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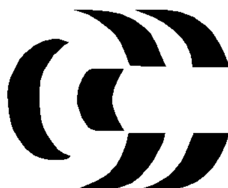

COMMERCE COMMISSION

# Draft Determination

**Note: This is a Draft Determination issued for the purpose of advancing the Commission's decisions on this matter. The conclusions reached are preliminary and take into account only the information provided to the Commission to date.**

Draft determination pursuant to the Commerce Act 1986 (the Act) in the matter of an application for authorisation of a business acquisition involving:

**KIWI CO-OPERATIVE DAIRIES LIMITED**
**and**
**SOUTH ISLAND DAIRY CO-OPERATIVE LIMITED**

**The Commission:** M N Berry
K M Brown
E M Coutts
P R Rebstock

**Commission Staff:** B Cossill
P Muysert
M Pickford
K Smith

**Summary of Proposal:** The acquisition by Kiwi Co-operative Dairies Limited, or any of its interconnected bodies corporate, of all the shares or assets of South Island Dairy Co-operative Limited.

**Draft determination:** The Commission determines, on the basis of the information provided to date, that it would be likely to grant an authorisation for the proposed acquisition pursuant to s 67(3)(b) of the Act.

**Date of draft :** 30 March 1999

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**CONTENTS**

THE PROPOSAL ........ 4
THE PROCEDURES ........ 4
THE INVESTIGATION ........ 5
THE PARTICIPANTS ........ 5
Kiwi Co-operative Dairies Limited (“Kiwi”) ........ 5
South Island Dairy Co-operative Ltd (“SIDCO”) ........ 6
OTHER RELEVANT PARTIES ........ 6
New Zealand Co-operative Dairy Company Ltd (“NZCDC”) ........ 6
Westland Co-operative Dairy Company Ltd (“Westland”) ........ 7
Other South Island Dairy Co-operatives ........ 7
BACKGROUND INFORMATION ........ 7
THE RELEVANT MARKETS ........ 8
Introduction ........ 8
The Market for the Acquisition/Supply of Unprocessed Milk ........ 9
The Substitutability Test and Payout Levels ........ 10
Transportation of Milk ........ 11
Acceptance of Milk by Substitute Acquirers ........ 12
Potential Substitute Acquirers ........ 13
Conclusion on Potential Substitute Acquirers ........ 14
New Zealand Market ........ 14
Conclusion on Extent of Geographic Market ........ 15
The Market for Cheese in New Zealand ........ 15
The Market for the Acquisition/Supply of Manufactured Dairy Products in New Zealand for Export ........ 15
Conclusion on Market Definition ........ 16
ASSESSMENT OF DOMINANCE ........ 16
Overview ........ 16
The Market for the Acquisition/Supply of Unprocessed milk in the South Island ........ 17
Market Shares ........ 17
Constraint by Existing Competition ........ 18
Constraint by Existing Competition – South Island ........ 19
Other Co-operatives ........ 21
Conclusion on Constraint by Existing Competition ........ 21
Constraint by Competition in the North Island ........ 22
Payouts to suppliers ........ 22
Constraint by Competition – North Island ........ 23
Conclusion on Constraint by Competition in the North Island ........ 24
Constraint by Potential Competition ........ 24
Conclusion on Constraint by Potential Competition ........ 25
Co-operative Ownership as a Constraint on Market Power ........ 25
Conclusion on Constraint by Co-operative Ownership ........ 27
Constraint by Potential Substitutes ........ 27
Conclusion on Constraint by Potential Substitutes ........ 28

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Conclusion on Dominance in the Market for the Acquisition/Supply of Unprocessed Milk in the South Island ..... 28
The Market for the Wholesale Supply of Cheese in New Zealand ..... 29
Conclusion on Dominance in the Market for the Wholesale Supply of Cheese in New Zealand ..... 29
The Market for the Acquisition/Supply of Manufactured Dairy Products in New Zealand for Export ..... 30
Interconnected or subsidiary ..... 32
The Dairy Board Act 1961 ..... 32
Conclusion on Interconnection ..... 33
Conclusion on Association ..... 37
Conclusion on Dominance in the Market for the Acquisition/Supply of Manufactured Dairy Products in New Zealand for Export ..... 37
CONCLUSION ON DOMINANCE ..... 37
PUBLIC BENEFITS AND DETRIMENTS ..... 38
Introduction ..... 38
The Counterfactual ..... 38
Conclusion on the counterfactual ..... 40
Detriments ..... 40
Allocative inefficiency ..... 40
Productive inefficiency ..... 45
Dynamic inefficiency ..... 46
Conclusion on Detriments ..... 47
Public Benefits ..... 47
Preservation of Competition ..... 48
Productive Efficiency ..... 48
Conclusion on Public Benefits ..... 58
THE DRAFT DETERMINATION ..... 58

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## THE PROPOSAL

1. On 26 February 1999, the Commission registered a notice pursuant to s 67(1) of the Commerce Act 1986 (“the Act”) seeking authorisation for the acquisition by Kiwi Co-operative Dairies Limited (“Kiwi”), or any of its interconnected bodies corporate, of all the shares or assets of South Island Dairy Co-operative Limited (“SIDCO”).

2. The acquisition is proposed to be effected by way of a merger of Kiwi and SIDCO, but the form and details of the merger have not yet been agreed by the participants. Any agreement which has been provisionally entered into, or which is subsequently entered into, by the participants, is or will be subject to Commerce Commission consent.

## THE PROCEDURES

3. Section 67(3) of the Act requires the Commission to issue a decision within 60 working days, or such other longer period as the Commission and the applicant shall agree. A final determination is required by Wednesday 26 May 1999.

4. If it is satisfied that the acquisition would not result, or would not be likely to result, in the acquisition or strengthening of a dominant position in a market, the Commission may give a clearance to the acquisition under s67(3)(a). In decision 341 (26 February 1999) the Commission declined to grant clearance for the proposed acquisition following an application for clearance under s66(1) of the Act.

5. If it is not satisfied that the acquisition would not result, or would not be likely to result, in a dominant position in a market being acquired or strengthened, the Commission may grant an authorisation for the acquisition if it is satisfied that the acquisition would result, or would be likely to result, in such a benefit to the public that it should be permitted under s67(3)(b).

6. If it is not satisfied as to the matters referred to in paragraph 4 or 5 above, the Commission shall decline to grant an authorisation under s67(3)(c).

7. Interested parties who wish to make submissions to the Commission on the finding of the draft determination should forward submissions to the Commission by Tuesday 13 April 1999. Experts employed by interested parties should submit their submissions by Tuesday 20 April 1999.

8. Section 69B of the Act provides that the Commission may hold a conference prior to determining whether or not to give a clearance or grant an authorisation under s67(3) of the Act. In respect of this application the Commission intends to convene such a conference in Wellington to be held on 5-6 May 1999.

9. Kiwi sought confidentiality for certain information contained in the notice seeking clearance, and a confidentiality order was made in respect of that information for a period of 20 working days from the Commission’s determination of the notice. When

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that confidentiality order expires, the provisions of the Official Information Act will apply to that information.

10. The Commission's draft decision is based on an investigation conducted by staff and their subsequent advice to the Commission.

## THE INVESTIGATION

11. The Commission contacted the following parties in investigating the proposed acquisition either as part of this application for authorisation, or as part of the investigation of the previous application for clearance:
    - The participants to the proposal;
    - Other dairy co-operatives including Tasman Co-op Dairy Co Ltd; Marlborough Co-op Dairy Co Ltd, Northland Co-op Dairy Co Ltd, Westland Co-op Dairy Co Ltd, NZ Co-operative Dairy Company Ltd, Kaikoura Co-op Dairy Ltd;
    - Federated Farmers of NZ (Inc) – Dairy Farmers New Zealand (Inc); and
    - The New Zealand Dairy Board.

12. The applicant and other interested parties provided the Commission with a range of submissions including legal and economic analyses. These have been considered by the Commission, and assisted in the making of this draft determination.

## THE PARTICIPANTS

### Kiwi Co-operative Dairies Limited ("Kiwi")

13. Kiwi is currently the second largest dairy co-operative in New Zealand, with 4,239 suppliers nationwide. The majority of these suppliers are located in Taranaki, Manawatu and Hawkes Bay. Kiwi's 240 South Island suppliers are located around Christchurch and South Otago/Southland. In 1998 Kiwi processed about 16.6 million kg of milk solids, or 9.2%, of the South Island milk solids.

