BEFORE THE COMPETITION APPEAL COURT

Case No. 20/CAC/Jun02

In the appeal of:

MONDI LIMITED **1st Appellant**

KOHLER CORES AND TUBES, **2nd Appellant**
A division of Kohler Packaging Limited

JUDGMENT : 14 FEBRUARY 2003

DAVIS JP

INTRODUCTION

[1] A proposed merger between first and second appellant was prohibited by the Competition Tribunal ('the Tribunal') in terms of an order issued on 23 May 2002, the reasons for which were provided on 20 June 2002. First appellant, a supplier of paper products, including those used in the manufacture of cores and tubes, sought to acquire the cores and tubes division of Kohler Ltd, ('KC&T') one of first appellant's downstream customers. First appellant is a wholly owned subsidiary of Anglo America plc ('Anglo American'). Both Anglo American and first appellant control numerous companies. First appellant consists of a number of divisions including Mondi Paper, Mondi Recycling, Mondi Carton Board, Mondipak, Mondi Kraft, Mondi Timber and Mondi Forest. The primary target firm is a division of Kohler Packaging Limited which is a subsidiary of Malbak Limited. Remgro Limited, Malbak's largest shareholder, holds 50,4% of the issued share capital of Malbak. First appellant intends to locate second

appellant within Mondipak which produces corrugated packaging for both agricultural and industrial markets.

[2] The value of the acquiring firm's annual turnover in South Africa ('first appellant') combined with that of the target firm ('second appellant') exceeded the threshold which had been set by the Minister of Trade and Industry in terms of section 11 of the Competition Act 89 of 1998 ('the Act').

[3] Once the parties had duly notified the merger, the Competition Commission conducted an investigation and, in terms of section 14 A(1) of the Act, forwarded its written recommendations with reasons to the Competition Tribunal for its consideration.

[4] A hearing was held on 9 and 10 May 2002 before three members of the Tribunal. Evidence was led by the Competition Commission in support of its recommendation as well as by appellants in response. The Competition Tribunal also called several witnesses to testify. It delivered its decision prohibiting the merger on 23 May 2002.

[5] This appeal, which has been brought by first and second appellant in terms of section 17(1) of the Act, concerns the question of whether this court should set aside the decision of the Competition Tribunal and approve the merger in terms of section 17(3)(a) of the Act.

FACTUAL BACKGROUND

[6] Second appellant informed the Commission that it wanted to sell its cores and tubes business, KC&T, because the manufacturing of cores and tubes did not constitute its central business. It approached two companies to purchase the cores and tubes business, namely Sonoco International and first appellant. Sonoco did not materialise as a prospective purchaser because it was concerned about the return it would receive on its investment due its view of the depreciation of the rand, labour problems and crime levels in the country.

[7] First appellant had previously considered the possibility of starting its own cores and tubes manufacturing business in order to ensure the quality of the cores and tubes employed in certain of its own manufacturing processes. When approached to purchase KC&T, first appellant adopted the view that it would be preferable to do so as opposed to commencing its own operations for a number of reasons, **inter alia**

i) KC&T would be purchased as a going concern together with the necessary technical skills;

ii) the cores and tubes market would not be destablised by the creation of additional capacity in an already small industry;

iii) first appellant intended to continue supplying other core and tube manufacturers with raw materials needed to manufacture cores and tubes.

[8] In evidence before the Tribunal, Mr Theo van Breda, the general manager of Mondi Cartonboard stated, 'the only reason we'll do the merger is if its value enhancing and its value enhancing according to our assumptions and calculations going forward'.

[9] The following exchange between the Chair of the Tribunal and Mr van Breda provides additional evidence as to first respondent's motive: 'I am still struggling to understand what motivated this decision to buy Kohler Cores and Tubes. You have, as Mr Coetzee has pointed out, spent I think thirty seven and a half(371/2) million Rand buying a plant that you could have put up yourself with twenty six (26) million Rand by your estimate.

So I am struggling to understand why you wanted to enter the cores and tubes business in general and why you wanted to buy Kohler in particular…..

Mr Van Breda: Well as I mentioned before Mr Chair I believe we can run it more cost efficiently than what Kohler is currently running at and that has been indicated in our submissions, largely due to the elimination of administrative costs. And secondly we will be securing market and skills, which if we were to do that with our own operations, and I am not sure how up-to-date those figures are, lets say the twenty five (25) to thirty (30) million if we were to start our own plant we would be acquiring markets and skills'.

[10] Mondi Cartonboard operates in two broad categories. It produces coated, uncoated and laminated folding boxboard which is used for packaging **inter alia** of food, pharmaceuticals and detergents. The division also manufactures speciality boards used in the stationery, match, paper and textile industries. The division's mill is situated at

Springs and it produces approximately 130 000 tons of board each year.

[11] Mondi Cartonboard supplies a number of products to KC&T and its competitors for use in the manufacturing of cores and tubes, **inter alia:** (1) Ndicore core board which is a core board manufactured from recycled paper with a maximum strength of 300-330 scott ply. Although not a strong paper, Ndicore creates bulk to build up the wall thickness and hence the crush strength necessary for thick wall cores. (2) Kraft paper which is manufactured for use in the corrugated box industry although, to a limited extent, it is also used in the manufacture of cores and tubes. Kraft paper is manufactured from virgin paper and is stronger and gives a smoother finish than Ndicore. Kraft prices are currently lower than the price of Ndicore.

[12] The other South African producer of paper products is Sappi which also produces kraft paper. Its product which is specifically directed at the manufacture of cores and tubes is called Spiralwind which is the trade name given to the kraft liner board which Sappi supplies to the cores and tubes industry.

[13] In the downstream market, KC&T manufacturers cores and tubes, angle board dufaylite and textile cones. Kohler operates in three factories located in Johannesburg, Pinetown, Natal and Cape Town.

[14] Cores and tubes are spirally wound paper tubes which are utilised as an inner core in various applications, including products, such as paper, board, textile, steel and plastic which are wound onto an inner core tube. These products are used by their downstream purchasers. The core is inserted into the printing press and the product is wound off. This means that, if the core collapses or crushes, it is not possible to use the surrounding material because it cannot then be easily or smoothly wound off the core. For this reason, although the value of the core is a fraction of the value of the material surrounding it, a malfunctioning core may render useless the very material that it supports.

