



Statement of Issues

17 October 2014

Rheem Australia Pty Ltd - possible acquisition of the water heater assets of Dux Manufacturing Ltd

Introduction

1. Outlined below is the Statement of Issues released by the Australian Competition and Consumer Commission (**ACCC**) on the proposed acquisition by Rheem Australia Pty Ltd (**Rheem**) of the water heater assets of Dux Manufacturing Ltd (**Dux**) (**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 (at www.accc.gov.au/processguidelines) the ACCC has established a secondary timeline for further consideration of the issues. The ACCC anticipates completing further market inquiries by 31 October 2014 and anticipates making a final decision on 20 November 2014. 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's 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. The ACCC commenced its public review of the proposed acquisition on 25 August 2014.

The parties

6. Rheem is Australia's largest manufacturer and supplier of water heaters. A subsidiary of Japan's Paloma Co Ltd, it has manufacturing facilities in Rydalmere

(NSW), Welshpool (WA) for solar heaters, and Moorabbin (Vic) for stainless steel water heaters and commercial boilers.

7. Dux is Australia's second largest manufacturer and supplier of water heaters. A wholly owned subsidiary of ASX listed GWA Group Ltd (GWA), it has a manufacturing facility in Moss Vale (NSW).

Other industry participants

8. Rinnai Australia Pty Ltd (**Rinnai**) is an importer and supplier of electric storage and solar water heaters, and Australia's largest importer and supplier of continuous flow water heaters. Rinnai has indicated it also intends to bid to acquire the assets of Dux.
9. Bosch Thermotechnology (**Bosch**) is a wholly owned division of Robert Bosch (Australia) Pty Ltd and imports and supplies gas continuous flow water heaters, heat pump water heaters and gas heating boilers.
10. Reece Plumbing Supplies (**Reece**) is Australia's largest distributor of plumbing products and a large customer of both Rheem and Dux.
11. Tradelink Plumbing Centres (**Tradelink**), a member of the Fletcher Building Group, is a plumbing supplies merchant and a large customer of both Rheem and Dux.
12. Plumbing Plus Bathroom Kitchen Laundry Pty Ltd (**Plumbing Plus**) represents Australia's largest group of independent plumbing supplies merchants and is a large customer of Rheem.

The transaction

13. GWA has stated that it intends to divest the Dux business as it is non-core. GWA's FY14 annual report and accompanying media release indicated that sales in the hot water product category were down 7% and that the category was "extremely challenging".
14. Rheem proposes to acquire the Dux water heater assets including intellectual property, brands, stock and equipment.

Market inquiries

15. On 27 August 2014 the ACCC commenced market inquiries regarding the proposed acquisition.
16. The ACCC received responses to its market inquiries letter from a range of industry participants including hot water heater manufacturers, plumbing supplies wholesalers and plumbers.

Future with and without the acquisition

17. Section 50 of the Act prohibits mergers or acquisitions that would have the effect or be likely to have the effect of substantially lessening competition in a market. In assessing a proposed acquisition pursuant to section 50 of the Act, the ACCC considers the effects of the acquisition by comparing the likely future competitive

environment post-acquisition if the acquisition proceeds (the “with” position) to the likely future competitive environment if the acquisition does not proceed (the “without” position) to determine whether the proposed acquisition is likely to substantially lessen competition in any relevant market.

18. On the basis of the information currently available, the ACCC considers that, in the future without the proposed acquisition, Dux is likely to be acquired by another party without significant Australian hot water heater manufacturing capability. This party may be Rinnai, which has indicated an intention to bid for the assets, or another (currently undisclosed) bidder.