14. Kiwi owns and operates the world's largest milk manufacturing site in Hawera, and plants at Longburn and Pahiatua in the North Island, and plants in Christchurch and Stirling in the South Island.

15. Acquisitions by Kiwi of South Island dairy processors over the preceding three years include:
    - Otago Co-Operative Dairy Company Limited;
    - Mainland Products Limited; and
    - South Island Dairy Farmers Co-Operative Limited.

16. Kiwi currently undertakes the following business activities:
    - acquisition and processing of raw milk;
    - manufacture and processing of various dairy and powdered milk products (cheese, casein, skim and wholemilk powders, butter, whey products), principally for export, at Hawera, Longburn, Christchurch and Stirling;
    - processing and wholesale distribution of liquid milk and cheese (Mainland);
    - development and commercialisation of technology (Kiwitech);

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- marketing of industrial and food ingredients (Kiwi Milk Products);
- marketing of abalone food and spray-on hay protectant (Promak);
- farm merchandise retailing (Kiwi Trading Stores);
- manufacture and marketing of ice-cream (Rush-Munro's of New Zealand Limited); and
- generation and sale of electricity (Kiwi Power).

17. Kiwi is a major exporter of dairy products through the New Zealand Dairy Board (NZDB). Product brands owned and used in New Zealand by Kiwi include Mainland, Valumetric, Galaxy, Ferndale, Tararua, Ski and Meadowfresh.

**South Island Dairy Co-operative Ltd ("SIDCO")**

18. SIDCO is a Christchurch based dairy co-operative company, involved in the purchase of unprocessed milk from 980 supplying shareholders in Canterbury and Southland. In 1998 SIDCO processed about 120 million kg of milk solids, or 66.4%, in the South Island.

19. SIDCO undertakes the following business activities:

- acquisition and processing of raw milk;
- manufacture and processing of various dairy and powdered milk products (cheese, casein, skim and wholemilk powders, whey products), principally for export, at Clandeboye and Edendale; and
- wholesale distribution of Pioneer and Cloverlea brands of cheddar and other cheeses within the Southland region.

20. SIDCO sells on the domestic market various processed cheeses, mostly in the South Island. According to SIDCO, its production amounts to 5% of the total domestic cheese market. The remainder of SIDCO's products are exported through the NZDB. SIDCO does not produce any liquid milk products.

**OTHER RELEVANT PARTIES**

**New Zealand Co-operative Dairy Company Ltd ("NZCDC")**

21. NZCDC, based in the Waikato, is the largest dairy co-operative in New Zealand with approximately 6,900 suppliers. Its subsidiaries include Anchor Products Ltd, Anchor Equities Ltd, New Zealand Dairy Foods Ltd ("NZ Dairy"), Glencoal Energy Ltd and Anchor Investments Ltd. NZCDC processed approximately 411 million kilograms of milk solids in 1998, or 46% of the national total. Currently NZCDC does not acquire or process raw milk in the South Island, although it has franchise arrangements with Nelson Milk and Southern Fresh to produce liquid milk in the South Island under the Anchor brand.

22. The principal activities of NZCDC and its subsidiaries include the collection and processing of its suppliers' milk into dairy based products for domestic and export markets; marketing and distribution of branded dairy based consumer products primarily in New Zealand; dairy related support activities including rural retailing, food ingredients marketing and packaging; and the provision of energy to the

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processing factories. NZCDC uses the Anchor brand for some of its products such as milk, butter and cheese.

**Westland Co-operative Dairy Company Ltd ("Westland")**

23. Westland, based in Hokitika, is involved in the production and supply of milk powder and butter. Westland exports its milk powder and butter through the NZDB, and supplies butter on the domestic market. Westland has about 350 suppliers and processed 24 million kg of milk solids, or 13.3% of South Island production, in 1998 at its only operating plant in Hokitika.

**Other South Island Dairy Co-operatives**

24. There are three other smaller co-operative dairy companies operating in the South Island - Kaikoura Co-op Dairy Co Ltd, Marlborough Cheese Co-op Ltd, and Tasman Milk Products Ltd. In 1998 the three together processed a total of 20 million kg of milk solids, amounting to 2% of New Zealand milk solids, or to 12% of South Island milk solids. Kaikoura produces Cheshire brand cheese, mainly sold to the US, but also into the domestic market. Marlborough is also active in the local cheese market, with the Koromiko and Waitohi brands.

**BACKGROUND INFORMATION**

25. Substantial rationalisation within the industry has occurred over recent years, predominantly in the North Island, where the bulk of the industry is located. As a result the Commission has assessed a number of business acquisition proposals involving dairy companies. The most recent reports over the period 1996-1998 include:

- Kiwi Co-operative Dairies Ltd/Tui Milk Products Ltd, M2305, 15 August 1996;
- New Zealand Co-operative Dairy Company Ltd/East Tamaki Co-operative Dairy Company Ltd, M2311, 2 September 1996;
- New Zealand Co-operative Dairy Company Ltd/Bay Milk Products Ltd, M2316, 27 September 1996;
- Mainland Products Ltd/Kiwi Co-operative Dairies Ltd, M2318, 15 October 1996;
- South Island Dairy Farmers Ltd/Westport United Dairies Ltd, Decision 300, 3 July 1997;
- South Island Dairy Farmers Ltd/Grey District Co-operative milk Producers Association Ltd and Scenicland Milk & Cream Ltd, Decision 301, 3 July 1997; and
- Mainland Products Limited/South Island Dairy Farmers Co-Operative Limited, Decision 342, 12 May 1998.

26. As some of these reports (Kiwi/Tui and Mainland Products Limited/South Island Dairy Farmers Co-Operative Limited) contain extensive detail on the structure and development of the New Zealand dairy industry, it is not intended to repeat that information in this report.

27. It was noted in the Commission's two most recent decisions relating to the dairy industry that the South Island dairy industry is characterised by a co-operative

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structure, like that of the North Island. All companies are owned by their milk supplying shareholders.

28. In Decision 342 it was noted that the trend towards dairying and away from sheep and beef farming is continuing in New Zealand, although the rate of growth of the dairy farming industry has slowed down. Over the last 5 years, on average, milk output in New Zealand has been growing annually at 4.5%,[1] and processing facilities have expanded accordingly. Information supplied by the NZDB and Kiwi indicates that Southland, Otago and Canterbury are expected to be the major growth areas for dairy farming and milk production over the next few years.

29. Based on kilograms (kgs) of milk solids processed each year, in the North Island at present there are now three large co-operatives - Northland, NZCDC and Kiwi, and one small co-operative - Tatua. In the South Island there are three large co-operatives – Kiwi, SIDCO and Westland, and three smaller co-operatives - Tasman, Marlborough and Kaikoura.

30. NZCDC has also entered negotiations to merge with SIDCO, but has not made any application to the Commission in relation to that proposed merger. On 19 February 1999 SIDCO's Board indicated it would recommend to its shareholders that they agree to the proposed merger with NZCDC. A shareholder vote is expected to be held on 14 April 1999.

## THE RELEVANT MARKETS

### Introduction

31. The purpose of defining a market is to provide a framework within which the competition implications of a business acquisition can be analysed. The relevant markets are those in which competition may be affected by the acquisition being considered. Identification of the relevant markets enables the Commission to examine whether the acquisition would result, or would be likely to result, in the acquisition or strengthening of a dominant position in terms of s 47(1) of the Act, in any market.

32. Section 3(1A) of the Act provides that:

> "… the term 'market' is a reference to a market in New Zealand for goods and services as well as other goods and services that, as a matter of fact and commercial common sense, are substitutable for them."

33. The Commission's Business Acquisition Guidelines provide information on how the Commission approaches the task of market definition.[2] A brief outline of this approach follows.

34. Markets are defined in relation to product type, geographical extent, and functional level. The boundaries of the product and geographical markets are identified by considering the extent to which buyers are able to substitute other products or across geographical regions in response to a change in relative prices of the products

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[1] *Situation and Outlook for New Zealand Agriculture 1997* (Ministry of Agriculture).

[2] Commerce Commission, *Business Acquisition Guidelines* 1996, pp 11-16

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concerned. A market is the smallest area in which all such substitution possibilities are encompassed. It is in this area that a hypothetical monopoly supplier of such substitutable products could exert market power.

