IN THE COMPETITION APPEAL COURT OF SOUTH AFRICA

CASE NO: 10/CAC/Aug01

In the large merger between:

SCHUMANN SASOL (SOUTH AFRICA) (PTY) LTD **First Appellant**

and

PRICE'S DAELITE (PTY) LTD. **Second Appellant**

JUDGMENT:

INTRODUCTION.

First appellant is a manufacturer of candle wax. Second appellant manufactures household candles. In 1995 the Leo Goodman Family Trust acquired a controlling interest in second appellant from first appellant. In the same year the parties concluded a wax supply agreement pursuant to which second appellant procured much of its wax from first appellant. This agreement was amended in 1998.

Second appellant is in a parlous financial position . The financial statements as at 31 August 2000 reflect that second appellant's current liabilities amount to some R79 293 796 whereas its current assets amount to R38 757 188. As at 31 August 2000 second appellant was indebted to first appellant in the amount of R73 429 797. But for the fact that first appellant agreed to subordinate its claims in favour of other creditors, second appellant would have had insufficient funds to pay its debts and would be commercially insolvent.

In 1998 an agreement of pledge was concluded between the Leo Goodman Family Trust as the majority shareholder of second appellant and first appellant in terms of which the former pledged its shareholding in second appellant to first appellant as security for the amounts owing under the supply agreement. In addition, loan agreements and pledge agreements were entered into in 1998, in terms of which first appellant advanced loans to

Avron Goodman and Ivan Goodman to acquire minority shareholdings in second appellant. Disputes arose between first and second appellant in respect of both the supply agreement and the pledge agreements. First appellant claimed that second appellant was in default of its payment obligations under the supply agreement and second appellant claimed that first appellant was in breach of the supply agreement.

On 12 September 2000 a settlement agreement was concluded between the parties in terms of which first appellant would exercise its rights under the pledge held by it and become the sole shareholder of second appellant. The shareholders of second appellant would be released from their obligations under the loan agreement with first appellant which would also release second appellant in respect of its claims under the supply agreement. The effect of the settlement agreement was that first appellant acquired control of second appellant.

As the settlement agreement included an acquisition by first appellant of second appellant's shareholding, this transaction by which first appellant acquired 100% of the shareholding of second appellant meant that the transaction constituted a merger. As a result the Competition Commission (the "Commission") was required to consider the effect of the settlement agreement in terms of section 12A of the Competition Act 89 of 1998 as amended ('the Act').

The Commission recommended that the Competition Tribunal ("the Tribunal") approve the proposed transaction subject to certain conditions. After a hearing the Tribunal concluded that the transaction would enable first appellant to extend its dominant position in the market for candle wax by strengthening its position in the downstream market. The Tribunal rejected the defences raised by first appellant. It concluded that the conditions proposed by the Commission did not meet the competitive concerns which had been identified. Consequently, it prohibited the merger in terms of Section 16(2) of the Act. It is against this decision that appellants have appealed to this Court.

The applicable law relating to mergers .

Section 12A (1) of the Act provides as follows:

> **Consideration of mergers.—(1) 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, by assessing the factors set out in subsection (2), and—**

(a) if it appears that the merger is likely to substantially prevent or lessen

competition, then determine—

(i) whether or not the merger is likely to result in any technological, efficiency or other pro-competitive gain which will be greater than, and offset, the effects of any prevention or lessening of competition, that may result or is likely to result from the merger, and would not likely be obtained if the merger is prevented; and

(ii) whether the merger can or cannot be justified on substantial public interest grounds by assessing the factors set out in subsection (3); or

(b) otherwise, determine whether the merger can or cannot be justified on substantial public interest grounds by assessing the factors set out in subsection (3).

Section 12A (2) sets out a range of guidelines which the Competition Tribunal should take into account in ascertaining whether the merger is likely to substantially prevent or lessen competition. The section provides as follows :

(2) When determining whether or not a merger is likely to substantially prevent or lessen competition, the Competition Commission or Competition Tribunal must assess the strength of competition in the relevant market, and the probability that the firms in the market after the merger will behave competitively or co-operatively, taking into account any factor that is relevant to competition in that market, including—

(a) the actual and potential level of import competition in the

market;

(b) the ease of entry into the market, including tariff and regulatory barriers;

c) the level and trends of concentration, and history of collusion, in the market;

d) the degree of countervailing power in the market;

(e) the dynamic characteristics of the market, including growth, I innovation, and product differentiation;

(f) the nature and extent of vertical integration in the market;

(g) whether the business or part of the business of a party to the merger or proposed merger has failed or is likely to fail; and

(h) whether the merger will result in the removal of an effective competitor.