Industry background

19. There are two broad types of hot water heaters in use within Australia: storage water heaters and continuous flow water heaters¹. Each of these types of water heaters can be powered using different energy sources.
20. Storage water heaters heat water prior to use and store it in a tank. These tanks are heavily insulated to maintain water temperature and increase unit efficiency. They also must be highly corrosion resistant as the minerals in the water can be very corrosive at high temperatures.
21. Storage water heaters can be:
- a. electric
 - b. gas
 - c. solar² or
 - d. heat pump³
22. In Australia the tanks used in storage water heaters are most commonly lined with a vitreous enamel coating, but can also be made with marine grade stainless steel. Market enquiries have indicated that stainless steel tanks, while they can be more durable, are significantly more expensive to produce than vitreous enamel tanks. The ACCC understands that stainless steel tanks are relatively common in solar and heat pump water heaters, but the proportion of electric and gas storage heaters supplied in Australia using stainless steel tanks is currently very small. They are primarily used in commercial rather than domestic applications
23. Continuous flow water heaters are wall mounted units that heat water only as needed. Continuous flow water heaters can be either:
- a. gas, or

¹ For the purposes of this Statement of Issues, the ACCC uses the term ‘continuous flow’ to refer to both continuous flow and instantaneous water heaters.

² Solar water heating systems typically also contain a gas or electric-powered booster for times when sufficient solar energy is unavailable.

³ Heat pump units use a reverse refrigerator-type cycle to draw heat from the air and also typically include a gas or electric-powered booster.

b. electric.

24. However, as is discussed below, the ACCC understands that continuous flow *electric* water heaters do not provide sufficient hot water for most households or commercial applications.

Electric and gas storage water heaters

25. Rheem and Dux both manufacture electric and gas storage water heaters in Australia, including the vitreous enamel storage tanks commonly used as a component of these heaters.

26. Rheem supplies the following electric and gas storage heaters:

a. **Electric:** models range from 25 to 400L in capacity; and

b. **Gas:** models range from 80 to 275 litres.

27. A small proportion of the electric and gas storage water heaters supplied by Rheem include a stainless steel tank rather than a vitreous enamel tank. Rheem also manufactures the stainless steel tanks.

28. Dux supplies the following electric and gas storage water heaters with vitreous enamel tanks:

a. **Electric:** models range from 25 to 400 litres capacity; and

b. **Gas:** models range from 135 to 170 litres in capacity.

29. Market participants generally considered that electric storage water heaters could be divided into categories of:

a. **large storage heaters:** ranging from around 125 litres in capacity upwards, these are suitable for providing water to an average sized family home; and

b. **small storage heaters:** being around 80 litres or less in capacity, these are primarily used for small apartments or low-water demand commercial settings such as under a kitchen bench.

30. The majority of electric and gas storage water heaters sold in Australia fall within the 'large' category.⁴

31. Rheem is the only remaining Australian manufacturer of small vitreous enamel storage water heaters, while all other suppliers (including Dux) import small electric vitreous enamel storage heaters. The proportion of small tanks supplied that are imported has been increasing, and it is not clear that the Australian manufacture of small units will continue to be cost effective.

⁴ For gas storage water heaters, the boundaries of these 'large' and 'small' segments may be different. The average tank size for gas storage water heaters tends to be smaller than for electric storage water heaters due to the higher calorific value of gas which provides gas units with a higher 'recovery rate' than electric units.

Continuous flow water heaters

32. Continuous flow water heaters typically deliver water at a slower rate than storage water heaters. However, they have other benefits such as wireless controls and a constant supply of hot water.
33. Most continuous flow heaters sold in Australia are gas models and therefore can only be installed in areas where reticulated gas is available or LPG tanks are in use. Electric continuous flow units are typically only suitable for small apartments or commercial settings such as under a kitchen bench. The ACCC understands that, in order to produce a sufficient amount of hot water for an average sized Australian home, an electric continuous flow water heater would require three-phase power, whereas most Australian homes have single-phase power.
34. Continuous flow heaters are not manufactured in Australia. Market participants suggested that this was because it was more cost effective to import continuous flow heaters than to manufacture them domestically.
35. Rheem and Dux both import and distribute continuous flow water heaters.