35. A properly defined market will include products which are regarded by buyers or sellers as being not too different ('product' dimension), and not too far away ('geographical' dimension). A market defined in these terms is one within which a hypothetical profit-maximising sole supplier of a product could impose at least a *s*mall yet *s*ignificant and *n*on-transitory *i*ncrease in *p*rice (the "*ssnip*" test), assuming other terms of sale remain unchanged. It will also include those suppliers currently in production who are likely, in the event of such a *ssnip*, to shift promptly to offer a suitable alternative product, or offer their product to alternative acquirers.

36. In this case, when considering the market relating to the acquisition of raw milk, the issue involves an acquirer rather than a supplier, and therefore the market has to be defined in relation to the behaviour within a market characterised by a hypothetical monopsonist, and its potential to exercise market power by its ability to lower prices to its suppliers. Therefore, the *ssnip* test needs to be adjusted to examine the likely effect of a 5% reduction in prices paid by the hypothetical monopsonist.

37. Markets are also defined in relation to functional level. Typically, the production, distribution, and sale of products proceeds through a series of vertical functional levels, so the functional levels affected by the application have to be determined as part of the market definition. For example, that between manufacturers and wholesalers might be called the "manufacturing market", while that between wholesalers and retailers is usually known as the "wholesaling market".

38. Previous Commission decisions have discussed at length the product, geographic and functional levels associated with markets in the dairy industry. The Commission has reached a preliminary conclusion that the potential areas of aggregation in the case of this application would be in the markets for the acquisition/supply of unprocessed milk, the wholesale supply of cheese, and for the acquisition/supply of manufactured dairy products for export.

**The Market for the Acquisition/Supply of Unprocessed Milk**

39. The proposal affects the market for supply of unprocessed or raw milk by dairy farmers to dairy co-operatives, which includes processing the raw milk into various dairy products to be sold on either the domestic or export markets. Of total milk produced in New Zealand, around 92% is used in the production of dairy products for export. For the co-operatives, there are no close substitutes to fresh milk as an input to their processes, while from the farmers' perspective, dairy co-operatives are the only customers realistically capable of absorbing quantities of raw or unprocessed milk on a continuing basis. In any case, farmers are the shareholders in the co-operatives to which they supply milk.

40. The principal market issue in the current application is the extent of the geographic market. Previous Commission decisions have defined the geographic extent of the market as either the North or South Island, while the applicant submits the market

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should be defined as New Zealand-wide, which is discussed at paras 67-72. Narrower definitions are also possible, for example the South East of the South Island.

41. In respect of previous business acquisition proposals relating to dairy companies operating in the North Island, the geographic extent of the market for the acquisition/supply of unprocessed milk has been defined as "the greater extent of the North Island". This was on the basis that if the payout from one dairy company fell 5% below that of its neighbour for the foreseeable future, this would result in suppliers on the border switching to a neighbouring dairy company, in the absence of a transport levy. The *Kiwi/Tui* decision also reflected the presence of two substantial co-operatives, one in the centre and one in the south of the North Island, together covering the majority of the North Island.

42. In order to define the geographic extent of the market it is necessary to determine which dairy co-operatives would be substitutable acquirers of raw milk for suppliers of the merged Kiwi/SIDCO entity if those suppliers were faced with a hypothetical drop in price from the co-operative.

43. This entails considering the following issues:

- the substitutability test and payout levels;
- transportation of milk;
- acceptance of milk by substitute acquirers; and
- potential substitute acquirers.

*The Substitutability Test and Payout Levels*

44. The *ssnip* test is used to assess substitutability. The test in this case is this: if a hypothetical monopsonist were to lower the price it pays to its suppliers for raw milk by 5%, for a period of at least a year, would this cause so many of its suppliers to transfer their supply to a neighbouring co-operative or co-operatives, that the price reduction would be unprofitable. The geographic market is the smallest area switching between co-operatives by farmers, under this test, is no longer likely to occur.

45. The manner in which the NZDB pays co-operatives, and how co-operatives pay suppliers, is described in detail in the *Kiwi/Tui* decision. In the past the NZDB payout to co-operatives was based on the production cost of their output, as calculated standard cost models for a range of different products. The NZDB is presently moving towards a system of payment based on international market rates for actual production.

46. The payout from the NZDB to co-operatives is based essentially on each co-operative's share of the export return for the products exported by the NZDB. The payout is calculated by dividing the NZDB's export returns by the total kilograms of milk solids provided by all the co-operatives. The payment to each co-operative is based on the amount of milk solids provided by that co-operative to the NZDB.

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47. The co-operatives pay their suppliers every 30 days based on the kilograms of milk solids in the milk supplied. This payment consists of the Board base payout and any margin the co-operative has been able to achieve above the Board's cost models. This margin is achieved by cost savings in the manufacture or transport of products, or by selling value-added products on domestic markets. The co-operatives must pass on the total base payout to their farmers, but the additional margin is discretionary. The margin is considered by the suppliers when assessing their co-operative's performance.

48. The 1997/98 farmgate payout level, including base and margin, from NZCDC was $3.51 per kg of milk solids, and from Kiwi was $3.47 per kg of milk solids. The only higher payout was from Tatua, a small co-operative producing high value products, at $3.65 per kg of milk solids.

49. Recent Commission decisions have used the figure of $3.50 as the average total payout to calculate the Commission's *ssnip* test, and current payout figures suggest that that figure is appropriate in this case. Based on a $3.50 payout to suppliers, the *ssnip* test shows that a 5% reduction in payout by the hypothetical monopsonist co-operative would be 17.5 cents per kg of milk solids. Considering transport costs alone (ie excluding capacity and other switching costs), if the gaining co-operative would have to impose a transport levy on the switching supplier in excess of 17.5 cents per kg of milk solids, then that supplier is unlikely to benefit from a switch of co-operatives. This then raises the issue of how far milk can economically be transported, and whether receiving co-operatives have sufficient capacity to accept additional milk supplies.

*Transportation of Milk*

50. Historically, for practical reasons, farmers tend to cluster around processing plants, which were relatively few and spatially dispersed. Transport costs for raw milk are a significant cost item which can impact on the economic performance of a co-operative. In the present case the parties submit, and the Commission accepts, that unprocessed milk is transportable over long distances (ie. 250-300 km) by both road and rail. Other South Island dairy companies contacted agreed that raw milk could relatively easily be transported 250-300 km or even further.

51. The long-distance movement of bulk milk is limited by the perishability of the product and the ability to move enough of it, far enough, quickly enough, at the right temperature. Most trucks and train tankers are not even insulated. Refrigerated tankers provide more time, and therefore allow greater distances to be covered, but at present are considered too costly to be in general use, and in any case are not required because of the current location and capacity of processing plants. Most milk can be moved effectively from farm to plant without the need for the more expensive refrigerated transport.

52. The rail transportation of milk is used to a limited extent in the South Island, for example, SIDCO transports milk during the peak of the season from Edendale in Southland to its Clandeboye plant in Canterbury, a distance of 380 kilometres. In the North Island Kiwi currently rails [ ] litres of milk twice a day about 208 km from Oringi to its Hawera site.

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53. According to the NZDB, the distances involved in collecting raw milk for processing are linked to the economies of scale of the manufacturing site. For example in the North Island, Kiwi's large manufacturing facilities make it viable for the company to haul bulk milk considerable distances. Kiwi has [ ] suppliers in the Hawkes Bay, so it is likely that Kiwi, given the economies of scale generated by the Hawera site, finds it more economic to move that milk to Hawera than to operate an inefficiently small plant in the Hawkes Bay.

54. In the case of the movement of bulk milk around the South Island, it is noted that this is generally undertaken to provide for processing of peak season milk volumes. Once a co-operative has accepted suppliers, it is bound to accept all their milk. During the peak of the season, if a co-operative's supply exceeds its processing capacity, it must either move the milk to another plant or dump it. In any case, it must pay the farmer for it. Moving milk a long distance to another plant at least provides some positive contribution for the co-operative, and can be the best option in the short-term when capacity expansion to process peak milk supplies is uneconomic. It was noted that in some cases this activity could impact negatively at the margin, but still be the least cost/profit maximising alternative when compared with the cost of dumping the milk.

