

5 May 2017

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By email: sarah.keene@russellmcveagh.com

Attention: Sarah Keene

11.04/16369

Dear Partner

Letter of Issues - Vero Insurance New Zealand Limited / Tower Limited

1. We refer to the application from Vero Insurance New Zealand Limited (**Vero**), a subsidiary of Suncorp Group Limited (**Suncorp**), seeking clearance to acquire up to 100% of the shares in Tower Limited (**Tower**).¹
2. At this stage, we consider that the proposed merger could give rise to competition issues in personal general insurance markets as a result of unilateral and/or coordinated effects.

Section 47 investigation

3. We also consider that Vero's completed acquisition of 19.99% of the shares in Tower could raise issues under section 47 of the Commerce Act 1986. The Commission has opened a separate section 47 investigation into this acquisition, which we are undertaking concurrently with our consideration of Vero's application for clearance.
4. We set out our concerns with Vero's existing stake in Tower in **Attachment A** to this letter. [

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¹ While Vero is the party that has applied for clearance, we will take into account all of Suncorp's insurance activities in New Zealand in assessing the proposed acquisition.

Process

5. In reaching the preliminary views set out in this letter, we considered information provided by Vero as well as information gathered from a range of industry participants. The Commission has not yet made any decisions on the issues outlined below (or any other issues) and our views may change, and new competition issues may arise, as our investigations continue.
6. We will advise you if we identify any further issues during our ongoing analysis of the proposed merger and Vero's acquisition of a 19.99% stake, including issues that may arise in markets not discussed in this letter.
7. We are available to meet with Vero to discuss any matter set out in this letter at a mutually convenient time once we have received Vero's response to the letter.

Information requests

8. The Commission invites Vero to make a submission on the issues and questions raised below, and to provide any additional evidence that it is able to.
9. We also have some specific requests for information which are set out in **Attachment B** to this letter. We request that Vero provides this information and any submission by close of business on **Friday 19 May 2017**.
10. Please note it is a criminal offence under section 103 of the Act to knowingly mislead or deceive the Commission in your response, including by omission if you have stated that all requested information has been provided.

Relevant markets

11. In its clearance application, Vero submitted that the relevant markets for assessing the proposed acquisition are:
 - 11.1 national markets for the following types of insurance:
 - 11.1.1 domestic house and contents;
 - 11.1.2 private motor vehicle;
 - 11.1.3 private pleasure craft;
 - 11.1.4 commercial motor vehicle;
 - 11.1.5 commercial property (including business interruption); and
 - 11.1.6 various forms of liability (including commercial liability);

- 11.2 national buying markets for:
- 11.2.1 auto-glass and windscreen repair/replacement services; and
 - 11.2.2 collision repair services.
12. The markets suggested by Vero are consistent with those defined by the Commission in its previous *IAG/Lumley* and *IAG/AMI* decisions. At this stage, we have received no evidence to suggest that we should depart significantly from the markets defined in those decisions (whether by defining separate functional markets or narrower geographic markets).
13. However, given that the main area of overlap between Vero and Tower is in the provision of personal general insurance, the focus of our investigation of the proposed merger is, at this stage, on the national markets for and any relevant bundles of:
- 13.1 domestic house insurance;
 - 13.2 domestic contents insurance; and
 - 13.3 private motor vehicle insurance.
14. At this stage, we consider that the proposed merger is less likely to raise concerns in other insurance markets (including commercial insurance markets, buying markets and the private pleasure craft market) given what the merged entity's market share would be in these markets.
15. We consider below the competitive effects in domestic house, domestic contents and private motor vehicle (HCMV) insurance together, as at this stage the competitive conditions in these markets appear to be largely the same.

The relevant counterfactual

16. To assess whether a substantial lessening of competition is likely requires us to compare the likely state of competition if the merger proceeds (the scenario with the merger, often referred to as the factual) with the likely state of competition if it does not (the scenario without the merger, often referred to as the counterfactual) and to determine whether competition would be substantially lessened comparing those scenarios.
17. In its clearance application, Vero submitted that, if it does not acquire Tower, Tower would remain a separate entity, implying that the counterfactual is not materially different from the status quo.
18. Where there are multiple likely counterfactuals, the Commission typically conducts its competition assessment against the most competitive counterfactual.

19. For the reasons set out below, we consider that there is real chance that, absent the merger, Tower will continue as an independent competitor (under either its current or new ownership) with increased competitive significance.