Solar and heat pump water heaters

36. Solar and heat pump water heaters also include, as a key component of the unit, a storage tank (commonly vitreous enamel), albeit with different attachments and connections than for electric or gas storage. Solar and heat pump water heaters may alternatively be assembled using stainless steel storage tanks.
37. Solar and heat pump water heaters are supplied in Australia both by the merger parties and by other companies, some of whom specialise in the supply of these types of water heaters. Some of these competing solar and heat pump water heater suppliers use tanks supplied by Dux, while others manufacture their own tanks (stainless steel only) or import either the tank or complete water heater.
38. The merger parties supply solar water heaters as follows:
 - a. Rheem supplies solar water heaters that are either gas or electric boosted and range in capacity from 150 to 5000 litres.
 - b. Dux supplies solar water heaters that are either gas or electric boosted and range in capacity from 250 to 400 litres.
39. Rheem and Dux both manufacture and supply heat pump water heaters.

Replacement water heaters versus new installations

40. Market participants generally agreed that approximately 70-80% of water heater sales in Australia are to customers seeking to replace an existing water heater.
41. Large electric and gas storage water heaters are the most prevalent type of water heater in Australian homes.
42. As discussed further below, the ACCC considers that there are a number of factors which may limit the substitutability of an alternative type of water heater for a customer seeking to replace an existing gas or electric storage heater.

43. For the approximately 20-30% of water heater sales which involve new installation (as opposed to replacement), choice of water heater unit is based on factors including availability of reticulated gas and state regulatory requirements, and is typically made by the builder.

Factors that affect choice of a replacement water heater

44. The majority of market participants contacted estimate that a substantial majority of installations in the replacement segment are like-for-like installations, where a customer replaces their existing unit with the same type of unit. Market participants suggested that factors that influence this preference for like-for-like replacement include:
- a) replacements are often an emergency purchase made when the customer's existing unit fails. In these circumstances, the consumer's lack of access to hot water means that speed of replacement is an important factor;
 - b) replacing a heater with the same type of unit (and often the same size unit) can allow faster and cheaper installation;
 - c) switching energy sources (e.g. from electric to gas) may not be possible (e.g. in areas where reticulated gas is unavailable), and even where it is possible switching can be expensive; and
 - d) particularly in circumstances where the purchase is unplanned (due to failure of the customer's existing unit), consumers may favour a low upfront cost (as opposed to investing in e.g. a solar model with higher upfront costs but lower running costs).
45. Market participants identified the following factors which affect the likelihood of a customer with an existing electric storage heater replacing that heater with a different type of unit:
- a) switching to any kind of gas-powered unit will only be an option if reticulated gas is available in the area where the unit is located, or if running the unit on bottled gas (LPG) is viable;
 - b) where gas is not available, the electric continuous flow water heaters available in Australia do not appear to have the capacity to supply sufficient hot water for anything larger than a small apartment (or other equivalent low-demand application); and
 - c) solar water heaters and heat pumps, while they may potentially be equivalent in cost or cheaper than storage heaters for the customer over the longer term, involve a significant upfront cost (approximately three times more than the cost of an electric or gas storage water heater in the case of heat pumps and even more in the case of solar) that some customers cannot afford or are not prepared to pay.
46. For customers who have access to reticulated gas, the ACCC understands that the unit price of continuous flow water heaters is comparable to that of gas storage water heaters, and may in fact be cheaper than the most energy efficient gas storage water heaters. However, market participants suggested that the degree of substitution from gas storage water heaters to continuous flow water heaters may be limited by factors including:

- a) most continuous flow units require high capacity gas which may necessitate replacing the gas pipes to the unit if the existing pipes are too narrow;
- b) as continuous flow units are typically mounted on a wall at eye level, and storage units are typically installed on the ground, gas and water piping connections need to be changed when switching from a storage unit to a continuous flow unit;
- c) continuous flow water heaters typically deliver water at a slower rate than storage water heaters. While regulatory standards for new shower heads may mean that there is little appreciable difference in most cases, there appears to be a perception amongst some consumers that continuous flow water heaters have insufficient flow rates; and
- d) for the reasons outlined above (i.e. ease and speed of installing a replacement unit), consumers may prefer to replace their existing water heater with the same type of unit.