55. Previous Commission decisions have based assessment of the overlap areas where the potential for switching between competing co-operatives might exist on a 250km radius from current processing plants. This provides a rough measure of the distance over which milk could economically be collected. However, it should be noted that this assumes available production capacity and suitable roading.

*Acceptance of Milk by Substitute Acquirers*

56. While a farmer may seek to switch between co-operatives because a neighbouring co-operative is producing a higher payout, the decision as to whether the farmer can switch rests with the acquiring co-operative, as there is no obligation on a co-operative to accept new milk suppliers. The decision by a co-operative to accept milk supply from a farmer is based on the net gain or loss to the payout margin of the extra milk for the co-operative as a whole, taking into account its current capacity surplus, if any, and various costs, including the cost of transporting the milk to its plants. If additional costs mean acquiring the extra milk is uneconomic, the co-operative is unlikely to accept the new supplier into the co-operative without imposing a special levy on the supplier. That levy is likely to discourage the farmer from switching.

57. Most of the dairy co-operatives contacted indicated that switching by farmers between co-operatives is not done frequently, and is only an option for those suppliers situated close to the boundaries between neighbouring dairy co-operatives. In the South Island, the current collection areas of the Kiwi (South Island) and SIDCO co-operatives overlap. In some cases farms in close proximity supply different co-operatives. Should this proposed merger proceed, there would not be any common borders between the merged entity and other co-operatives' catchment areas. For example, Christchurch to Hokitika is about 252 km, and the resulting merged entity and Westland would be separated by the Southern Alps.

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58. There are four co-operatives in the South Island which might be considered substitute acquirers of milk when assessing the geographic extent of the market – Westland, Kaikoura, Marlborough and Tasman.

*Potential Substitute Acquirers*

*Westland*

59. In this case, using a 250 km radius from Westland's Hokitika plant, Kiwi submits that there are approximately [ ] suppliers in Canterbury who would be in the border area with Westland. This does not take into account Westland's ability to accept more milk to process without expanding capacity, or any other additional costs.

60. Westland noted in discussions with Commission staff that rail was available to it as an option, and that Westland can transport milk to Canterbury for processing if needed at the peak of the season.

61. Therefore, it could reasonably be concluded that, if certain conditions existed, Westland and the merged entity might compete for suppliers. While the costs for the respective co-operatives to bridge the gaps between current collection areas are relevant to establishing the possible extent of the geographical market, those issues are discussed in more detail when considering constraints on market power.

*Kaikoura*

62. Kaikoura is about 180 km from Christchurch. SIDCO collects from as far north as around Culverden, about 100 km north of Christchurch. Kaikoura currently collects milk from about 25 km south of the town, so about 65 km separate the SIDCO and Kaikoura collection areas. Using the 250km radius standard, Kaikoura is considered to be within the same geographic market as the combined merged entity, however Kaikoura is currently constrained as to capacity.

*Marlborough*

63. The road distance from Kiwi's plant in Christchurch to Marlborough's plant at Tuamarina is about 320 km. Again using the 250 km radius standard from each processing plant, the possible collection areas would overlap, and Marlborough could arguably be considered to be within the same geographic market as the combined merged entity, with substantial excess capacity.

*Tasman*

64. The road distance from Westland's plant in Hokitika to Tasman's plant near Takaka is about 430 km. Inquiries with Westland and Tasman indicate that some suppliers are located in areas that could economically supply either of these co-operatives. Accordingly, Tasman could be considered to be in the same geographic market as Westland, although not in the same geographic market as the merged entity.

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*Conclusion on Potential Substitute Acquirers*

65. It was noted in the *Mainland/SIDF* decision that while it may not be economically viable for suppliers to transport raw milk from one end of the South Island to the other, transport costs do not appear to represent a major obstacle to its transportation across considerable distances. In that case, the Commission concluded that it was appropriate to consider the geographic extent of the market as the greater South Island.

66. Therefore, based on road distances between processing plants, if potential areas of collection overlap exist between merged entity and Westland, the merged entity and Kaikoura, and the merged entity and Marlborough, this indicates that, for the purposes of assessing market power in this decision, Kiwi/SIDCO, Westland, Kaikoura, and Marlborough could be considered to be within the same geographic market.

*New Zealand Market*

67. Kiwi, however, submits that the market should be defined as New Zealand-wide because the merged entity would be prevented from exercising market power over its South Island suppliers by the competition at its border with NZCDC in the North Island.

68. Kiwi has asserted that its inter-Island transportation trial proved technically successful, and in the past, Kiwi has commented that with developing technology and decreasing transportation costs, transporting milk by rail inter-Island on an ongoing basis may become a possibility in the future. Kiwi has stated that with sufficient available capacity, Kiwi would be able to transport inter-Island.

69. No co-operative currently transports bulk unprocessed milk inter-Island throughout the season, and even short-term movements are unusual. Figures quoted for inter-Island rail transport of milk indicate the cost would be far greater than the 17.5 cent per kg of milk solids calculated by the *ssnip* test.

70. Industry participants noted that the risks associated with transporting bulk raw milk across the Cook Strait are high. The cost of setting up the infrastructure to do so would be high, and should the ferries be unable to cross for a day for any reason, the co-operative would be left with a large quantity of milk on the wrong side of the Strait. The co-operative would still have to pay the farmer for the milk, which would then probably have to be dumped. One South Island market participant stated he would not consider planning to transport milk inter-Island over the entire season.

71. As noted above, previous decisions have defined the unprocessed milk market as either North Island- or South Island-wide. The principal factor excluding the possibility of a New Zealand-wide market being found has been and continues to be the economic viability of transporting bulk unprocessed milk inter-Island. The Commission is not satisfied that ongoing inter-Island transportation of unprocessed milk is economically viable as a means of providing farmers with a choice of co-operatives, and therefore that a New Zealand-wide market definition would currently be inconsistent with the Commission's substitutability test.

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72. The discussion on possible effects of competition in the North Island to constrain the merged Kiwi/SIDCO entity from exercising market power in the South Island is considered as part of the competition analysis at paras 118-133.

*Conclusion on Extent of Geographic Market*

73. The Commission concludes that the geographic market is not larger than the South Island. In terms of the present application, it might be smaller than the entire South Island because of doubts that Tasman and Marlborough could actually compete with Kiwi and SIDCO, given their relative geographic isolation.

74. However, should dominance concerns arise with the market broadly defined as South Island-wide, those concerns would be accentuated with any narrowing of the geographic market definition.

75. For the purposes of assessing the effect of the proposed merger, it is proposed that the relevant market to consider is the input market for the acquisition/supply of unprocessed milk in the South Island.

**The Market for Cheese in New Zealand**

76. In previous decisions the Commission has defined the relevant product/function markets as the processing and supply of a range of manufactured dairy products, and the geographic market as national. However, these decisions have not found it necessary to distinguish separate product markets within the generic dairy products grouping.

77. In the present decision the only dairy product sold on the domestic market by both Kiwi and SIDCO where there is an aggregation of market share is cheese. For the purposes of this decision, cheese will be taken to constitute a separate product market. Even with this possibly conservatively narrow product market definition, a market power problem is unlikely to arise, as discussed below.

78. It is concluded that the market for the wholesale supply of cheese in New Zealand is the relevant market for the purposes of considering this application.

**The Market for the Acquisition/Supply of Manufactured Dairy Products in New Zealand for Export**

79. Section 3 of the Commerce Act provides that every reference in the Act to the term "market" is a reference to a market in New Zealand.

80. By statute, all New Zealand co-operatives wishing to export their products must sell their products to the NZDB for export. For some smaller product lines, licences are sometimes issued by the NZDB to co-operatives, which allow them to market those products overseas. Also, a small percentage of manufactured dairy products are marketed within New Zealand by co-operatives operating in the domestic milk, cheese and butter markets. However, the vast majority of manufactured dairy products in New Zealand are acquired by the NZDB for sale overseas. As these products are acquired in markets in New Zealand, behaviour by the dairy co-

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operatives and the NZDB in respect of these products, and therefore the impact of the proposed acquisition, fall within the ambit of the Act.

81. The NZDB acquires manufactured dairy products from co-operatives operating in Northland, Waikato, Taranaki, Canterbury, the West Coast of the South Island, Otago and Southland. When considering what substitute acquirers there are for manufactured dairy products for export, under current legislation, there are no alternatives in New Zealand to the NZDB. Accordingly the geographic extent of this market can be described as New Zealand-wide.

