heaters) compared to an electric storage water heaters. Such information may include any associated switching costs (including the upfront cost of water heater units and their installation costs) as well as ongoing running costs. The ACCC would be particularly interested in such information in relation to consumers living in areas which are not able to access reticulated gas;
- evidence of significant shifts in consumer demand as a result of non-price competition. This might include, but should not be limited to, information and data on the impact on consumer demand of factors such as functionality and performance, availability of service and support and environmental concerns;
- ability for new entrants and/or smaller fringe suppliers of electric storage water heaters to provide an effective competitive constraint on the merged entity, particularly in relation to price;
- price competition between Rheem, Dux and Aqua-Max for the supply of electric storage water heaters. This might include information and data on the wholesale and retail prices offered by each of these suppliers, and any

effect the pricing of any one supplier is likely to have on other rival suppliers; and

- extent to which the merged entity and Dux will have an incentive to compete vigorously post-acquisition to maintain their respective operational economies of scale, given the further decline in the sales of electric storage water heaters that would appear likely to result from existing and anticipated regulatory bans on these types of water heaters.

Issues that may raise concerns

54. The ACCC's preliminary view is that the proposed acquisition may raise competition concerns in relation to the gas storage water heater segment of the national water heater market.

Reduction in the number of available suppliers to the gas storage water heater segment of the national water heater market

55. Rheem and Aqua-Max are currently the first and third largest suppliers of gas storage water heaters in Australia. The ACCC considers that the proposed acquisition by Rheem of Aqua-Max may have the potential to reduce competition for the supply of gas storage water heaters to customers, particularly as Dux (as the second largest supplier) will be the only remaining significant supplier of these types of water heaters post-acquisition.

56. The ACCC's market inquiries have indicated that Aqua-Max is currently a strong competitor in terms of its gas storage water heater product offering. In particular, market inquiries have indicated that Aqua-Max and Rheem are each others' closest competitors for the supply of 5-star rated gas storage water heaters, with Aqua-Max currently positioned as the market leader for 5-star rated gas storage water heaters.

57. The initial phase of market inquiries indicated that there may be a level of discrete demand for 5-star rated gas storage water heater products.

58. The initial phase of market inquiries also indicated that up-front costs including installation costs associated with switching from a gas storage water heater to an instantaneous gas water heater may impair the ability of suppliers of instantaneous gas water heaters to credibly constrain the merged entity.

59. The ACCC invites further information and comments from market participants on this issue. In particular, the ACCC seeks further information and comments in relation to the:

    - relative cost of other types of water heaters (e.g. instantaneous gas water heaters, solar water heaters and/or heat pump water heaters) compared to a gas storage water heater. Such information may include any associated switching costs (including the upfront cost of water heater units and their installation costs) and ongoing running costs;

    - ability for new entrants and/or smaller fringe suppliers of gas storage water heaters to provide an effective competitive constraint on the merged entity, particularly in relation to price;

- price competition between Rheem, Dux and Aqua-Max for the supply of gas storage water heaters (particularly 5-star rated gas storage water heaters). This might include information and data on the wholesale and retail prices offered by each of these suppliers, and any effect the pricing of any one supplier is likely to have on other rival suppliers; and
- extent to which the merged entity and Dux will have an incentive to compete vigorously post-acquisition to maintain their respective operational economies of scale, given the further decline in the sales of 3-star rated gas storage water heaters that would appear likely to result from existing and anticipated regulatory bans on these types of water heaters.

Issues unlikely to pose concerns

Other water heater product segments of the national water heater market

60. The ACCC considers that the proposed acquisition is unlikely to pose competition concerns in relation to the other product segments of the national water heater market (i.e. instantaneous gas water heaters, solar water heaters and heat pump water heaters).

Bundling strategies by the merged entity to foreclose rivals' access to customers

61. The ACCC considers that the proposed acquisition is unlikely to have the potential to result in an increased ability for the merged entity to bundle its water heater product offerings, foreclosing rival suppliers' ability to access wholesale customers post-acquisition.

62. Market inquiries have indicated that the merged entity would be unlikely to have the ability to engage in a bundling strategy sufficient to effectively prevent competing suppliers from accessing customers, for the following key reasons:
    - remaining suppliers will be able to supply water heater products in relation to all existing product segments, with Dux in particular having the ability to supply a complete range of water heating products and offering a volume-based incentive and rebate pricing structure similar to Rheem's;
    - the merged entity's very significant market share in relation to the supply of 5-star rated gas storage water heaters would not be likely to provide it with an increased ability to engage in an effective bundling strategy;
    - major wholesale customers have indicated that exclusive supply arrangements are not a common feature of the national water heater market, with such customers typically maintaining a policy of obtaining supply from a range of different suppliers and brands; and
    - other smaller suppliers such as Rinnai and Bosch have well-recognised and established brands and are the current market leaders in relation to the supply of imported instantaneous gas water heaters, a significant product segment in which the merged entity will be the third largest supplier.

Further submissions and comments in relation to issues unlikely to pose concerns

63. Although the ACCC is of the preliminary view that the above issues are unlikely to pose concerns, the ACCC will accept further submissions from

market participants with regard to the above issues and will further consider possible competition concerns if it considers that such an assessment is warranted.

ACCC's future steps

64. The ACCC will finalise its view on this matter after it considers market responses invited by this Statement of Issues.

65. The ACCC now seeks submissions from market participants on each of the issues identified in this Statement of Issues and on any other issue that may be relevant to the ACCC's assessment of this matter.

66. Submissions are to be received by the ACCC no later than **13 May 2009**. The ACCC will consider the submissions received from the market and the merger parties in light of the issues 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.

67. The ACCC intends to publicly announce its final view by **27 May 2009**. 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.