Previous ACCC decisions

47. On 30 July 2009, the ACCC released a Public Competition Assessment in relation to Rheem's proposed acquisition of Aqua-Max Pty Ltd, which was not opposed by the ACCC.⁵ Based on the information available at the time, the ACCC adopted an Australian market for the manufacture and supply of water heaters as the relevant market. However, the ACCC also considered the impact of the proposed acquisition on a range of narrower product segments.
48. In its decision, the ACCC took into account the then current and likely future regulation of water heaters. In particular, at that time the Commonwealth, states, and territories had jointly proposed to begin phasing out electric storage water heaters. However, many of these government initiatives have ultimately not been implemented or have been significantly scaled back. At the time of the decision there were also significant government rebates available to customers who chose to install more energy efficient water heaters, such as solar models. These incentives have similarly been discontinued or scaled back in most states/territories.
49. The changes in the regulatory environment since the ACCC's decision in the Rheem/Aqua-Max matter is one factor that may warrant analysis of narrower product markets in the current matter, as these changes may have made customer substitution between types of water heaters less likely than was the case in 2009.

MARKET DEFINITION

50. The ACCC's starting point for delineating relevant markets to assess the competitive effects of the proposed acquisition involves identifying the products actually or potentially supplied by the merger parties. The ACCC then considers what other products constitute sufficiently close substitutes to provide a significant source of constraint on the merged entity.

⁵ This proposed acquisition was later completed by Rheem.

Areas of overlap

51. Rheem and Dux overlap in:
- the manufacture and supply of gas and electric storage water heaters;
 - the manufacture and supply of solar storage water heaters (gas or electric boosted);
 - the manufacture and supply of heat pump water heaters; and
 - the importation and supply of continuous flow gas water heaters.
52. Post-acquisition Rheem would become the only Australian manufacturer of vitreous enamel storage water heaters. The proposed acquisition would significantly increase Rheem's market share in the supply of electric and gas storage water heaters, as imports of these products by other parties are relatively small.
53. Rheem and Dux also overlap in the supply of solar water heaters and heat pumps. The ACCC understands that Dux's share of sales of these products is not large, and that these products may be more readily imported, at least at the exchange rates that have prevailed in recent years.
54. While both Rheem and Dux also supply (imported) continuous flow water heaters, the proposed acquisition would create significantly less aggregation in this product category as Dux only supplies a relatively small number of units. Rinnai is currently the largest supplier of continuous flow water heaters in Australia. Bosch is also a significant supplier of continuous water flow heaters in Australia.

Customer substitution opportunities

55. On current information, the ACCC considers that in geographic areas where households do not already have a mains gas connection, there is likely to be minimal opportunity for customers to substitute from electric storage water heaters to continuous flow heaters. While LPG is available in some areas, the ACCC understands that running a water heater on LPG involves very high operating costs. As noted above, electric continuous flow water heaters are likely to be suitable only for very small apartments.
56. In areas where households do not already have a mains gas connection, substitution from electric storage water heaters to solar or heat pump water heaters is likely to be limited by the relatively higher upfront costs and possibly other (non-price) factors that render these options unsuitable in some situations.
57. Even where households do already have a mains gas connection, market enquiries indicate that the opportunity for customer substitution away from electric or gas water storage heaters is likely to be limited by:
- consumers' preference to replace existing water heaters on a like for like basis (as noted in the industry background section above, where the replacement is due to breakdown of the existing unit, a key consideration for the consumer will be to replace the unit as quickly as possible);

- the relatively high cost to switch from a larger capacity storage water heater to a continuous flow unit in buildings that do not have a high capacity gas connection. This may require replacing the pipes from the meter to the water heater if the existing pipes are too narrow; and
- the higher cost to install a solar or heat pump water heater relative to the cost to purchase and install a replacement electric or gas water storage heater.