82. Therefore, an additional market to be considered is that for the acquisition/supply of manufactured dairy products in New Zealand for export.

**Conclusion on Market Definition**

83. The Commission therefore concludes that the relevant markets for the purpose of analysing the competition issues arising from the proposed acquisition are:

- the market for the acquisition/supply of unprocessed milk in the South Island;
- the market for the wholesale supply of cheese in New Zealand; and
- the market for the acquisition/supply of manufactured dairy products in New Zealand for export.

| Q1 | The Commission seeks comment on the appropriateness of the markets as defined. |
|---|---|

## ASSESSMENT OF DOMINANCE

### Overview

84. Section 67(3) of the Act, when read in conjunction with s 47(1) of the Act, requires the Commission to give clearance for a proposed acquisition if it is satisfied that the proposed acquisition would not result, and would not be likely to result, in a person acquiring or strengthening a dominant position in a market. If the Commission is not so satisfied, clearance must be declined.

85. Section 3(9) of the Act states that a person is in a "dominant position" in a market if:

> "... a person as a supplier or an acquirer of goods or services either alone or together with an interconnected or associated person is in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market ..."

86. That section also states that a determination of dominance shall have regard to:

- market share, technical knowledge and access to materials or capital;
- the constraint exercised by competitors or potential competitors; and
- the constraint exercised by suppliers or acquirers.

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87. In the case of co-operatively owned and operated companies such as dairy companies, consideration is also given to the degree of constraint imposed by the co-operative ownership structure.

88. In reaching a view on whether a person is in a position to exercise a dominant influence in a market, the Commission considers the foregoing non-exhaustive factors and any other relevant matters that may be found in a particular case.

89. In the Commission's view, as expressed in the Business Acquisition Guidelines 1996 (p.17), a dominant position in a market is generally unlikely to be created or strengthened where, after the proposed acquisition, either of the following situations exist:

- the merged entity (including any interconnected or associated persons) has less than in the order of a 40% share of the relevant market; or

- the merged entity (including any interconnected or associated persons) has less than in the order of a 60% share of the relevant market and faces competition from at least one other market participant having no less than in the order of a 15% market share.

90. In *Port Nelson Ltd v Commerce Commission* [ ] 3 NZLR 554, the Court of Appeal approved the following dominance standard, adopted by McGechan J in the High Court:

> "...dominance involves more than "high" market power; more than mere ability to behave "largely" independently of competitors; and more than power to effect "appreciable" changes in terms of trading. It involves a high degree of market *control*. (emphasis in original)."

91. Each of the relevant markets is considered below to assess whether the proposed merger might lead to the acquisition or strengthening of a dominant position.

**The Market for the Acquisition/Supply of Unprocessed milk in the South Island**

92. In considering whether the proposed merger might lead to the acquisition or strengthening of a dominant position in a market, the following issues are relevant:
- market shares;
- constraint by existing competition;
- constraint by potential competition;
- constraint by co-operative ownership structure; and
- constraint by potential substitutes.

*Market Shares*

93. On the basis of information provided by the NZDB, the applicant and other dairy companies, existing shares in the market for the acquisition of unprocessed milk solids in the South Island are as shown in Table 1.

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**TABLE 1**
**SOUTH ISLAND MARKET SHARE BY MILK SOLIDS – 1998**

| Co-op | Mkg Milk Solids | % SI Milk Solids | Suppliers | % Suppliers |
|---|---|---|---|---|
| Kiwi (Sth Is.) | 16.6 | 9.2 | 240 | 13.6 |
| SIDCO | 120 | 66.4 | 980 | 55.7 |
| **Kiwi / SIDCO** | **136.6** | **75.6** | **1220** | **69.3** |
| Westland | 24 | 13.3 | 350 | 19.9 |
| Tasman | 12 | 6.6 | 80 | 4.5 |
| Marlborough | 5 | 2.7 | 80 | 4.5 |
| Kaikoura | 3 | 1.6 | 30 | 1.7 |
| TOTAL | 180.6 | 100 | 1760 | 100 |

94. Given the geographic market definition as the South Island, the combined entity's market share would fall outside either of the Commission's "safe harbours", with the combined entity having a 75.6% share of the market, and facing competition from one other market participant with a 13.3% market share.

*Constraint by Existing Competition*

95. It is necessary to address the extent to which the merged entity would be in a position to exercise undue market power over the acquisition of raw milk in the South Island, such that it would be considered to acquire or strengthen a dominant position. This might be tested by considering whether the merged entity could decrease its payout relative to that of Westland (or any other dairy co-operative), without causing a significant loss of its existing suppliers through 'switching', to the point where the decrease would be unprofitable.

96. Switching costs have been analysed in past decisions. The main factors are: switching uncertainties; financing opportunity costs; transport costs; and farm vat ownership, although farm vat ownership issues are relatively minor and not discussed further. Switching is also limited to the period between supply seasons.

*Switching Uncertainties*

97. One issue affecting switching is the uncertainty faced by the farmer in the switching decision. Co-operative payouts can vary significantly from year to year, for a variety of reasons. In switching, the farmer bears the risk that two or three years later the former co-operative might be paying as much or more than the new one. This risk is particularly high if the cause of the payout differential is poor management performance which might be remedied in the short to medium term. This implies both that farmers are unlikely to switch because of one bad year alone, and that if they do they are likely to require a greater difference in payouts than analysis assuming certainty of future payments would imply. This is consistent with the observation that large scale switching has occurred only when the long term viability of co-operatives was in doubt. As this belief would imply an expectation of a widening payout differential, it greatly lowers the perceived risk of losing at a later date from unexpected adverse changes in future payouts.

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98. In addition, there are predictable causes of payout differences. Payouts can vary with the investment cycle of the company, falling when major investment occurs and improving as capacity is utilised. When it is clear that in the next few seasons payouts will be moving in a predictable pattern likely to remove or reverse the observed difference, switching is unlikely to occur.

*Financing Opportunity Costs*

99. The issue of financing of capital contribution arises if the current co-operative elects to withhold the leaving supplier's capital. Co-operatives have the right to withhold shareholder funds for up to five years under section 18 of the Co-operative Companies Act. Legal opinions indicate that co-operatives are only able to exercise this option when paying out the share capital could threaten the solvency of the co-operative. For individual or small groups of suppliers, this provision is unlikely to be exercised. However, should large numbers choose to switch, this clause could be invoked. It would then raise a significant barrier to changing, typically requiring financing of more than $100,000 of capital for the period the original capital is withheld, which can be up to five years.

100. The restriction on time of the year switching can occur is not a major impediment in itself, but it could increase the risk of the co-operative exercising its right to withhold the funds, by concentrating applications to switch within a short period.

*Transport Costs*

101. For the purposes of assessing road transport costs, Kiwi has submitted two costs of running a tanker. The first is a marginal cost which includes costs such as fuel, tyres and repairs and maintenance. In economic terms this would be classified as a short run marginal cost. The second cost supplied is described as full cost, which is the marginal cost of operation, plus labour and capital costs. In economic terms this would approximate long run marginal cost.

102. Kiwi has submitted to the Commission that short run marginal cost is the appropriate cost. However, the Commission is interested in the possibility of switching on a scale sufficient to affect the economics of a large co-operative. This would involve tens, if not hundreds, of (average) farms. As tankers can hold milk for perhaps five average farms on a run, even on round-the-clock collection, more tankers will be required to service the higher peak demand. Hence the relevant cost is closer to the second than the first. The Commission concludes that full cost, or long run marginal cost, is the appropriate cost concept to apply to transporting of milk in the context of this determination. This is the cost concept applied throughout this decision.

*Constraint by Existing Competition – South Island*

103. As well as assessing the degree of constraint imposed on the merged entity by existing competition in the South Island market, the Commission will also consider what degree of constraint exists from competition in the North Island. Factors affecting the degree of constraint imposed by any other co-operatives include the above switching issues and transport costs, and the available capacity of the acquiring co-operative.

104. The decision to switch is at the discretion of the receiving co-operative. In making this decision, key variables are the receiving co-operative's contribution gain from the

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new milk, transport costs and, where relevant, the production capacity costs incurred. The co-operative then calculates whether to accept the supplier. This decision is dependent, amongst other things, upon the product mix of the co-op, the size and current capacity utilisation of the receiving factory and the transportation costs involved. The result of the analysis will be unique to the receiving co-operative.