The structure and ownership of Tower in the counterfactual

20. At its 30 March 2017 Annual General Meeting of shareholders, Tower noted that it was currently considering the following two options other than the offer from Vero to acquire Tower:
- 20.1 acquisition of Tower by Fairfax Financial Holdings Limited (Fairfax) via Scheme of Arrangement; and
- 20.2 structural separation of Tower into two entities (“New Tower” and “RunOff Co”) and injection of \$100m incremental capital. We understand that this separation would be implemented by means of a Scheme of Arrangement.
21. Tower stated that the second of these options was the default option if the sale of Tower (to Vero or Fairfax) does not proceed.
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The competitiveness of Tower in the counterfactual

24. In forming our view of the likely counterfactuals (and how it would differ to the state of competition with the merger), we are also considering whether Tower’s competitive significance might be materially different following sale to Fairfax (or another party) or following Tower’s separation plan. At this stage, we consider that there could be a “real and substantial prospect”³ that Tower will be significantly more competitive in the counterfactual.

² [

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³ *Commerce Commission v Woolworths Ltd & Ors* (2008) 12 TCLR 194 (CA) at [135].

25. In the counterfactual, Tower appears likely to undergo significant reform, separating into two companies (New Tower and RunOff Co), raising substantial levels of capital, and making a significant investment in a new IT platform.⁴ [] This is a step-change in strategy which could make Tower significantly more competitive.
26. [] It recently introduced a “simple and easy” products package, developed online quote-to-buy functionality for its core branded products and repriced its portfolios. It has also developed an innovative partnership with TradeMe to distribute insurance products and recently implemented a new partnership with Air New Zealand Airpoints. In 2014, Tower introduced the first telematics system to New Zealand with its SmartDriver app.⁵ The app won the Innovation of the Year award at the 2014 New Zealand Insurance Industry awards.⁶
27. Therefore, we are considering whether our competition analysis in respect of Vero’s application for clearance should be conducted on the basis that the most competitive counterfactual includes an independently owned Tower that is of increasing competitive significance.⁷

Competition assessment

28. At this stage, we are concerned that the proposed merger could give rise to unilateral and/or coordinated effects in HCMV insurance markets.

Unilateral effects in personal insurance

29. Where two suppliers compete in the same market, a merger can remove a competitor that would otherwise provide a competitive constraint, allowing the merged entity to raise prices. The primary theory of harm we are investigating in this case is whether the proposed merger would enable the merged entity to unilaterally increase policy premiums and/or reduce the quality of its offering by, for example, reducing the scope of cover or providing worse claims services. We are also considering whether the merger could reduce incentives to innovate on aspects such as digital sales strategy and pricing methods (for example, smart use of data to better price risks).
30. For the reasons set out below, we are currently exploring whether the merger, when compared to a counterfactual where Tower would be independently owned and more competitively significant, would have the effect, or likely effect, of substantially lessening competition in HCMV insurance markets.

⁴ Tower AGM Address (30 March 2017).

⁵ http://www.nzherald.co.nz/personal-finance/news/article.cfm?c_id=12&objectid=11271711.

⁶ <http://smartdriver.tower.co.nz/>.

⁷ However, we have not reached a final view on whether Vero’s acquisition of 19.99% of the shares in Tower breached section 47. In any event, only the High Court, on application by the Commerce Commission, can determine whether a breach of section 47 has occurred.

31. Post-merger, these markets would be highly concentrated, with two insurers, IAG and the merged entity, holding very high market shares. The acquisition of Tower would result in significant change to Vero's existing market shares.

Existing competition

32. Vero submitted that the proposed acquisition would not enable the merged entity to raise prices (or decrease quality) as a result of unilateral effects, arguing that:
- 32.1 the degree of market share aggregation resulting from the proposed acquisition would be low;
 - 32.2 the merged entity would face strong competition from substantial and well-established existing competitors, as well as smaller competitors; and
 - 32.3 Vero and Tower are not each other's closest competitors in personal insurance markets. Instead, Vero's closest competitors in these markets are IAG and Youi.
33. We are exploring whether Vero and Tower compete closely with each other at present. Both have well-established and high-profile general insurance brands. Vero and Tower are two of only three insurers (the other being IAG) with current experience in New Zealand of underwriting for distribution partners, and with the existing capability to do so. [⁸]
34. In addition, given Tower's increasing competitive significance in the counterfactual, we are concerned that the merger could eliminate a more vigorous independent competitor. The loss of such a competitor in what is already a highly concentrated market could have a substantial effect on competition. We are considering whether, the removal of Tower may reduce constraints on IAG and Vero raising prices, and/or could remove incentives on IAG and Vero to innovate or otherwise improve the quality of their services.
35. In terms of the constraint from other competitors, IAG may provide strong constraint on the merged entity, but we are considering whether the merged entity would face any meaningful additional existing competition. After IAG, it appears there is a large drop-off in terms of the size and market share of other competitors. We also note it appears that:
- 35.1 while Youi was cited by Vero as a close competitor, it has a very small market share and is significantly differentiated by its business model;
 - 35.2 FMG and the Medical Assurance Society are highly differentiated and therefore are distant competitors to the merged entity; and

⁸ []

- 35.3 other insurers (eg, QBE, Chubb and ANDO) are currently only minor players in HCMV insurance offering cover through brokers.
36. Accordingly, we have concerns that the constraint between Vero and Tower lost as a result of the merger could be substantial and that the remaining existing competitors may not be sufficient to prevent a substantial lessening of competition.