Section 12A provides for definite stages in the inquiry which it mandates. In the first place the Commission or the Tribunal must determine whether the merger is likely to substantially prevent or lessen competition. In making such a determination the Competition Tribunal must assess the strength of competition in the relevant market and the probability that, after the merger, the firms in the market will behave competitively or co-operatively. In making this assessment consideration must be given to the non exhaustive list of factors set out in s12A(2) which are relevant to the assessment of competition in that market. This initial inquiry may be termed the threshold test. The test must be applied to the *relevant market* which is the actual market and not a hypothetical or idealised market.

It is only where the Commission or Tribunal makes an initial determination that the merger is likely to substantially prevent or lessen competition that it then becomes obliged to proceed and determine whether the merger is likely to result in any technological, efficiency or other pro-competitive gain which would outweigh the effects of a prevention or diminution of competition that may result or is likely to result from the merger.

In addition to engaging in an examination of technology and efficiency gains, the Commission or Tribunal is also obliged to determine whether the merger can be justified on substantial public interest grounds. In making this determination, section12A(3) enjoins the Competition Tribunal to consider the effect the merger will have on:

(a) a particular industrial sector or region;

(b) employment;

(c) the ability of small businesses, or firms controlled or owned by historically disadvantaged persons, to become competitive; and

(d) the ability of national industries to compete in international markets.

In its analysis of this legislative framework of merger control, the Tribunal accepted that there is a distinction to be made between the determination of the effects of vertical and horizontal mergers. This distinction is supported by a significant body of academic literature. For example, A *Areeda ,Hovenkamp and Solow*: **Anti Trust Law** (Volume IV A) at 137 write:

> **"A vertical merger, standing alone does not alter concentration either in the supplier's market or in its customer's markets and hence adds nothing to whatever market position either firm previously had. Nor would a series of vertical mergers, as such, change market concentration at either level or necessarily contribute to market power. Accordingly, any anti competitive effects of a vertical merger must arise from other structural or behavioral consequences such as increased entry barriers, the elimination of unintegrated rivals by foreclosure, or the raising of rivals costs."**

Whish **Competition Law** (4th ed) at 541 writes:

> **"It is fairly obvious that the horizontal agreements, for example, to fix prices or to limit output, should be prohibited: in this situation, firms combine their market power to their own advantage; vertical agreements do not involve a combination of market power. Vertical agreements are likely to have an effect on competition only where the firm imposing a vertical restraint already has some degree of market power".**

This academic approach to the issue of mergers has found favour with courts in the United States of America. Thus, for example, in **Alberta Gas Chemicals Ltd v E I du Pont de Nemours** 826 F.2d 1235 (3d Cir.1987) 1244 the court said:

> **"Indeed, respected scholars question the anti-competitive effects of vertical mergers in general. As one commentator phrases it: "Foreclosure does not, however, reflect an actual reduction in competition in any meaningful sense"…. A vertically integrated firm seeking to increase profits will engage in self dealing if the supplying division's output cannot be profitably sold elsewhere, or is not more costly or inferior than the product of outside suppliers… Because of post merger efficiencies allowing it to purchase the acquiring company's output at a better price than in the market place, the acquired company's purchasing cost would fall – a pro competitive benefit capable of being passed on via lower prices for its products. Thus, in this**

> **scenario , post merger self -dealing could result in efficiencies reflected in lower prices to the ultimate consumer."**

In Canada , the Merger Enforcement Guidelines of 1991 adopt the approach that vertical mergers rarely present sufficient ground for enforcement action. The Director of Investigation and Research at the Bureau of Competition Policy is unlikely to conclude that a vertical merger is likely to prevent or lessen competition substantially unless:

a. **the merger results in rendering unlikely entry into the primary market on a scale sufficient to eliminate a material price increase within two years , due to the need to simultaneously enter the secondary market ; and**

b. **the exercise of market power in the primary market is likely to be facilitated by the merger in the absence of such entry .** *(Merger Guidelines para 4.11.1)*

This comparative approach to vertical transactions assists in the development of the interpretative approach to s12A where the threshold test to be considered by the Commission or the Tribunal is whether or not the merger is likely to substantially prevent or lessen competition. As *Mr Unterhalter* who appeared on behalf of appellants contended, the requirements set out in section 12A capture the central premise of merger control, being that transactions should be permitted unless it can be shown that the threshold requirement has been met on the basis of evidence placed before the Tribunal. Only, if such a test is met do questions of technology, efficiency and public interest become important.