Supplier substitution opportunities

58. There appears to be significant potential for substitution between the manufacture and supply of electric storage water heaters and gas storage water heaters. The ACCC understands that electric and gas storage water heaters contain a number of common components and are often manufactured in the same facility and using the same equipment.
59. On current information, there appears to be limited opportunity for substitution by suppliers of other types of water heaters into the supply of electric and gas storage water heaters. As noted above, continuous flow water heaters use substantially different technology and are not manufactured in Australia.
60. Solar and heat pump storage water heaters may be supply-side substitutes for electric and gas storage water heaters as they use the same type of tanks. However, as there are no other domestic manufacturers of vitreous enamel tanks, post-acquisition a new entrant would need to either import vitreous enamel tanks (issues with importing large storage tanks are discussed below) or obtain supply from Rheem. It is not clear that Rheem would be willing to supply a potential competitor with vitreous enamel tanks at a price that would enable it to compete effectively.
61. While some Australian solar and heat pump water heater suppliers use stainless steel tanks, market enquiries indicate that these are significantly more expensive to produce than vitreous enamel tanks. Therefore a solar or heat pump water heater supplier seeking to begin supplying electric and gas storage water heaters using stainless steel tanks is unlikely to place significant competitive constraint on Rheem.
62. However, the ACCC will continue to consider the likelihood of companies which currently supply solar or heat pump water heaters switching to supplying electric and gas storage heaters in response to an increase by Rheem in the price of storage water heaters post-acquisition.
63. The ACCC will also consider the potential for other hot water heater companies to begin importing (or expand their importation of) storage hot water heaters in response to a price increase by Rheem post-acquisition. The issue of imports is discussed further under the 'Issues of concerns' heading below.

Potential for price discrimination

64. On current information, the ACCC considers it is likely that a monopolist supplier of electric storage heaters (or both electric and gas storage heaters) would have considerable scope to charge different prices for electric storage water heaters than for gas storage heaters. The ACCC understands that the majority of households that acquire electric storage heaters either do not have access to

reticulated gas or prefer to replace their electric storage heater with another electric storage heater. Even if continuous flow water heaters act as a constraint on the pricing of gas storage units, they are unlikely to constrain the pricing of electric storage heaters. The ACCC is seeking further information to test this view.

65. Manufacturers and importers of storage water heater units typically supply Australia-wide. However, the ACCC will consider whether there is potential for price discrimination by suppliers between different geographic regions, for example between areas with access to reticulated gas and areas without reticulated gas.

Preliminary view on relevant market(s)

66. As outlined above, based on information received by the ACCC to date, there appear to be strong limitations on the ability of customers to substitute from electric storage to gas-powered water heaters (including gas storage and continuous flow water heaters). There also appear to be some significant limitations on substitutability both from the customer and supplier perspective between electric or gas storage water heaters and other types of water heaters. The ACCC is continuing to explore the degree of substitutability within these markets.
67. The ACCC's preliminary view is that the markets relevant for assessing the competition effects of the acquisition are likely to be separate markets for the supply of different types of water heaters in Australia, in particular electric and gas storage water heaters (either together or separately), continuous flow water heaters and solar and heat pump water heaters.
68. The ACCC will further consider the extent to which competitive conditions differ as between:
- a. the supply of electric storage water heaters compared to gas storage water heaters (to assess whether there may be separate markets for gas storage and electric storage water heaters); and
 - b. the supply of large storage water heaters compared to small storage water heaters.
69. Even if the relevant market is a broader one, such as a market for the supply of all types of water heaters, for the reasons set out below in the 'Issues of concern' section, the proposed acquisition may still be likely to have the effect of substantially lessening competition in that market.