[15] KC&T's largest customers for its cores and tubes are Sappi Paper, Hulletts Aluminium, Columbus Steel and SA Nylon Spinners. These high end industrial customers represent 65% of KC&T's cores and tube turnover per annum. Mondi Carton board, Mondi Paper and Modi Kraft currently purchase 25%, 57% and 50% respectively of their cores and tube requirements from KC&T.

[16] KC&T's largest rival is Framen which supplies most of Mondi's core and tube requirements. According to the parties, Framen supplies 100% of Mondi's requirements in the Gauteng province while KC&T supplies 100% of Sappi's requirements in the same

region. The cores and tube market accounts for 65% of KC&T's turnover and is the focus of the present dispute.

THE COMPETITION COMMISSION'S ASSESSMENT.

[17] The Commission examined the concern that the merger would create a structure which could give rise to (a) foreclosure and (b) raising the cost of rivals.

[18] Dealing with the question of foreclosure, the Commission observed that the proposed transaction could facilitate foreclosure for the top end of cores and tube manufacturers and it could foreclose suppliers of paper such as Sappi which was supplying paper which compliments Mondi's Ndicore core board to high end cores and tube manufacturers.

[19] The Commission considered whether the merger would give first appellant the ability to raise the costs of top end core and tube manufacturers. In short, first appellant could increase the cost of Ndicore core board to the top end cores and tube manufacturers and make its profits on the supply of raw material, thereby achieving healthy profits while forcing other cores and tube manufacturers out of the top end of the market. This could then compel the top end cores and tube manufacturers to compete in the low end of the market and the end result would be that either the top end manufacturers or the low end manufacturers would exit the market.

[20] The Commission recommended that the proposed transaction be prohibited for the following reasons:
'The merger will result in a market structure which could foreclose the top end core and tube manufacturers. Furthermore the merger may result in foreclosing existing and potential suppliers' paper and core board which is used in conjunction with Mondi's Ndicore core board, for producing cores and tubes in the high-end of the market.

The merging entity's dual position as supplier and competitor of cores and tubes would be likely to create a channel conflict in the market. Using its strong market position as a supplier of the raw material, the merged entity may be able to raise core and tubes manufacturers costs and marginalise their market position as suppliers of cores and tubes'.

THE FINDINGS OF THE COMPETITION TRIBUNAL.

[21] In essence the Competition Tribunal found that first appellant's objective, which would be achieved by tacit co-ordination with its major competitor Sappi, was

i) to raise the costs of rivals of KC&T doing business in the "downstream market".

The merger was likely to result in 'input foreclosure'; that is it would preclude

cores and tube manufacturers from accessing key input into their production process;

ii) to raise the cost of rivals of both first appellant and Sappi doing business in the upstream market. The merger was likely to result in 'customer foreclosure'; that is it would effectively preclude other suppliers of core board including foreign investors from entering the South African market;

iii) to establish a mechanism which would facilitate the exchange of price and other sensitive information and hence "facilitate coordinated conduct", indeed cement a cartel between Sappi and first appellant in the upstream market and a number of other markets in which both are engaged.

[22] Before this court, appellants contested these findings of the Tribunal on the following bases:

(i) The Tribunal's conclusions amount to nothing more than speculation which breaks down under close analysis.

ii) The findings were not supported by the available evidence. In particular, the Tribunal made use of contested assumptions rather than basing its conclusion on clear evidence which was available on the record.

iii) No opportunity was afforded at the hearing to appellant to counter any of the Tribunal's 'speculation'.

[23] The findings followed upon the mandated enquiry in terms of s 12A of the Act, namely whether the merger was likely to substantially prevent or lessen competition in the relevant market. In dealing with this enquiry, the Tribunal engaged in four separate but interrelated issues, namely

i) the definition of the market;

ii) input foreclosure;

iii) customer foreclosure;

iv) facilitation of co-ordination.

The Market : The Downstream Product Market.

[24] The Commission concluded there was not a single market for cores and tubes but rather two markets, namely a top end and a bottom end market, being a market for heavy industrial cores in which the quality of the cores and particularly its crush strength, (its ability to withstand considerable pressure) was paramount and a market for light industrial and consumer product cores. While acknowledging that it was not 'easy to specify a precise point of delineation between these market segments', the Tribunal accepted the delineation and identified the downstream market relevant to this dispute as the market for heavy industrial cores and tubes with its principle customers being in the metal paper and textile industries.

Upstream Market.

[25] The Commission found that the relevant upstream product market was that for the supply of Ndicore, namely the speciality core board produced exclusively by first appellant. The Commission referred to evidence that there was no efficient, commercially viable substitute for Ndicore in the manufacture of 'top end' or 'heavy industrial' cores and tubes and concluded that Ndicore core board constituted a separate and distinct market for top-end cores and tubes.

[26] The Tribunal disagreed, concluding: 'We cannot ignore the clear evidence that demonstrates that, despite Ndicore's technical superiority, users of heavy industrial cores and tubes who are clearly concerned with the quality of the product are using cores made up of Sappi's Spiralwind as well as locally produced kraft paper… all other things being equal, Ndicore is the preferred product for producing industrial cores and tubes, that is cores and tubes in which crush strength is an important requirement. However it is clear that substitution is technically and commercially feasible albeit limited by Ndicore's clearly superior qualities'.

[27] For these reasons the Tribunal concluded that the upstream product market constituted the market for the provision of board utilised in the production of industrial cores and tubes which would include Ndicore, Spiralwind and first appellant's kraft paper.

Input foreclosure.

[28] Having determined the market, the Tribunal examined the question of input foreclosure. The Tribunal considered the question of whether the integrated entity after the merger, would 'largely self deal', confining its sales of Ndicore to its integrated downstream cores and tubes manufacturers and the latter would confine its purchases of core board to its upstream producer of core board. First appellant would engage in a limited amount of trade in the market. This limited participation would 'facilitate the flow of information and hence facilitate co-operation between Mondi and Sappi'. Once the merged entities largely self dealt, other cores and tube manufacturers would be compelled to negotiate with 'an effective Sappi monopoly'.