*Westland*

105. Westland currently has limited capacity to receive additional suppliers. Westland indicated that its peak capacity is currently [ ] million litres per day, with peak milk flows of up to [ ] million litres a day. [

]

106. Westland has a moth-balled plant at Karamea. If re-opened it would deliver additional capacity of [ ] litres/day. If this were to occur, Westland's costs to collect milk from the Culverden area of SIDCO's catchment would be no more than the costs for collecting from within its current catchment area. [

]. However, the outcome is dependent on casein market projections, which are in turn dependent on European subsidy levels.

107. Given a sufficient price differential between the Canterbury region and Westland, Westland considered it could compete in Canterbury given a sufficient number of suppliers wishing to change. While it would prefer to collect from 50 to 100 suppliers, it might be economic, given a sufficient price differential, if as few as 10 wished to switch.

108. Industry participants noted that Westland has limited growth available in its catchment area through other land users converting to dairying. Most of the suitable land is already engaged in dairying, so to justify expansion of its plant, Westland would likely need to be assured of gaining milk supply from elsewhere.

109. Added to capacity considerations is the cost that would be associated with Westland seeking to acquire milk from the other side of the Southern Alps. As noted, the distance that can be supported is related not only to the cost of transport, but also to the economics of the receiving plant, and so it is not possible to state categorically a maximum distance applicable in all situations. However, as an example of the balancing of transport and processing costs, SIDCO has confirmed [

]

110. Kiwi provided calculations for the transporting by rail of milk between Hokitika and Clandeboye which show that the rail transport costs that Kiwi would have to bear to transport milk between those points would be in the region of [ ] cents/kg of milk solids.

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111. NZCDC provided calculations for establishing a greenfields site in the South Island which indicated its average collection costs would be [ ] cents/kg of milk solids. Kiwi stated that its actual average North Island collection costs are [ ] cents/kg of milk solids. So deducting the higher average cost of collection of [ ] cents, this indicates a switching Westland supplier could face a transport levy of about [ ] cents.

112. Conversely, calculating from figures supplied by Kiwi, using the best-case road transport costs to establish the extra radius the *ssnip* test of 17.5 cents per kg of milk solids would offer, for economic pick-up distance from Westland's plant, this gives a radius beyond Westland's current collection area of 105 km. This would possibly just reach current SIDCO or Kiwi suppliers on the eastern side of the Southern Alps. Therefore, it could be concluded that Westland is unlikely to consider seeking milk supplies from over the Alps without imposing some levy on suppliers.

113. In the Commission's view, it is unlikely that Westland could currently accept large quantities of milk from the east side of the South Island, due to transport and capacity issues. This situation might change if sufficient available volume encouraged Westland to significantly expand production capacity. However, substantial and 'lumpy' investment is required for the expansion of dairy factories, and is reliant on there being a large number of new suppliers or rapid supply growth from existing suppliers to bring the operation back to efficient utilisation rates. As the potential for supply growth from within Westland's own region is geographically restricted, a large number of suppliers from the Canterbury region would be required. Without a high degree of certainty of long term supply from those suppliers, such an investment appears unlikely.

*Other Co-operatives*

114. In considering whether the other co-operatives in the South Island might be either willing or able to accept milk from Kiwi/SIDCO farmers, Kaikoura, which operates a specialist cheese operation, currently has [ ] suppliers and [ ]. For Kaikoura to provide capacity to constrain the merged entity would require a virtual 'greenfields' investment, the economics of which are discussed at paras 134-142 under *Constraint by Potential Competition.*

115. Tasman's plant is over 400 km from the Culverden area. There is a wide space without dairy farms separating the collection areas, and no merged-entity suppliers would be within economic collection range of Tasman.

116. Marlborough's plant is over 320 km from Christchurch, and currently has about [ ] litres per day of spare processing capacity. While Marlborough currently collects from a localised area around Blenheim, SIDCO's 47 suppliers in the Culverden area are at the limit of the theoretical 250 km radius from Tuamarina. Therefore, given sufficient incentive, Marlborough could possibly contest approximately [ ] of the merged entity's suppliers in the Culverden area.

*Conclusion on Constraint by Existing Competition*

117. While, if a series of conditions were met, Westland and Marlborough could arguably be considered to provide a degree of constraint on the merged entity, the Commission

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is not satisfied that the merged entity would be sufficiently constrained by existing competition from those other South Island co-operatives.

*Constraint by Competition in the North Island*

118. The applicant submits that the market should be defined as a national market on the basis of the competition analysis that was utilised in the process of considering the *Kiwi/Tui* decision. That analysis reflected the observation that competition between co-operatives exists in border areas. Given the rules of co-operatives, which generally require equal payouts to all members, Kiwi argues this should effectively deliver the benefits of border competition to all members of the co-operative, including those in the South Island.

119. Kiwi submits that part of its bid for SIDCO includes the provision for the inclusion in the merged entity's constitution that payouts will be the same for all farmers supplying it, and that because of the constraint of switching provided for in the Kiwi/NZCDC overlap area, this extends the effective area of competition to include the whole of New Zealand.

120. In its submission on behalf of the applicant, the NZIER has analysed the argument applied in *Kiwi/Tui*, and concluded that the assumptions which must hold for the argument to extend to a national market are:

- that all suppliers will receive an equal payouts regardless of their geographic location;
- that at least one dairy co-operative operates on <u>both</u> islands of New Zealand; and
- this co-operative has an area of overlap with a rival co-operative on <u>one</u> island where suppliers are at risk of switching.

121. The Commission proposes to treat these assumptions as relating to the question of constraints on the exercise of market power.

122. For the Commission to clear the proposed acquisition on the basis of the above model, it would need to satisfy itself that:

- the assumption of equivalent payouts across suppliers is valid in the long term; and
- the area of overlap between Kiwi and NZCDC in the North Island is sufficient to constrain the merged entity.

*Payouts to suppliers*

123. The rules governing establishment of payout policies by co-operatives are contained within the constitution of the individual co-operative. Different co-operatives have different rules governing changes to those policies. Currently Kiwi's directors decide payout levels, although part of Kiwi's offer to SIDCO includes provision that the merged entity will accept SIDCO shareholders as full shareholders, without differentiation in share value, type or payout structure.

124. It is not likely to be simple for a co-operative to alter its payout structure, and it is noted that there are statutory mechanisms designed to protect shareholders. However,

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the industry is in a period of substantial change. For example, the changes currently being introduced to the way the NZDB calculates its payouts to the co-operatives mark a significant shift from complete sharing of commercial risk and return between the co-operatives, to a structure where individual co-operatives can create and retain their own added value in export markets.

125. It is not inconceivable that such developments, with or without future deregulation of the export industry, might lead to intensified competition between the remaining co-operatives. In other industries with geographically separate markets, it is not uncommon to see customers or suppliers in highly contested areas getting more competitive deals than those in less contested areas. This has not occurred historically in the dairy industry, where equal payouts to all suppliers has been the norm. However, while the Commission is not assuming that any such change in behaviour is necessarily imminent, it is of the view that there is sufficient uncertainty as to the future development of competition within the industry that some doubt over the long term structure of payments to suppliers can be raised.

126. The Commission has therefore concluded that it is not satisfied that the proposed equivalent payout to all merged-entity suppliers can be assumed to be permanent and unchangeable.

*Constraint by Competition – North Island*

127. Whether the area of overlap is capable of constituting a sufficient constraint depends on the economics of switching between co-operatives, the number of suppliers available to switch, and the impact of the loss of suppliers on the losing co-operative.

128. Commission analysis of information supplied by Kiwi indicates that a large number of suppliers would need to be lost to substantially impact on the economics of a co-operative of the size of the current Kiwi operation. To raise fixed costs by 5 cents per kg of milk solids, a material amount though still only 1.4% of a $3.50 per kg payout, would likely require the loss of several hundred suppliers.

129. Moreover, the view is held by some that the Kiwi/NZCDC border is well defined, and that the two co-operatives are separated by difficult roads, and by terrain unsuited for further conversion to dairying. No switching has occurred in the past five years at this border, although this probably reflects the relative equality of the payouts of the two co-operatives.

130. Given the size of the merged entity if this proposed merger were to proceed, relative to the proportion of either Kiwi's or NZCDC's suppliers in the border area, the Commission is not satisfied that the threat of border switching is sufficient to constrain the merged entity in the relevant market.