The ACCC invites comments from market participants on its preliminary views about the definition of the relevant market(s). In particular market participants may wish to comment on the following:

- The extent to which continuous flow heaters are currently chosen by customers seeking to replace an existing gas storage heater, and the factors that limit such switching including:
 - details of the costs and time involved in switching from gas storage to continuous flow;

- whether the below-mains pressure flow of continuous flow water heaters is a significant disincentive for such switching; and
- customer perceptions of the advantages of continuous flow units compared to storage water heaters, including in terms of economic efficiency, environmental benefits and long-term cost savings.
- The extent to which customers seeking to replace an existing electric storage water heater currently choose a different type of water heater, and the factors that limit such switching including:
 - in areas where reticulated gas is available, but not connected to the customer's premises, the costs involved in installing those connections; and
 - the extent to which an LPG-powered continuous flow water heater is a viable option for customers in areas without reticulated gas.
- The extent to which consumers would be likely to switch from either electric or gas storage water heaters to continuous flow water heaters in the event of a significant increase in the price of electric or gas storage water heaters.
- The extent to which customers currently choose stainless steel electric or gas water heaters, or would be likely to do so in response to an increase in the price of vitreous enamel water heaters.
- The availability of data or reliable estimates in relation to:
 - the proportion of hot water heater installations that take place in a replacement context in comparison with new installations;
 - the proportion of replacement hot water installations that are like-for-like as opposed to instances of customers switching between hot water heater types; and
 - the proportion of new water heater installations (as opposed to replacement) that are for end users with access to reticulated gas, and the proportion that would be for end users with access to the high capacity gas necessary for larger continuous flow units.
- The extent to which solar water heaters and heat pump water heaters constrain the prices of electric and gas storage water heaters, taking into account factors such as higher upfront costs and potentially lower running costs.
- How changes to the regulation of hot water heaters (including changes to rebate schemes) have affected customers' choice of hot water heater.
- Whether suppliers of solar or heat pump water heaters are likely to switch to supplying electric or gas storage water heaters in response to an increase in the price of electric or gas storage water heaters.
- Whether importers of vitreous enamel tanks for solar and heat pump water heaters could also cost effectively import vitreous enamel tanks for gas or electric storage water heater use.

Statement of issues

70. For the purposes of this Statement of Issues, the issues in this matter are divided into two categories, 'issues of concern', and 'issues that may raise concerns'.

Issues of concern

Unilateral effects: likely increase in Rheem's market power in the supply of electric and gas storage water heaters

71. Based upon its inquiries to date, the ACCC is concerned that the proposed acquisition is likely to substantially lessen competition by further strengthening Rheem's position in the relevant market(s) and eliminating the competitive constraint provided by Dux. The ACCC is concerned that post-acquisition there is likely to be insufficient constraint to prevent Rheem from raising prices or reducing service levels, particularly with respect to its larger capacity gas and electric storage water heaters.

Market concentration

The proposed acquisition is a substantial aggregation in the supply of electric and gas storage water heaters in Australia. Rheem and Dux are the only Australian manufacturers of vitreous enamel storage water heaters.

72. While there are other manufacturers of electric and gas storage water heaters using stainless steel storage water tanks, these companies do not have significant market share and it is not clear that they would have the ability to constrain the merged firm post acquisition.
73. There are a small number of importers of electric and gas storage water heaters other than the merger parties, but their market share is small. The role of imports is discussed further below.

Barriers to entry

74. Market participants have generally submitted that barriers to entry for vitreous enamel storage water heater manufacture are high as establishing a factory for these tanks involves large sunk costs. The ACCC also understands that vitreous enamel tank manufacturing facilities have a minimum efficient scale that is large relative to the level of demand in Australia.
75. The importance of branding and the need to develop relationships with wholesalers and installers were also cited as barriers to entry. The ACCC understands that volume rebates paid by manufacturers/importers to wholesalers and installers are common within the industry. These may present a barrier for a potential new entrant.

Imports

76. Imports of continuous flow and small storage water heaters are commonplace (although the latter are primarily imported by the merger parties). However market inquiries have indicated that there are limitations on the commercial viability of importing large electric and gas storage water heaters.
77. Market participants generally considered that large electric and gas storage water heaters are significantly more difficult to import than smaller storage water

heaters. Market participants generally stated that the difficulties were due to the size of the tanks, which results in low shipping container utilisation and therefore increased shipping and handling costs when compared with smaller storage or continuous flow units. The high shipping costs for large storage water heaters may potentially outweigh the cost savings from lower overseas labour costs.