[29] On this basis, the Tribunal found that there would be little to prevent Sappi from exercising its market power by charging a monopoly price for Spiralwind. First appellant's best interests would lie in following Sappi's price increase, thereby permitting both producers of core board to extract monopoly rents from non-integrated cores and tube manufacturers in the downstream market. By reducing the supply of Ndicore to the market, first appellant would permit Sappi to increase the price of core board to non-integrated producers of cores and tubes.

[30] In evaluating first appellant's interest in allowing Sappi to charge a monopoly price to customers, the Tribunal found that such an act would raise the cost of first appellant's rivals in the downstream cores and tubes market, thereby enabling first appellant's newly acquired cores and tubes division to capture a larger share of the market or enabling it to raise its prices to its customers in the downstream market, a market in which it would, through its acquisition of second respondent, command a dominant share.

CUSTOMER FORECLOSURE.

[31] Much of the debate before the Tribunal was devoted to the argument that imports

would undermine any attempt at input foreclosure. The Tribunal rejected this argument concluding that 'high quality European core board will continue to be used in small volume for the manufacture of particularly demanding cores. It will however not be a viable general alternative to local suppliers of core board – it is extremely costly both because of its quality and because of the depreciation of our exchange rate visa vis developed country currencies'.

[32] While a supply of core board might be possible from developing country core board producers, the Tribunal concluded that in the past, first appellant had vigorously prevented the acquisition of substitute product. The Tribunal referred in this connection to an extract from second respondent's divisional budget 2001/2: 'We have been importing raw materials at prices well below the local mill's prices. However the local mills represent 25% of our turnover and Mondi has taken business away from us as a result of the imports. As a result of this we have stopped importing raw materials and are working with Mondi to gain more business'.

[33] The Tribunal concluded that imports 'carry considerable risk for local downstream producers. And the South African market for core-board with the 'lion's' share' foreclosed by the actions of the powerful domestic duopoly will not be an attractive market for exporters….'

FACILITATION OF CO-ORDINATION.

[34] The Tribunal found that Mondi's downstream cores and tubes operation 'may thus purchase a small quantity of Spiralwind or Sappi kraft. It will also likely sell a certain amount of Ndicore to its downstream competitors who are clearly destined to purchase the bulk of their core-board requirements from Sappi. This will be likely to include Framen which will rely upon Sappi as the supplier of its core-board inputs. By the same token, the divisions of Mondi that require cores and tubers – and this would cover most, probably all, of its key paper producing activities – will most secure its requirements from its downstream cores and tubes manufacturers.' On the basis of this evidence, the Tribunal held that the transaction would facilitate tacit or express co-ordinated conduct which would be likely to substantially prevent or lessen competition by facilitating the exchange of pricing and other competitively sensitive information in both

the input or output markets.

EVALUATION.

[35] As Mr Petersen, who appeared together with Mr Wilson as amici curiae (having been invited by this court to so appear), submitted, the findings of the Tribunal raised three critical interrelated questions which all impact upon the determination of the likelihood or otherwise that substantial anti competitive effects are likely to result from the proposed merger. These questions are

i) To what degree the availability of imported material capable of being substituted for the products of first appellant and Sappi in the production of heavy industrial cores and tubes is likely to restrain uncompetitive conduct on the part of these organisations.

ii) Whether, even in the absence of a similar vertical integration by Sappi, uncompetitive parallel conduct between first appellant and Sappi would be feasible and would be rendered more likely as a result of first appellant's merger with second appellant.

iii) Whether, assuming the likelihood of parallel conduct between first appellant and Sappi, following first appellant's merger with second appellant, it is likely that significant price increases of Ndicore, coreboard and other paper supplied by first appellant for the production of heavy industrial cores and tubes could be introduced, could be sustained and passed on to consumers without effective resistance, notwithstanding the continued existence of other producers of cores

and tubes such as Framen.

[36] To a considerable extent, the responses to these three questions depend upon the particular theoretical approach adopted by the adjudicating authority.

THE THEORETICAL FRAMEWORK FOR MERGERS.

[37] Mr Unterhalter who appeared together with Mr Gotz on behalf of appellants, submitted that the Tribunal should have shown the 'same zeal' in exploring the potential efficiencies of the transaction as it did in its attempt to confirm an anti competitive theory which underpinned its entire findings. Underlying the arguments placed before this court were different approaches to a vertical merger; thus appellants approached the dispute from the premise that the transaction was efficiency enhancing.

[38] The issue of the proper theoretical framework within which the Tribunal is required to analyse a merger is of particular importance, given the wording of section 12 A(1) of the Act. This section provides **inter alia** that whenever required to consider a merger, the Competition Commission or Competition Tribunal must initially determine whether or not the merger is likely to substantially prevent or lessen competition. The test is not whether a merger necessarily prevents or lessens competition but whether it is likely substantially to so prevent or lessen competition. As this court observed in **Schumann (Sasol)(South Africa)(Pty) Ltd v Price's Daelite (Pty) Ltd** (unreported decision of the Competition Appeal Court case No: 10/CAC/01) the decision required by S 12 A(1) must be made on evidence which is available to the Tribunal. In other words, the Tribunal cannot base its decision upon 'speculation of a kind which cannot be attributed to any evidential foundation placed before the Tribunal'. But the prohibition against unjustified speculation should not be confused with the need for a predictive judgment. The section enjoins the Tribunal to forecast a likely possibility; that is, it makes a predictive judgment, based on evidence which has been placed before it. The issue of an underlying theory is important because, in coming to different predictive judgments, appellants and the amici adopted different theoretical frameworks within which to evaluate the meaning of section 12 A.

[39] Appellant submitted that vertical mergers are presumptively regarded as efficiency enhancing. Relying, **inter alia,** on Roirdan and Sallop 'Evaluating Vertical Mergers: a Post Chicago Approach' 1995 (63) **Anti Trust Law Journal** 513, Mr

Unterhalter submitted that anti trust law in general adopts the approach that cooperation among firms in a vertical relationship holds the potential for greater efficiency than does cooperation among horizontal competitors. As vertical mergers often do not raise a significant likelihood of consumer harm, it is unnecessary in most cases to assess the efficiency benefits of a specific proposed merger to evaluate the net competitive impact thereof.