131. A related issue to border switching is the possibility of competition between Kiwi and NZCDC deep into each other's current collection areas. It has been submitted that such competition could occur using bulk rail transport. While the data supplied confirms that this is technically possible, the Commission does not consider that the costs presented support the likelihood of such competition for small levels of payout difference.

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132. On the basis of the data presented to the Commission, and in view of the size of the proposed merged entity, the Commission is not satisfied that the potential for switching in the North Island can be relied upon to impose sufficient constraint on the proposed merged entity.

*Conclusion on Constraint by Competition in the North Island*

133. Having regard to the potential for switching in the claimed areas of overlap, and the lack of certainty over the permanence of equal payouts, the Commission is not satisfied that competition between Kiwi and NZCDC in the North Island is likely to provide sufficient constraint on the merged entity in the South Island.

*Constraint by Potential Competition*

134. When assessing previous applications involving the dairy industry, the Commission reached the view that the prospect of new entry was unlikely to provide significant constraint on the merged entity. For instance, in *Kiwi/Moa-Nui* (Decision 267) the Commission noted that *de novo* entry into dairy manufacturing had been "extremely rare", and that amalgamations and rationalisation had characterised the industry. The underlying industry economics – economies of scale and scope increasing over time with technological change, falling transport costs and large capital investments – would suggest that such rationalisation is likely to continue, particularly in the South Island, and that new entry is highly unlikely.

135. In the case of this application, it has been suggested that entry by NZCDC into the South Island might occur, on the grounds that it must have a strategic presence in the South Island. From the Commission's perspective, the issue is whether such motivations might lead to NZCDC, or to any other new entrant, constructing a competing facility within the boundaries of the proposed merged entity's collection area.

136. In considering the possibility of greenfields entry by any potential competitor, the Commission has been supplied by NZCDC with an estimate of the economics of constructing a 'greenfields' dairy factory operating at a minimum economic scale of [ ] million/litres a day in the SIDCO collection area. The model assumes a capital cost of the order of $50 million, and that the site enjoys supply from farmers in the immediate area, not from remote areas. The model suggests that should the proposed factory achieve close to 100% utilisation, it could potentially deliver a payout of the order of [ ] per kg of milk solids. However, should utilisation fall to 60%, the potential payout falls below [ ] per kg of milk solids, a figure [ ] current levels enjoyed by Kiwi suppliers, which in the last financial year was $3.50.

137. The model suggests that even given 100% utilisation, which would require rapid capture of around [ ] of SIDCO's current supply base, such an enterprise would run a high risk of being uncompetitive. At low levels of utilisation the exercise would be uneconomic, and would be unlikely to be able to maintain its supply base. It has been noted in previous decisions that, in general, switching in the industry is rare until it appears a co-operative is clearly uneconomic, in which case mass switching is likely to occur. This would suggest farmers would be unlikely to switch to the new supplier unless assured of the long run viability of the venture. Assuming a competitive level of payout was financed for the startup period and a reasonable number of suppliers

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converted initially, the enterprise would still face the possibility of suppliers leaving in substantial numbers should the new enterprise fail to achieve critical mass, and of confidence in the long run viability of the factory being lost.

138. While entry at a larger scale could deliver more competitive returns assuming good capacity utilisation, this is offset by the higher risk associated with the larger capital investment required, and the increased risk of poor capacity utilisation due to the larger share of the market that would need to be gained to achieve a competitive cost position.

139. It can be argued that any new factory might be part of NZCDC, and that all its suppliers would receive an equivalent level of payout, implying that NZCDC would cross-subsidise the factory for strategic reasons. Much of the reasoning revolves around issues associated with the future of the NZDB. While key co-operatives are currently positioning themselves for potential future changes, there is considerable uncertainty as to precisely when and what changes might occur. This in turn implies that the exact benefits of any such strategic moves are likely to be difficult to estimate. Shareholders would be balancing uncertain future returns against substantial current investment.

140. Given the importance of the NZDB to the future of the industry, the possibility of such a decision cannot be totally ruled out. In the *Southland Times*, 26 December 1998, it was reported that the Chairmen of both SIDCO and NZCDC had commented that “the merger was unusual in that it offered more strategic gains than immediate financial gains”. This might suggest that current investment is being undertaken against the possibility of long term gains. Nonetheless, it is quite a different prospect to undertake a merger with no obvious short term gains or losses, with a view to the possibility of long term gains, however uncertain, than it is to invest $50 million or more in plant and equipment which may never be economic.

141. The proposal of constructing a competing factory within the catchment of the proposed merged entity would result in loss of volume and under-utilisation of capacity at existing factories of the incumbent dairy company. This combination of fixed costs and spare capacity could be expected to lead to competition for suppliers in the local area, which would be likely to adversely affect the performance of both the new entrant and the incumbent.

142. While there are no insurmountable technical barriers to new entry into the region that would be covered by the proposed merged entity, in the Commission’s view, the economics and business risk associated with such a proposal, carried out for strategic reasons or otherwise, make such an undertaking unlikely.

*Conclusion on Constraint by Potential Competition*

143. The Commission is not satisfied that the threat of new entry is likely to impose sufficient constraint on the merged entity.

*Co-operative Ownership as a Constraint on Market Power*

144. Kiwi has stated in its application that:

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> "…[ ]he nature of a co-operative provides an element of constraint as a dairy co-operative must have regard to its shareholder suppliers or face losing those suppliers to its competitors."

145. For most firms, any constraint offered by suppliers is external to the firm. In a dairy co-operative, however, such constraint from suppliers is internal. If a dairy co-operative attempts to exercise market power by decreasing its payout or increasing its costs, the supplier shareholders are potentially able to constrain these actions. Therefore, the issue is the degree of constraint offered by the co-operative structure.

146. In its consideration of several previous applications, the Commission has examined the extent to which co-operative ownership provides a constraint on the market power of a co-operative. These include the NZ Dairy/Waikato Valley (Decision 264), Kiwi/Moa-Nui (Decision 267) and Ravensdown/SouthFert (Decision 279) decisions. The issue was also considered by the High Court in *The New Zealand Co-operative Dairy Company Limited & Anor* v *Commerce Commission* (1991) 3 NZBLC 102,059 where the court considered that:

> "…Dominance is a measure of market power. In this instance such market power could only be exercised against the interests of the suppliers. The suppliers are in a position through ownership of the company to prevent or at least curtail the exercise of any such power by the merged entity, whose ability and motive to exploit suppliers would be restricted accordingly. Against this the commission no doubt balanced the fact that the merged entity would have such a cost advantage over its competitors that it could to some extent use its payout advantage to retain suppliers who were dissatisfied with its performance. Some waste, inefficiency or inappropriate investment could go unchecked so long as its payouts comfortably exceeded those of its competitors."

147. In a traditional firm, owned either by public or private shareholders, it is assumed that the long run objective is to maximise profit, or returns to shareholders. The benefits of these gains, if any, are eventually delivered to shareholders either through dividends, or through capital gains in the value of the firm itself. In the case of a dairy co-operative with no other lines of business, its most important cost item is the cost of raw milk. Minimising this cost is an area which, other things being equal, could deliver substantial gains to the firm's results. However, those gains would either increase owners' equity, by definition owned by the shareholders, or be paid out in the current period as dividends to the shareholders. In either case the shareholders, in this case the suppliers, ultimately receive the value. Given this relationship, the fact that 100% of suppliers are shareholders, and that ownership is in proportion to the value supplied, there seems to be little or no value to be gained by the co-operative from lowering payouts for the purpose of transferring value from suppliers to shareholders.

148. The above discussion ignores timing issues, which are likely to be significant. Farmers have substantial investments of their own, and are likely to prefer cash payouts that enable them to develop their farms or reduce debt to accumulation of value in the co-operative. For this reason, there are likely to be differences between managers and shareholders of the dairy companies relating to issues such as retaining funds for future investment needs, the timing and nature of investments and whether investment should be debt or equity financed. These issues and disputes are non-trivial. However, they are a different issue to transfers of wealth between participants in a market due to the market power of one of the parties.

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149. Inefficient investment decisions and excessive cost structures are commonly encountered where firms are subject to insufficient competitive pressures, or inability of owners to monitor closely the performance and activities of the business. As with any large firm with a separation of ownership from management, co-operatives are likely to suffer from these problems.