78. Some large electric storage water heaters are imported into Australia, although the proportion of overall sales remains small. Some market participants suggested that these heaters were of inferior quality. Some market participants questioned the profitability of these imports and suggested that they were reliant on a favourable foreign exchange rate over recent years and therefore may not continue to be viable in the future.
79. Market participants indicated that a number of companies had attempted the importation of large storage water tanks in the past, but these imports had rarely been successful or sustained.
80. The ACCC notes that solar and heat pump units (which typically include a large storage water tank) seem to be more commonly imported (at current exchange rates) than large electric or gas storage water heaters. Market participants indicated that this was because the tank was a less significant component of the overall cost of these units and as such they could be more economically imported, particularly if the entire water heater was assembled overseas. Some market participants also suggested that the importation of heat pump water heaters is viable as the imported units may be of higher quality than the domestically manufactured units.

Removal of a vigorous and effective competitor

81. Market participants contacted generally considered Dux to be an effective competitor to Rheem, noting that Dux has often led prices down in its supply of electric and gas storage water heaters.
82. It was also noted that Dux has been more willing than Rheem to supply electric and gas storage heaters through different channels. For example, Dux supplies storage units to Reece for sale under Reece's Thermann brand. Dux also supplies storage units to Bunnings with the option of an installation service, and supplies tanks to solar water heater manufacturers for assembly with their own imported solar collectors.
83. The ACCC's preliminary view is that these and other activities by Dux may have contributed to lower prices for electric and gas storage water heaters than would have existed without the presence of Dux in the market.

Countervailing power

84. In the ACCC's view, countervailing power exists when buyers have special characteristics that enable them to defeat a seller's attempted exercise of market power by credibly threatening to bypass the merged firm by vertically integrating into the upstream market, establishing importing operations or sponsoring new entry.⁶ Countervailing power is therefore more than the ability of key customers to switch to alternative products or suppliers.

⁶ ACCC Merger Guidelines 2008, 7.48.

85. The customers of Rheem and Dux include a number of large plumbing supplies wholesalers such as Reece, Tradelink and Plumbing Plus.
86. However, the ability of these customers to exercise countervailing power against Rheem post-acquisition depends on their ability to bypass Rheem and begin either manufacturing or importing electric and gas storage water heaters themselves. The ACCC's preliminary view is that it is unlikely that even the merged entity's largest customers would begin manufacturing storage water heaters domestically, or sponsor new entry, due to the large sunk costs and minimum efficient scale discussed above. Accordingly, the ability for customers to exercise countervailing power most likely depends on their ability to import large storage water heaters.
87. The ACCC will continue to explore whether large customers of Rheem and Dux have the ability to bypass the merged entity and begin importing large electric and gas storage water heaters themselves in the event of a significant and non-transitory price increase by Rheem post-acquisition.

ACCC's preliminary views

88. In summary, the ACCC is concerned that:
 - a. the threat of imports may be insufficient to constrain Rheem in its pricing of large electric and gas storage water heaters;
 - b. for many customers who do not have access to reticulated gas, there may be no viable alternative to a large electric storage water heater (due to the significantly higher upfront cost of solar and heat pump water heaters and because small units provide insufficient water); and
 - c. even for those customers that do have access to reticulated gas, there may be potential limitations on customer switching to continuous flow gas heaters (for the reasons discussed above).