[40] Mr Petersen submitted that a recourse to American economic theory which was predicted upon the specific body of American anti trust law required qualification within the South African context. The idea that a monopolist may decrease prices when its costs are reduced depends on an assumption that the monopolist can preserve or increase profit by way of increasing the volume of sales at the lower price. This practice might well be successful within the context of a vast continental market with a mass of affluent customers, but, in a less developed economy with a limited market afflicted by a monopoly oligopoly, this form of generalisation was less likely to hold. Furthermore, even where efficiency and cost savings were demonstrated, it did not follow that these benefits would be passed on to the ultimate consumers where a few producers had substantial collective market power at several inter-connected levels.

[41] In support of this series of submissions, Mr Petersen cited Charles Mueller **Anti Trust Law and Economics Review** volume 26 no. 4 (Glossary of Anti-trust terms) who describes an oligopoly thus:
'A market structure characterized by "fewness of sellers, as distinguished from Atonomism ("many" sellers) and Monopoly (a single seller). Given a situation in which there are only a few sellers, a phenomenon called "oligopolistic interdependence" is expected. Whereas the individual firm in an atomistic industry has such a small share of aggregate industry sales that nothing it can do will perceptibly influence the overall market wide price (e.g., the withdrawal of its entire supply from the market would not affect that market price), the individual firm in an oligopolistic industry is, by definition, sufficiently large that any substantial change in its output volume will have a perceptible effect on the overall *market-wide* price-and hence on the volume of sales, and price received, by each of its rivals. The latter are thus expected to notice these changes, recognize their source, and take appropriate measures to protect their respective interests.

A price decrease, for example will normally prove unprofitable for the price cutter. The others will promptly match his lower prices, thus removing any incentive for buyers to switch suppliers. With his market share unchanged, but priced now at a lower level, the price-cutter's profits are presumably lower than before. Similarly, a failure to go along with the price increase would generally prove unprofitable, since the others will quickly drop back to protect their market share if there is a holdout still selling at the lower price, the result being that the holdout gets no increase in his market share and foregoes higher per-unit price that all could have had if it had gone along with the change. By a series of such adjustments, rational oligopolists are expected to eventually arrive at the price level that will maximise their joint profits, i.e. the industry's profit-maximising price level, the

same price as that a single-firm monopolist would charge.

The possibility of this result actually being reached is dependant on other factors, however, particularly on (1) whether the industry in question belongs to the Tight Knit or Loose sub category of oligopoly, that is whether its concentration ratio is very high or only moderate, and (2) whether its entry barriers are high enough to permit the exercise of that pricing policy without inducing new entry.'

[42] Mueller defines a Tight Knit oligopoly as 'a market structure so highly concentrated that prices are expected to be significantly above, and output significantly below, the competitive norm. In general, ….studies suggests that this result is to be expected when the four largest sellers have 50% or more of the sales in the market or when the eight largest have 70% or more'.

[43] This latter definition is relevant to the present dispute in that, on the evidence, first appellant and Sappi each produce about 38% of the requirements of the South African market for core-board. First appellant produces 33% and Sappi 51% of the requirements of the South African market for pulp, paper and wood chips. This represents a very high concentration of ownership in relation to production and supply of materials for cores and tubes. Both Sappi and first appellant are also major producers of products which are wound onto the heavy industrial cores and tubes. They are also important purchasers in the market supplied by the producers of cores and tubes. Mr Davies divisional managing director of second appellant confirmed that 'Mondi and Sappi ..are the two dominant users of cores'.

[44] South African competition authorities should be careful to base a decision on the presumptively efficiency enhancing approach to mergers coupled with otherwise benign consequences. The Chicago school's approach to vertical mergers (following their critique of the restrictive approach to mergers in **Brown Shoe Co v United States** 370 US 294(1962) was based upon two assumptions being, (1) that while a vertical merger may foreclose rival firms' access to the supply of inputs, it does not mean that the net supply of inputs available to those rival firms has been reduced and (2) that vertical mergers carried out by a monopolist cannot enhance monopoly power. Both of the assumptions have come under searching scrutiny. See, for example, Herbert Hovenkamp '**Antitrust policy after Chicago'** 1985(94) Michigan Law Review 213.

[45] The article by Riordan and Sallop, supra afford further significant theoretical insight into the assumptions generated by the Chicago School (see Robert H Bork **The Anti-Trust Paradox** (1978). The authors observe that 'some vertical mergers…. have the potential for anti competitive effect by creating, enhancing or facilitating the exercise of market power. The competition affected may be in the sale of input produced by one merger partner ("the upstream" or "input" market) the sale of the products produced by the other merger partner that uses these inputs ("the downstream" or "output" market) or in markets that are ancillary to the input and output markets.'(at 519). The authors then

observe that anti-trust concerns regarding these anti competitive effects flow from three main sources, being (1) vertical mergers can lead to exclusionary effects by increasing rivals' costs of doing business which may involve raising input costs by foreclosing access to important inputs or foreclosing the access to a sufficient customer base, (2) by facilitating tacit or express coordinated conduct by facilitating the exchange of pricing and other competitively sensitive information in either the input or output market and (3) by permitting a firm to evade a variety of pricing regulations such as where a vertical merger can help a regulated firm to evade cost-based, maximum price regulations by setting an artificially high transfer price on inputs sold by the upstream division to the downstream division and as a result shift profits from the regulated to the unregulated market. (at 519-520).

[46] In assessing the effect of a proposed merger, an assumption of efficiency enhancement cannot trump nor should it prevent an enquiry into the manner in which market pricing is exercised, viewed in terms of the structure of the market. Hence, the very assumption upon which appellants have based their attack has but limited analytical purchase in this the South African legislative context.

[47] The examination of theoretical approaches has been conducted without recourse to the Act. Brassey et al **Competition Law** (2002) at 30 suggest that the ultimate concern of merger control 'is not with dominance or (what amounts to much the same thing) the number of participants in the market, but with the greater harm to the market that large firms can potentially wreak'.