The approach of the Tribunal.

The Tribunal emphasized that there was clear evidence that there was a high horizontal market concentration in both the sectors involved in the proposed merger, namely in the production of candle wax and in the production of household candles . First appellant enjoys a 75% share of the upstream industry in South Africa while second appellant enjoys a 42% of the downstream industry in South Africa.

The Tribunal found that the merger would affect both the upstream and downstream markets. It would prevent or lessen competition in the upstream wax market by raising barriers to entry. A potential entrant would be unable to sell its output of wax to the largest candle producer, being second appellant and may even be forced to enter candle manufacturing itself. The acquisition of 100% of the shares in second appellant would enable first appellant to protect its monopoly position in the candle wax market.

After the merger, first appellant would discriminate in favour of second appellant relative to the latter's competitors, thus consolidating and extending second appellant's powerful position in the manufacture of candles. Even were first appellant to desist from engaging in such discriminatory practices, second appellant would gain from its upstream parent's knowledge of the capacities, demands and strategies of its rivals who would be forced to enter into supply agreements with first appellant.

With regard to the upstream market the Tribunal found that the transaction would ensure that first appellant's competitors would be:

> **"… reduced to the role of bit players participating at the fringes of the market. They are excluded from the largest part of the market in an area of production subject to scale economies and in which the respective**

participants – the supplier and customer – placed a high premium of certainty of supply and demand. Their only way of entering the upstream candle wax market would be to enter simultaneously the downstream candle market but this is unlikely to happen. Like SCHS, they are not candle manufacturers and, in a market where there is already one dominant candle producer , one owned moreover, by the dominant competitor in the candle wax market, this approach is fraught with risk".

The Tribunal examined the influential role that first appellant could play in the downstream market, after the acquisition of the shares in second appellant thus:

"[s]hould SCHS believe that its share of the candle wax market, the upstream market, is threatened by a possible tie-up between an alternative supplier of wax and one of the smaller producers of candles, its dominance of the upstream market combined with its powerful position in the downstream candle market will enable it to consolidate its position in the latter market precisely in order to maintain the already significant barriers in the upstream market that have… been consolidated and extended by this transaction".

In summarizing its finding as to of the effect of the transaction in both markets, the Tribunal said:

> **"[w]e conclude that the transaction before us enables SCHS to maintain and extend its dominant position in the market for candle wax. Furthermore, should SCHS deem it necessary to further secure its position in the upstream market by extending its powerful position in the downstream market and this too is facilitated by the transaction. Accordingly we find that the transaction will substantially lessen or prevent competition in both markets in question."**

In attacking these findings *Mr Unterhalter* submitted that the risk of foreclosure lay at the heart of the Tribunal's rejection of the merger. In other words the Tribunal had concluded that in terms of the settlement agreement, the customer firm (second appellant) could foreclose as a market for the supplier's (i.e. first appellant's) rivals or the supplier firm could foreclose as a source of supply for the customer's rivals. (cf: *Areeda, Hovenkamp and Solow, (supra)* at 157). *Mr Unterhalter* submitted that this theory rested upon what he termed "*shaky foundations*".

As *Areeda et al (supra)* at 157 write;

> **" … the foreclosure theory has serious weaknesses. First, merger is a purely '*structural*' act that indicates nothing about whether outsiders will be foreclosed from dealing with the merged firm. Second, even in the case of complete self-dealing to the exclusion of all others, foreclosure has no anti-competitive effect whatsoever in competitive markets and often has little effect in oligopolistic markets. Third, even when foreclosure has the effect of making it more difficult for one or more existing firms to find inputs or patronage, injury to competition is not obvious and an additional explanation must be supplied."**

Mr Unterhalter contended that there was no realistic possibility of first appellant foreclosing the market to suppliers of wax when manufacturers had ready access to imported wax the supply of which did not depend upon any economies of scale in the South African market nor upon entry into the household candle manufacturing market. He further submitted that it was not a plausible argument to contend that first appellant would be able to utilise second appellant for the purposes of either securing its position or procuring market power for second appellant, given the low barriers to entry into the market for a manufacturer of household candles.