The ACCC invites comments from market participants on its concerns in relation to the extent to which the proposed acquisition is likely to increase Rheem's ability and incentive to raise price or reduce service. In particular market participants may wish to comment on the following:

- The viability of importing large storage water heaters into Australia, including:
 - the impact of foreign exchange rates on the viability of large storage water heater imports (as compared with smaller unit);
 - whether imported large and small vitreous enamel tanks are of comparable quality to tanks produced by Rheem and Dux; and
 - the extent to which imports of large vitreous enamel tanks have occurred, and details of such instances.
- Whether, at current exchange rates, it is more commercially viable to import solar and heat pump water heaters (or the storage tanks used in these heaters) than it is to import large electric and gas storage water heaters. If so, why?
- Details as to whether Dux has acted as a constraint on prices in the supply of storage water heaters.
- The impact that Dux's greater willingness (compared with Rheem) to supply through different channels has had on the market to date (e.g. whether it has led to lower prices).

- The ability for plumbing supplies wholesalers and other customers to constrain potential price increases by Rheem post acquisition.
- The sunk costs faced by, and minimum efficient scale for, a new domestic manufacturer of vitreous enamel storage tanks, or water heaters that use these tanks.
- The extent to which rebates paid to wholesalers and installers act as a barrier to entry for potential new suppliers of water heaters.
- The barriers to entry in the manufacture of stainless steel water heaters.

Issues that may raise concerns

Reduced competition in the supply of solar and heat pump water heaters

89. Solar and heat pump water heater units typically include either a vitreous enamel or marine grade stainless steel storage water tank as a key component.
90. Market participants have indicated that Dux is the only Australian manufacturer of vitreous enamel storage water heater tanks which supplies tanks to Australian assemblers of solar water heaters.
91. The ACCC will consider whether Rheem is likely to have reduced incentives to supply vitreous enamel tanks to solar water heater assemblers (or alternatively may increase the supply price to just below the import parity price) if the proposed acquisition were to proceed, and the potential impact this would have on those assemblers (noting the availability of stainless steel tanks as an alternative for at least some types of solar water heaters).
92. The ACCC will also consider whether, if the value of the Australian dollar falls, the commercial viability of importing storage tanks and/or assembled solar or heat pump water heaters will be reduced, potentially increasing Rheem's market power in the supply of these products.

The ACCC invites comments from market participants on its concerns in relation to the supply of solar and heat pump water heaters. In particular market participants may wish to comment on the following:

- The vitreous enamel tank supply options for solar and heat pump water heater assemblers and manufacturers.
- The stainless steel tank supply options for solar and heat pump water heater assemblers and manufacturers.
- The importance of the supply of vitreous enamel storage water heater tanks to solar and heat pump water heater assemblers and manufacturers.
- The exchange rate value(s) at which it is likely to become uneconomic to import solar or heat pump water heater tanks and/or assembled solar or heat pump water heaters.

Reduced competition in the supply of continuous flow water heaters

93. Market participants have indicated that hot water heater manufacturers and importers commonly offer rebates to both plumbing supplies wholesalers (e.g. Reece or Tradelink) and installers and that these rebates are designed to encourage the merchant or installer to maintain or increase both volume and breadth (across product categories) of its sales of that manufacturer/importer's products.

94. Some market participants have suggested that if the proposed acquisition were to proceed, Rheem may have an enhanced ability and incentive to offer rebates structured in a way that would encourage customers to purchase continuous flow water heaters as well as storage water heaters from Rheem. These market participants suggested that this bundling conduct could adversely affect competition in the supply of continuous flow water heaters.
95. The ACCC will consider whether Rheem would have the ability and incentive to use its enhanced position in the supply of storage water heaters post-acquisition to substantially lessen competition in the supply of continuous flow heaters.

The ACCC invites comments from market participants on its concerns in relation to the supply of continuous flow water heaters. In particular market participants may wish to comment on the following:

- The extent and nature of rebates used in the wholesale supply of hot water heaters in Australia.
- Whether Rheem would be able to leverage its enhanced position with respect to storage water heaters post-acquisition to diminish competition in the supply of continuous flow water heaters.

ACCC's future steps

96. The ACCC will finalise its view on this matter after it considers market responses invited by this Statement of Issues.
97. 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.
98. Submissions are to be received by the ACCC no later than 31 October 2014. 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 in light of the issues raised above.
99. The ACCC intends to publicly announce its final view by 20 November 2014. 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.