[48] The assessment of harm has to be analysed within the specific framework of the Act. This enquiry necessitates recourse to the preamble to the Act and the purpose thereof as set out in section 2. These are important sources for interpretative guidelines (see also section 1(2) of the Act). Thus care must be taken before an uncritical borrowing of traditional anti-trust economic theories, as developed in the United States of America, encrust the process of interpretation of our Act. Unlike much comparative competition law, the Act specifies among overall its purpose of the maintenance of competition, that small and medium size businesses have an equitable opportunity to participate in the economy and that there be promotion of a greater spread of ownership, in particular to increase the ownership stake of historically disadvantaged persons (section 2(e) and (f) of the Act).

IMPORTS.

[49] Appellants placed considerable reliance on the Competitiveness Report which contained a table setting out the estimated market share of competitors in respect of the product sold by Mondi Cartonboard. The figure for imports including Europe and from

the East was estimated at 24%.

[50] Mr van Breda, general manager of Mondi Carton boardtestified before the Tribunal as follows: 'Currently the market, as I see it, is extremely competitive and imports is (sic) possible low cost alternative in the business…' He further informed the Tribunal that 'imported paper is the real threat to Mondi… The threat of substitutability is great'.

[51] Mr Unterhalter submitted that the evidence available from 'the smaller players in the cores and tubes manufacturing market' did not assist in answering the critical question as to whether they would turn to imports if first appellant and Sappi significantly raised the price of their core board. He referred particularly to evidence which suggested that all of the smaller manufacturers had imported core board in the past. Mr Unterhalter then examined the evidence of Mr Davies, a representative of second appellant who testified as follows:
'MR UNTERHALTER. Could we just talk a little bit about imported paper? It has been suggested by the Competition Commission that effectively this market can't utilise imported products, one, because they say they are too expensive, that the exchange rate is adverse and that there is so much inconvenience and holding costs and difficulty of securing supplies that, practically speaking, imports are not an option for local manufacturers. Could you comment on that proposition?
MR DAVIES: That's totally incorrect. I would just like to allude to is the fact that we placed an order two (2) days ago for two hundred (200) tons of imported paper at a very competitive price.
MR UNTERHALTER. Where did you source that paper?
MR DAVIES. From Finland.
MR UNTERHALTER: Where are the sources of paper that would be, imported paper, that would be utilised in this industry?
MR DAVIES: Obviously the whole, I mean there are lots of manufacturers in Europe, but if I can just tell you from where we have imported, we import from Finland, from the UK, we have imported from France, from Indonesia, those are probably, and the US.'

On the basis of this evidence Mr Unterhalter contended that, on a balance of probabilities, there was insufficient evidence to conclude that imports were likely to have little constraining effect on the prices of first appellant and Sappi.

[52] In my view, these submissions do not deal with the essence of the Tribunal's findings. The Tribunal found that high quality European core board might be used in small volumes for the manufacture of particularly demanding cores but would not be a viable general alternative to local supplies of core board because it was extremely costly, both as a result of its quality and the depreciation of the rand.

[53] While the Tribunal did recognise that small producers from other developing

countries (such as Indonesia) may provide a viable alternative, it concluded that the board produced by these countries was of a lower quality. It also referred to the reaction of first appellant when second appellant had attempted to import core board from Indonesia. The Tribunal concluded that it was likely that only the smaller cores and tubes manufacturers would be potential importers of core board, but 'in relying on imports they all face reduced certainty in the source of supply of their critical input; in order to take advantage of volume discounts and deductions in transport costs they will have to purchase input in greater volume and face concomitantly larger storage and finance charges; they will have to cope (without commanding the resources necessary to hedge large foreign exchange exposures) with the volatility that characterizes emerging market exchange rates; they will, given Sappi's injunction, cut themselves off from Sappi's customers; and they run the risk, as the much larger KC&T earlier discovered, of incurring Mondi's wrath'.

[54] These conclusions were also supported by other witnesses who testified before the Tribunal. Mr Silva, who has been associated with the industry for twenty years and who had recently started a company called Diversified Cores and Tubes testified thus: 'If you can give me an alternative product, …that can do exactly the same job that Ndicore does, I have got no qualms ….I can't source it. We can import paper better but when you have got the fluctuation of the exchange rate the way it is at the moment the prices are just not compatible. And then inventory, you have got to keep stocks for a much longer period. So we will be at a total disadvantage'.

[55] He went on to say that '[i]f you take your imports, price of imports in comparison to local based prices, you are probably looking at the difference of about five percent (5%) if that, because the Rand in the last week, as you know has appreciated in value. But the Rand is very volatile, look what happened last year. So if you tell me that imports would be a secure option in the future to come, I don't think I would be able to accept that, I don't think there is a guarantee whatsoever'.

[56] This view was supported by Mr Peter Jooste of International Tube Technology who testified that his company had previously imported paper but no longer did so because of a volatile exchange rate.

[57] Of particular significance was the evidence of Mr Bouzaglou, managing director of Framen which was described by the Tribunal as second appellant's largest rival. Fifty two percent of Framen's annual turnover was derived from sales to first appellant. Mr Bouzaglou described how Framen had sought to develop a relationship with a paper manufacturer in Zimbabwe, in order to obtain an additional source of supply. His

explanation is significant (albeit that the wording of his testimony is hardly the essence of clarity) 'I know where you live …we are busy with another paper manufacturer out of the country in Zimbabwe. And now it is a concern to us the story of the Mondi and Kohler and all of that. Even what you said sir you know about are you going to join Sappi. Sappi can turn around and put you in the same situation and next year too. We've gone even two steps ahead by looking to bring paper and helping another guy that makes wood the same as Mondi to make paper for the core industry. We succeeded to make that payable. The same thing as what we helped Mondi building the Ndicore. We helped this guy to make the paper and we are very pleased with our result. So you know what ? If Sappi wants to play around we can bring paper, so we're not concerned'.