Before analysing the details of *Mr Unterhalter's* attack on the Tribunal's decision, it is necessary to establish the test which should be applied by this Court in an appeal of this nature. In terms of section 17 of the Act this Court can, in an appeal from a decision made by the Tribunal in terms of section 16: (a) set aside the decision; (b) amend the decision by ordering or removing restrictions or by including or deleting conditions; or (c) confirm the decision.
In terms of section 17(3) if the Court allows an appeal and sets aside the decision, it must either: (a) approve the merger; (b) approve the merger subject to any conditions; or (c) prohibit implementation of the merger.

The approach which this Court adopts to an appeal against the decision of the Tribunal in respect of a merger should take cognizance of the composition and role of the Tribunal as a specialist body which consists not only of lawyers but also of members possessed of the necessary financial and economic knowledge and thorough grasp of the relevant policy issues required in these kind of deliberations. Section 12A requires that the Tribunal make a determination after a holistic inquiry into whether the proposed merger is likely to substantially prevent or lessen competition. In assessing such a decision, this Court should take account of the composition and expertise of the Tribunal as well as the nature of the enquiry which entails an element of probabilistic investigation into the effect of the proposed merger. Account also needs to be taken here of the fact that the dispute concerns a vertical merger in which case, as has been shown, there is considerable comparative authority in favour of a different approach to such a merger. In its decision as to whether to set aside, amend or confirm the decision of the Tribunal, this Court must be cautious before imposing its own conception of the policy considerations upon the decision adopted by the Tribunal. The Court should seek rather to examine and test rigorously the justifications offered by the Tribunal for the decision to which it has arrived before it invokes its power in terms of s17.

An Evaluation of the Tribunal's Decision.

To recapitulate, the central finding of the Tribunal was that the proposed transaction –

> **"prevents or lessens competition in the candle wax market, the upstream market, by raising barriers to entry in respect of that market. Furthermore, the transaction significantly increases the capacity of the merged entity to consolidate and extend Price Daelite's already powerful position in the downstream market".**

These conclusions were based on the following process of reasoning:
In the case of the upstream market the Tribunal found that once second appellant's custom had been secured, first appellant had exclusive access to the majority of the market share, being the 42% of the market for household candles enjoyed by second appellant and the 13% controlled by Willowton and Cape Mills which had entered into a supply agreement with first appellant. First appellant's competitors would therefore have to compete for the minority of the market or enter the downstream candle market to ensure the purchase of their production of candle wax. Such a competitor would have to hope that the demand of other customers would be sufficient to purchase their supply.

The Tribunal found that second appellant, which operated in the downstream market, would be accorded:

> **"a massive anti-competitive advantage by the mere fact that Schuman Sasol, its parent in the upstream market, has intimate, direct and immediate knowledge of the production capacities and output levels of all Price Daelite's competitors in the downstream market, including knowledge of fluctuations**

in their demand for wax….".

By means of this transaction, second appellant would obtain privileged insight into the strategy as well as the capacity of its competitors. In addition the transaction would enhance second appellant's scope for anti-competitive practice such as predation. By predation the Tribunal must be assumed to mean that the predator (in this case second appellant) would take some action to harm its competitors, which action would not be considered *per se* to be rational action designed directly to maximize profit. However the harm would cause rivals to exit the market and once such exit had occurred, the predator would be able to raise prices above the level that prevailed prior to the act of predation.

The Tribunal also found that it would be extremely difficult for a new entrant to operate successfully in the candle manufacturing market in which the largest participant enjoyed 42% market share of such market and the dominant supplier of the key input would control this largest participant in the market.

Mr Unterhalter submitted that there was an inherent contradiction in this approach. In its determination, the Tribunal recognised that the existing candle wax market structure was '*ripe for competitive entry*'. In particular it referred to the absence of tariff barriers and the real prospect of international competition particularly in the form of Chinese imports. It also mentioned that Shell, which was a potential alternative supplier ,had resolved certain technical problems in its Malaysian refinery and was considering entry into the local market. *Mr Unterhalter* contended that nowhere in its determination had the Tribunal offered any explanation as to how these competitive forces would be dissipated by the proposed transaction. However to find that the transaction would promote the competitive abuse required the Tribunal to ignore the effect of its own finding of the very real existence of alternative sources of candle wax. Once account is taken of the prospect of a viable imported supply of wax (which could be increased depending upon demand) , it follows that to ensure the disposal of its product, first appellant must set its price below the level of competing imports. On the basis of this reasoning ,Mr Unterhalter contended that the observed high market share of appellant would be more the consequence of rather than the determinant of its pricing behavior.