Potential competition

37. Vero submitted that the barriers to entry in personal insurance markets are not significant, as evidenced by recent entry and expansion in these markets in the past two years. It submitted that there is a high likelihood of entry and expansion in personal insurance markets that would constrain the merged entity.
38. We are considering whether entry or expansion would be likely, timely, and sufficient in extent to prevent a substantial lessening of competition.
39. In terms of expansion, we are considering whether other existing, smaller, competitors present in HCMV insurance markets are likely to expand to become a greater constraint on the merged entity within the next two years. [

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Countervailing power

43. Vero submitted that the countervailing power of individual consumers, banks and brokers would continue to provide a significant constraint on the merged entity in personal insurance markets.

44. While intermediaries such as brokers and banks could have some countervailing power, we are concerned whether their countervailing power would be sufficient to effectively constrain the merged entity. []

Coordinated effects in personal insurance

45. A merger can substantially lessen competition if it increases the potential for the merged entity and all or some of its remaining competitors to coordinate their behaviour and collectively exercise market power such that output reduces and/or prices increase across the market. Unlike a substantial lessening of competition which can arise from the merged entity acting on its own, coordinated effects require some or all of the firms in the market to be acting in a coordinated way.
46. Vero submitted that the relevant markets do not have any of the structural features that potentially facilitate coordinated conduct.
47. []
48. []

49. For these reasons, we are considering whether the proposed merger could give rise to coordinated effects in the provision of HCMV insurance.

Concluding remarks

50. We welcome any further evidence, analysis and comment that Vero can provide about the issues raised in this letter, and also in **Attachment A** which addresses Vero's completed acquisition of 19.99% of the shares in Tower. We also ask that Vero responds to the specific requests for information set out in **Attachment B**.
51. We have also written to Tower seeking further information relevant to our assessment of the likely counterfactual(s) and our section 47 investigation into Vero's acquisition of a 19.99% stake in Tower.

52. I note that once we have had a chance to consider Vero's response to this letter, we are likely to want to meet with Vero to discuss issues further.

Yours sincerely

A handwritten signature in blue ink, consisting of several loops and a long horizontal stroke extending to the right.

Susan Brown
Senior Investigator

Attachment A: Vero's completed acquisition of 19.99% of the shares in Tower

Introduction

- A1. Between 22 February 2017 and 14 March 2017, Vero acquired a 19.99% shareholding in Tower in three separate tranches. []
- A2. []
- A3. We note that only the High Court, on application by the Commerce Commission or another party, can determine whether a breach of section 47 has occurred. []

Substantial degree of influence

- A4. As set out in our *Mergers and Acquisitions Guidelines*, we will consider that a person (A) has a substantial degree of influence over another person (B), if A has the ability to bring real pressure to bear on the decision-making process of B.⁹
- A5. Whether there is a substantial degree of influence is a question of fact. In making this assessment we consider a number of factors, including:
- A5.1 the nature and extent of ownership links between the companies;
 - A5.2 the presence of overlapping directorates;
 - A5.3 the rights of one company to appoint directors of another;
 - A5.4 the nature of other shareholder agreements and links between the companies concerned (including family or financial links); and
 - A5.5 the nature and extent of communications between the persons, and the apparent influence of one person on the key strategic decisions of the other.¹⁰

⁹ *Merger and Acquisition Guidelines* July 2013 at [2.7].

A6. In considering whether Vero’s shareholding in Tower results in a substantial degree of influence, we focus on Vero’s ability to:

A6.1 influence the passing of, or block, ordinary resolutions;

A6.2 block special resolutions; and

A6.3 succeed in having a Vero-nominated director being voted on to the Tower board.

A7. We then consider the decisions relating to Tower that Vero may be able to influence.

Ordinary resolutions

A8. The Constitution of Tower provides that each share in Tower entitles the holder to one vote on any resolution. [

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A9. [

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Special resolutions

A10. []Decisions requiring special resolution include approving “major transactions”.

A11. For a special resolution to pass, 75% of shareholder votes cast need to be in favour. [

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A12. [

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Board representation

A13. The Constitution of Tower provides that directors of Tower must be appointed by an ordinary resolution of shareholders. The minimum (and current) number of directors on the Board is five and the maximum is eight. A shareholder may propose a person be appointed as a director.

¹⁰ Ibid at [2.8].

A14. []

Decisions that Vero may be able to influence

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Incentive to use substantial degree of influence anti-competitively

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Attachment B: Information requested

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