[58] These protestations of a lack of concern notwithstanding, Mr Bouzaglou's evidence indicated the necessity for Framen to find an alternative supplier so as not to be vulnerable to the exercise of the power of first appellant and Sappi. Somewhat later in his evidence in an exchange with Mr Unterhalter, Mr Bouzaglou testified as follows:
'ADV UNTERHALTER. Yes, yes. Now just lets just analyse what your options are as far as moving to other papers. As I understand it in respect of the very, very high crush strength, even Indicore [Ndicore] by and large isn't good enough. You've got to have imported paper anyway.
MR BOUZAGLOU. Ja. That's for certain cores, ja.
ADV UNTERHALTER. Yes. So the only area where Indicore can be advantageous if the price is right is for not the very highest crush strength but for those customers who require a particular crush strength like, well you tell us, what's the sort of crush strength where you would be looking to use Indicore?
MR BOUZAGLOU: Okay. The Indicore you can use it in ninety nine comma nine percent (99,9%) of the market and the high crush imported paper is used in like one (1) to two (2) percent of the market. So the Indicore you can use it everywhere.
ADV UNTERHALTER: Yes. What I'm asking you is that if the price, if Indicore became non-available….
MR BOUZAGLOU: Ja?
ADV UNTERHALTER: Or if the price of Indicore was increased very substantially….
MR BOUZAGLOU: Ja?
ADV UNTERHALTER: Where would you be left? What would you do?

MR BOUZAGLOU: I would have gone into Kraft.
ADV UNTERHALTER: You'd go into Kraft?
MR BOUZAGLOU: Ja.'

[59] This passage from the record indicates that Framen was not prepared to accept imported paper as a general substitute for Ndicore. The substitute for Ndicore could only be Kraft which would inevitably draw Framen back into the scale of influence of first appellant and Sappi. Furthermore as Mr Petersen submitted, Zimbabwe, as was evident from the Competitiveness Report, has no significant track record in this area. In the context of the present political and economic circumstances of Zimbabwe, Mr Petersen was justified in submitting that dependence on supplies from that country could hardly be considered to be a satisfactorily viable option for South African cores and tube producers to reliance upon Sappi and first appellant.

[60] Much was made of the volatility of the South African rand. Mr Unterhalter submitted that there was no evidence that the rand would continue to be volatile. By contrast, the Tribunal, staffed with expert economists, arrived at the opposite conclusion, on the basis of evidence of the overall pattern of the rand over the past number of years. For these reasons it cannot be expected that, following the merger of first and second appellant, the availability of imported paper input suitable for the manufacture of heavy industrial cores and tubes would exert significant competitive pressure upon Sappi and first appellant. In other words, the conclusion of the Tribunal that the supply of imports would be insufficient to mitigate any effective foreclosure of the supplier of core board inputs is not one which justifies interference from this court. In my view, it is the most reasonable conclusion based upon the evidence.

THE POSSIBILITY OF COMPETITIVE PARALLEL CONDUCT BETWEEN FIRST APPELLANT AND SAPPI.

[61] Appellant attacked the approach adopted by the Tribunal that the merger was designed to foreclose inputs utilised by rival manufacturers of cores and tubes. The Tribunal had concluded this part of its determination thus: 'We are concerned that the transaction is the centre-piece of the strategy designed to facilitate the flow of price and other competitor sensitive information between Mondi and Sappi thus cementing the domestic duopoly, indeed cartelising a number of segments of the broad domestic paper manufacturing market'.

[62] In my view, appellants are correct in their submission that there was no evidence to justify the conclusion of a conscious strategy of foreclosure which motivated the merger. That the Tribunal might have been unimpressed by the explanations of first appellant as to the business motivation for the merger is one issue. That it adopted the view that the merger was designed to create an opportunity for monopoly pricing through parallel conduct with Sappi is another proposition and it was one which was never put to any witness nor was counsel for the merging parties asked to address the Tribunal's concern. In this regard Mr Petersen's observation that inferences should be conservatively drawn and not over elaborated is advice which the Tribunal should have followed. Nonetheless, the key question which arises is whether, on the evidence available to the Tribunal, there was a clear justification for the conclusion ultimately reached, namely that the merger was likely to have substantial uncompetitive effects.

[63] Mr Unterhalter submitted that in order for the finding that 'potential entrants at the cores and tube manufacturing stage of the production process would find their source of core board effectively foreclosed by the collective dominance of Mondi and Sappi', a number of hypothesis had to be sustained:

(i) appellant would 'self deal' by largely confining its sales of Ndicore to the integrated second appellant and the latter would largely confine its purchases of core board to that sold by first appellant

(ii) after the merger Sappi would have an effective monopoly and would increase the

price of the kraft paper that it sold to monopoly levels.

(iii) Imports from **inter alia** Indonesia and other developing countries would not be purchased by cores and tubes manufacturers if Sappi charged a monopoly price.

iv) First appellant would follow any monopoly price increase by Sappi, permitting it to extract monopoly rents when supplying core board to non-integrated cores and tubes manufacturers in a downstream market.

v) The object of input foreclosure would be achieved through tacit co-ordination between first appellant and Sappi.

[64] Regarding the question of self dealing, Mr Unterhalter referred to the following evidence of Mr van Breda:
'MR COETZEE. Could you give us an indication on what your approach would be as regards the business that Mondi is presently allocating to Framen? What would happen to that business?
MR VAN BREDA: As far as possible I'd like to keep business as usual as it currently is structured in the industry.
MR COETZEE: Are you telling us that post-merger Mondi, having absorbed Kohler, you will still outsource Mondi business to Framen?
MR VAN BREDA: I'd outsource it to other people, provided they are cost competitive. I think it would be inordinately risky to bring all the business in-house for a group as large as Mondi.'

Mr van Breda then went on to testify as follows:
'MR COETZEE: Taking what you've just said into consideration would you then say that imported paper is a real threat to Mondi and with specific reference to Indicore?
MR VAN BREDA: Absolutely. Not only imported paper but also papers available in South Africa. The threat of substitutability is great.
MR COETZEE: Will Mondi post-merge allow Kohler or the division that will be Kohler to source raw material at the cheapest possible prices or will you expect them to source from Mondi alone?

MR VAN BREDA: They have to source at the cheapest possible price if we're going to make this acquisition pay and it has to be the best cost decision for the other divisions.

We operate on a very decentralised basis in Mondi, so the divisions make their own decisions largely.

MR COETZEE: Perhaps asking the previous question just in another way, post-merger are you going to manufacture all your own requirements in-house?
MR VAN BREDA: I already gave the answer to that. I said it will be inordinately risky for us to do all of that. And secondly I do believe by doing that we won't have an opportunity to cross-benchmark ourselves as a known internal operation. So the answer to that is no, we won't'. (emphasis added by appellants).