Were first appellant to raise its prices to all downstream manufacturers within the context of an alternative source of wax through importation , competitors of second appellant would then purchase the cheaper imported product of medium candle wax. Were first appellant to sell medium candle wax to second appellant at the increased price, it would place the latter at a significant price disadvantage. Such a pricing decision could well cause second appellant to lose its market share to competitors who would be able to acquire wax at what would then be the cheaper price.

Although the Tribunal suggested that as a result of the transaction, second appellant would be able to engage in predation it cited no evidence nor explanation as to how such conduct would be rational; that is whether or not , following the exit of competitors, second appellant would be able to raise prices above the level that would have prevailed prior to its act of predation. On the basis of the Tribunal's own finding concerning the lack of barriers to entry into the candle manufacturing market, there is a clear implication that a recoupment of profits after the exit of competitors would not necessarily be possible. With prices constrained by import competition and low barriers to entry in candle manufacturing, candle prices could not easily be raised above the competitive level without inducing a greater measure of import substitution and/or entry into the candle market which would undermine the very objective of predation.

Mr Unterhalter also criticised what he called the Tribunal's "*speculative accounts'*'of the supposed anti-competitive behaviour of second appellant. Any information which first appellant might gain from its customers who were competitors of second appellant was likely to be patchy, given the access of rival candle manufacturers to other sources of wax supply. Furthermore no evidence was presented which indicated that first appellant would behave in the manner described. If first appellant pursued such conduct it would be subject to scrutiny as having engaged in a prohibited practice. Such conduct would be subject to Chapter 2 of the Act.

The conclusion reached by the Tribunal that the merger was likely to substantially prevent or lessen competition is based upon speculation of the kind which cannot be attributed to any evidential foundation placed before the Tribunal. On the evidence, there appears to be no plausible basis by which the Tribunal was able to conclude that first appellant could foreclose the market to suppliers of wax, particularly when manufacturers had ready access to imported wax, which supply is not dependant upon economies of scale within the South African market nor upon entry into the household candle manufacturing market.

The Tribunal acknowledged that the relationship between the appellants was a troubled one. As at 31 August 2000, second appellant was indebted to first appellant in the amount of R73 429 797,00. As already noted, the total of second appellant's current liabilities amounted to R79,293,796 whereas its current assets amounted to R38 757 188. But for the fact that first appellant has agreed to subordinate its claims in favour of other creditors, would have been commercially insolvent. The settlement agreement, which provided for the merger transaction which is the subject of this dispute, purported to settle all disputes between appellants.

In summary, the settlement agreement provided that first appellant would exercise its rights under a pledge held by it, in terms of which the major shareholder of second appellant pledged its shareholdings in the latter to first appellant as security for the amounts owing under an agreement. First appellant would become the sole shareholder of second appellant. The shareholders of second appellant would be released from their obligations under various loan agreements with first appellant Second appellant would be released from obligations in terms of claims under the supply agreement.

Viewed within this context the entire settlement agreement was based on financial considerations; in particular the resolution of a dispute relating to a considerable amount of debt. The Tribunal placed very little substantive importance upon these objectives. Rather it engaged in speculation which had too weak an evidential foundation to conclude that the real objective or result of the agreement was to guarantee first appellant's dominance of the upstream market by raising barriers to entry in that market. The analysis advanced by the Tribunal to justify its conclusion that the financial considerations relating to debt were effectively of little importance and that broader competition issues powered the settlement agreement is sufficiently contradicted by the objective facts concerning alternative sources of supply of wax and the nature of the market with its ease of entry.

For these reasons we find that the Tribunal's justification for concluding that the merger was likely to substantially prevent or lessen competition in either of the markets identified lacks sufficient justification to be confirmed. Given this finding that the merger does not pass the threshold test, it is unnecessary to deal with the additional tests contained in Section 12A(1)(a)(i) and (ii). No argument was addressed to us with regard to the effect and application of section 12A(1)(b), upon which we make no comment. As the evidence does not show that the transaction is likely substantially to prevent or lessen competition, the appeal must be upheld. The failure to meet the threshold test means that there is no necessity to impose the kind of conditions recommended by the Commission, nor are there facts which indicate that any other conditions should be attached.

For these reasons it is ordered that the decision of the Competition Tribunal be set aside and the merger be approved.

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DAVIS JP

I agree:

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HUSSAIN JA

I agree

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SELIKOWITZ AJA