[65] In short, Mr van Breda testified that first appellant would continue to source cores and tubes from manufacturers such as Framen and that second appellant would continue to source core board from suppliers other than first appellant.

[66] However upon closer examination, Mr van Breda's evidence reveals that he acknowledged that the plant that manufactures Ndicore suffered from a definite capacity constraint. First appellant did not have sufficient capacity to supply the needs of the entire South African packaging and industrial market.

[67] Mr van Breda also conceded that cores and tube manufacturers who did not have

contractual supply relationship with first appellant (such as Framen and second appellant) would have to take their changes and obtain supply on the spot market, thereby being placed in a far more vulnerable proposition

[68] In the context of a post merger market, there is a clear basis for drawing an inference that second appellant, as a vertically integrated manufacturer, would continue to receive priority in supplies over other manufacturers. While there is no direct evidence that first appellant would be likely to restrict supplies of Ndicore to non-integrated cores and tube manufacturers after the merger, the existence of an acknowledged capacity constraint, and the legitimate inference that first appellant would, in all probability, give priority to the firm which it acquired (second appellant) constituted a sufficient justification for a conclusion that, post-merger, there would, in all likelihood, be a restriction of suppliers of Ndicore to non-integrated cores and tube manufacturers.

[69] Turning to the question of whether Sappi would have an effective monopoly and thus increase the price of its kraft paper, the evidence indicated that manufacturers of cores and tubes, particularly second appellant, had been able to buy supplies from either Mondi or Sappi and thus ensure that the pricing of supply would reflect competitive levels. Manifestly, the merger would be likely to have the effect of substantially curtailing customers' ability to so do. Mr Bouzaglou's testimony, in which he expressed concern about being susceptible to the power of Sappi following the merger and hence was seeking an alternative source outside South Africa, supports this conclusion.

[70] Given the nature of the duopoly, Sappi would be able to pass on increased prices it is charged as purchaser of cores and tubes to its own customers. First appellant as the other duopolist would be able to do likewise. Accordingly, Sappi would suffer no risk of losing its market to first appellant as a result of these price increases. This practice would be made all the easier because the price of cores and tubes constitutes so small a component of the price of the composite products sold by Sappi. Hence the latter would not face any significant resistance from its customers following the price increase. This conclusion is supported by the Tribunal's finding regarding low price elasticities that characterise the cores and tubes market.

[71] On this basis there is clear support for the Tribunal's conclusion that there would be 'little to prevent Sappi from exercising its new found market power by charging a monopoly price for its core board, Spiralwind. To the extent that Mondi's newly merged entity continues to participate in the market (that is to the extent that it does not exclusively self deal but rather continues to supply some Ndicore to non integrated cores and tubes manufacturers) it will have no interest in increasing output and decreasing prices in order to wrest market share from its rival, Sappi. On the contrary Mondi's best interests would simply lie in following Sappi's price increase thus permitting both producers of core board to extract monopoly rents from non integrated cores and tubes manufacturers in the downstream market.'

[72] Mr Unterhalter sought to counter this conclusion by contending that it would be irrational for Sappi to charge its clients at the cores and tubes manufacturing level a price above the competitive level because Sappi itself was a downstream customer of such manufacturers. This submission overlooks the fact that Sappi is but one of the customers of the manufacturers to whom it will be able to supply paper at an increased price. Therefore, whatever cost it incurs pursuant to the increase which it bears as a downstream customer, would be recouped from its other customers.

The influence of a theoretical approach.

[73] To a large extent, these conclusions depend upon the manner in which the duopoly between first appellant and Sappi is analysed. Mr Unterhalter urged that this court should not presume the existence of collaborative behaviour by oligopolists; in this case duopolists. Fundamental to appellants' approach was the submission that the

structure of an oligopolistic market does not constitute evidence of a probability of uncompetitive parallel conduct. Such conduct is nothing more than a possibility. Although the issue of theory has been examined in general, it is necessary to analyse appellants' specific submissions regarding tacit coordination, themselves a product a particular the vertical approach.

Mr Unterhalter relied heavily on the decision of the Appeal Court of Justice in **Airtours plc v Commission of the European Communities** (6 June 2002) in support of his argument that the Tribunal's theory of how the strategy of tacit coordination will operate in practice suffered from serious flaws. The relevant passage of the judgment reads thus: 'As the applicant has argued and as the Commission has accepted in its pleadings, three conditions are necessary for a finding of collective dominance as defined:
first, each member of the dominant oligopoly must have the ability to know how the other members are behaving in order to monitor whether or not they are adopting the common policy. As the Commission specifically acknowledges, it is not enough for each member of the dominant oligopoly to be aware that interdependent market conduct is profitable for all of them but each member must also have a means of knowing whether the other operators are adopting the same strategy and whether they are maintaining it. There must, therefore, be sufficient market transparency for all members of the dominant oligopoly to be aware, sufficiently precisely and quickly, of the way in which the other members' market conduct is evolving;
second, the situation of tacit coordination must be sustainable over time, that is to say, there must be an incentive not to depart from the common policy on the market. As the Commission observes, it is only if all the members of the dominant oligopoly maintain the parallel conduct that all can benefit. The notion of retaliation in respect of conduct deviating from the common policy is thus inherent in this condition. In this instance, the parties concur that, for a situation of collective dominance to be viable, there must be adequate deterrents to ensure that there is a long-term incentive in not departing from the common policy, which means that each member of the dominant oligopoly must be aware that highly competitive action on its part designed to increase its market share would provoke identical action by the others, so that it would derive no benefit from its initiative (see, to that effect, **Gencor v Commission**, paragraph 276);
third, to prove the existence of a collective dominant position to the requisite legal standard, the Commission must also estabish that the foreseeable reaction of current and future competitors, as well as of consumers, would not jeopardise the results expected from the common policy' (at para 62, appellant's emphasis).

[74] Mr Unterhalter submitted that, in order for the Tribunal to have concluded that there was tacit coordination between first appellant and Sappi, it would have had to establish (1) that the two parties had the ability to know how the other was behaving in order to monitor whether or not they were both adopting the common policy of input foreclosure, (2) the policy would have to be sustainable over time so that there was no incentive to depart from the policy and (3) the foreseeable reaction of current and future customers such as Framen and ITT as well as customers such as Columbus Steel would

not jeopardise the result expected from the common policy.

[75] In my view, these submissions did not take sufficient account of the specific context of the market in which this disputed transaction must be evaluated. The facts of this case show that substantial market power exists in the hands of two parties and is likely to be strengthened significantly if the merger takes place.

[76] The structure of the market reveals that, insofar as the estimated national market share for the products manufactured by second appellant and its competitors are concerned, it dominates the market (45% market share of the cores and tubes, 65% of angle board, 33% of dufaylite and 75% of textile cones). The estimated market share for raw materials supplied to the cores and tubes, angle board, dufaylite and textile cone markets are as follows: first appellant enjoys 38% of the market share, Sappi 38% and 24% is supplied by imports.

[77] In its recommendations the Commission cast further doubt on the significance of the role of imports. It said that it 'has its reservations regarding these high import figures since all the competitors contacted confirmed that imports are possible but not economically viable due to the exchange rate'. Based on this market share information the Commission found that the market were highly concentrated, far above 1800 points in terms of the HHI calculation.

[78] Even the merging parties acknowledged that the structure of the market was susceptible to collusion prior to the merger. The following passage from a submission made to the Tribunal by appellants' attorney's is illustrative:
'The Commission's conclusion that the merger is anti competitive because this strategy is likely to occur following the merger and that the merger should therefore be prohibited is flawed for the following reasons….Absent the merger, the upstream market is oligopolistic in nature. Structural conditions in the upstream market thus are such that Mondi would be able to pursue a collusive strategy with Sappi in any event should it wish. The merger certainly does not enhance the possibilities for collusion between Sappi and Mondi. In addition, the dangers of relying solely on structural conditions to conclude on potential conduct post transaction are well known'
In the light of the context of the market in terms of which this merger transaction has taken place, the conclusion of the Tribunal that the requirements as set out in the **Airtours** case are easily met, namely that the two parties have the ability to know how the other behaves so as to monitor common practices, sustainable tacit co-ordination and the inability of competitors (who do not effectively exist) and customers to jeopardise the results obtained from the common practice is manifestly reasonable.

CONCLUSION

[79] The evidence on the record clearly supports the Tribunal in its conclusion that

'importing carries considerable risk for local downstream producers. And the South African market for core-board, with the lions share foreclosed by the actions of the powerful domestic duopoly will not be an attractive market for exporters'.

[80] Once it is decided that the importation of supply is not a viable option to the supply of the products produced by first appellant and Sappi, it becomes critical to examine, on the basis of the available evidence, whether uncompetitive parallel conduct between first appellant and Sappi will be rendered more likely as a result of the proposed merger.

[81] In this assessment, it is important to emphasize that a finding of uncompetitive motive or intention is unnecessary in the determination as mandated by section 12 A of the Act. The question, of which the section requires an answer, is whether the merger is likely, on the available evidence, to have substantial anti competitive effects. Given the structural relationship between first appellant and Sappi, the likelihood is that, post the merger, second appellant will continue to receive priority of supply over other manufacturers in the downstream market. There is clear evidence, particularly provided by Mr Bouzaglou, that manufacturers such as Framen will increasingly be dependent upon Sappi for supply as a result of the merger. It therefore follows that the possibility of having to pay higher prices to Sappi can only be offset by seeking alternative sources for paper supplies outside of South Africa, arguably at a higher price, which increases will then, in turn, be passed on to consumers.

[82] There is also a realistic likelihood that the merged entity will largely self deal. Once that occurs other cores and tubes manufacturers are effectively left with Sappi as the supplier to provide for its requirements of core-board, by way of a supply of Spiralwind.

ALLEGED UNFAIRNESS.

[83] Appellants raised the issue of compliance with the **audi alteram partem** rule by the Tribunal Mr Unterhalter contended that the particular construction of the Act and its application to the evidence relied upon by the Tribunal in coming to its decision that the proposed transaction substantially prevented or lessened competition, was not raised at the hearing in a way which would have allowed appellants a proper opportunity to deal with this approach.

[84] Although appellants are correct that, where reasonably possible, the concerns of members of the Tribunal ought to be indicated so that they can be adequately addressed by appellant, the test must be, whether on the evidence which was led before the Tribunal, there is a likelihood that the proposed merger would substantially prevent or lessen competition. Were this court to uphold an appeal on the basis that the precise nature of its particular conclusion was not put by the Tribunal to appellants' representatives at the hearing before the Tribunal, it would constrain the scope of the Tribunal's activity and render many sound decision susceptible to a successful appeal in most complex cases. The nature of the probabalistic enquiry mandated by section 12 A makes it exceptionally difficult for the Tribunal to consider each and every implication of 'probabalistic possibility' at the hearing. An appeal must test the essence of the finding against the evidence on the record. As I am satisfied that, on the evidence before it, the proposed merger is likely to substantially lessen or prevent competition, the appeal must be dismissed.

[85] At the hearing, the Commission was represented by Mr Maleka and Mr Mokoena who also submitted that, in the final analysis, the transaction is likely to lead to an increase in price and hence the non-integrated parties will be forced to acquire raw material at non-competitive prices so that the transaction is likely to lessen competition. The issue of the ***locus standi*** of the Commission was raised by appellants. In particular, Mr Unterhalter referred to S 17 of the Act in terms of which the Commission is precluded from being heard by this Court, in that it is neither a party to the merger nor is it a party contemplated in terms of S 13 A(2).

Given the conclusion to which I have arrived and the absence of a cost order against appellants there is no need to decide this question. However there is some merit in the argument of appellants and it is preferable if the Legislature were to examine the Act with a view to considering the desirability of the primary investigating agency, the Commission having a right to appear in proceedings of this nature.
[86] The court wishes to record its appreciation for the considerable assistance which it received from counsel for the amici, Mr Petersen and Mr Wilson.

ORDER.

The appeal is dismissed. There is no order as to costs.

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DAVIS JP

HUSSAIN J A and MAILULA AJA concurred.