150. In *Kiwi/Tui* the level of influence of co-operative members on the directors and activities of the company was discussed in detail. The discussion indicated that farmers are relatively active shareholders. It has been argued that these shareholders, because of their very high level of interest in the business of the co-operative, are likely to be more effective than shareholders of a publicly traded company. However, shareholders of publicly traded companies are able to easily sell their shareholding if dissatisfied, and are also able to lobby directors. Members of co-operatives have little ability to exit the co-operative other than by switching co-operatives or exiting the industry itself. As noted in this and previous decisions, switching is really only an option for farmers in border areas, and is rarely observed. Furthermore, publicly traded companies often have significant shareholdings held by companies rather than individuals. Often these companies are specialists in the industry being considered, or are businesses specialising in investment analysis. Publicly traded companies are further scrutinised by market/share analysts, and share price movement can be used as a constant measure of company performance.

151. It was also noted in the *Kiwi/Tui* decision that the constraint provided by the co-operative structure is moderated by the limited influence small numbers of suppliers are able to exercise as the dairy co-operative increases in size.

152. The Commission acknowledges that the co-operative ownership structure would impose some degree of constraint on the market power of the merged entity to make decisions which could adversely affect its suppliers. However, the degree of discipline imposed by the market on publicly traded companies is not present in co-operatives.

*Conclusion on Constraint by Co-operative Ownership*

153. In accordance with previous decisions, the Commission concludes that there are some elements of difference between co-operative and corporate structures, and the merged entity would face some degree of internal constraint from its co-operative ownership. However, the Commission is not satisfied that it would impose a sufficient degree of constraint.

*Constraint by Potential Substitutes*

154. Suppliers ultimately have the option of converting to other land uses such as sheep, beef or deer farming, should payouts fall below acceptable levels. In the past the industry has seen trends both out of dairying into other forms of agriculture, and over more recent periods into dairying. Discussions with dairy industry participants confirm that there is also the potential for some variation in quantities supplied by individual farmers in response to changes in payout.

155. In terms of entry and exit decisions at the farm level, it has been argued that the capital costs of conversion to dairying are substantial, requiring construction of the

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milking shed and more intensive fencing than is commonly used in some other forms of farming. Once incurred, these costs are sunk, until the point that the facility requires substantial renovation or upgrading. This may take many years. This would suggest that prices would need to fall substantially below those that encouraged entry to promote substantial exit activity. Hence, while the Commission accepts the validity of the industry exit argument given price changes of sufficient magnitude over a long enough time span, the scale of price changes and time span involved are considered likely to fall outside the boundaries commonly used by the Commission to assess the size of markets and gauge market power.

156. There is also in some cases the ability to switch to domestic (town) milk supply. While it is true that this may be possible in some cases, it is noted that only some 8% of milk production goes to the domestic market, of which a subset is town milk, and that the town milk market is fully supplied. For this reason, relative to the volumes produced for export, it is not believed that this option is a substantial constraint on a large co-operative.

*Conclusion on Constraint by Potential Substitutes*

157. The Commission is not satisfied that the merged entity would face sufficient constraint from potential substitutes.

**Conclusion on Dominance in the Market for the Acquisition/Supply of Unprocessed Milk in the South Island**

158. It is concluded that the potential and actual constraint of competition from other co-operatives and the co-operative ownership structure of the proposed entity, while providing some constraint, are not sufficient to satisfy the Commission that the merged entity would not be likely to acquire or strengthen a dominant position in the market for the acquisition/supply of unprocessed milk in the South Island.

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Q2 The Commission seeks comment on the constraints faced by the merged entity, particularly those imposed by:

- existing competitors;
- the likelihood of new entry;
- competition in the North Island; and
- the co-operative structure of the industry.

**The Market for the Wholesale Supply of Cheese in New Zealand**

159. The proposed acquisition would lead to some aggregation of market share in the market for the wholesale supply of cheese in the New Zealand market. Kiwi currently has [ ]% of the market, with SIDCO holding [ ]%, taking the combined entity to approximately [ ]% of the market. This combined entity faces competition from NZCDC which currently holds around [ ]% of the market. The balance is held by a number of smaller suppliers.

160. The proposed acquisition falls within the second of the safe harbours outlined in paragraph 89 of this decision. None of the parties contacted as part of the inquiry have indicated any concerns with regard to this market. The market for cheese is national and hence there are no concerns in terms of local geographic dominance. It has been noted that overseas specialty cheeses are imported to New Zealand, and that a number of small independent cheese manufacturers operate independently of the dairy co-operatives, indicating barriers to entry to this market are not insurmountable.

161. While no retailers have been contacted during investigation of this application, recent decisions in this industry have noted the presence of large downstream customers operating nationally, and inquiries undertaken as part of these decisions have suggested strong countervailing power exists in downstream markets.

162. In summary, the Commission has not identified any unusual circumstances in the case of this market that would suggest the normal guidelines are inappropriate.

**Conclusion on Dominance in the Market for the Wholesale Supply of Cheese in New Zealand**

163. On the basis of the application of the Commission's normal guidelines for business acquisitions, and in the absence of any unusual circumstances, the Commission is satisfied that no person would be likely to acquire or strengthen a dominant position in the market for the wholesale supply of cheese in New Zealand as a result of the proposed acquisition.

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**The Market for the Acquisition/Supply of Manufactured Dairy Products in New Zealand for Export**

164. The proposed merger would result in some aggregation of market share in the market for the acquisition/supply of manufactured dairy products in New Zealand for export. Based on the proportion of milk solids supplied by co-operatives to the NZDB, the approximate market shares as at 1998 are:

| | % |
|---|---|
| Kiwi | 26.5 |
| SIDCO | 12.0 |
| | 36.5 |
| | |
| NZCDC | 46.5 |
| Northland | 9.7 |
| Others | 5.3 |
| | 100.0 |

165. The proposed acquisition falls within the first of the safe harbours outlined in paragraph 89 of this decision. However, following the enactment of the Dairy Board Amendment Act 1996, which permits the NZDB to issue shares to co-operatives based on the respective percentages of milk solids supplied, the merger would lead to an increase in entitlement to shares for the merged entity. In turn, this could arguably lead to a change in the status of the relationship between the merged entity and the NZDB.

166. It could be argued that the merged entity might become either interconnected or associated with the NZDB for the purposes of the Commerce Act, which, given the NZDB's dominance in the market for the acquisition of manufactured dairy products for export, raises the issue of Kiwi gaining the NZDB's dominance in that market.

167. The NZDB is constituted under, and governed by, the Dairy Board Act 1961. Section 14(1)(c) of the Act, in effect, gives the Board statutory monopoly power over the export of dairy produce from New Zealand. The Board purchases dairy products from dairy co-operatives and sells them either directly or through its world-wide marketing network of subsidiary and associate companies, distributors and agents. Accordingly, the Board is dominant in the market for the acquisition of manufactured dairy products in New Zealand for export.

168. Section 2(7) of the Commerce Act states that:

> "For the purposes of this Act, any 2 bodies corporate are to be treated as interconnected if—
>
> (a) One of them is a body corporate of which the other is a subsidiary (within the meaning of sections 158 and 158A of the Companies Act 1955 or sections 5 and 6 of the Companies Act 1993, as the case may be); or
>
> (b) Both of them are subsidiaries (within the meaning of those sections) of the same body corporate; or
>
> (c) Both of them are interconnected with bodies corporate that, in accordance with paragraph (a) or paragraph (b) of this subsection, are interconnected—

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and ``interconnected bodies corporate'' has a corresponding meaning."

169. Section 3(9) of the Commerce Act states that:

> "For the purposes of sections 47 and 48 of this Act, a person has, or 2 or more persons that are interconnected or associated together have, as the case may be, a dominant position in a market if that person as a supplier or an acquirer, or those persons as suppliers or acquirers, of goods or services, is or are in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market and for the purposes of determining whether a person is, or 2 or more persons that are interconnected or associated, are, in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in a market regard shall be had to—
>
> (a) The share of the market, the technical knowledge, the access to materials or capital of that person or those persons:
>
> (b) The extent to which that person is, or those persons are, constrained by the conduct of competitors or potential competitors in that market:
>
> (c) The extent to which that person is, or those persons are, constrained by the conduct of suppliers or acquirers of goods or services in that market."

170. Section 47 of the Commerce Act states that:

> "(1) No person shall acquire assets of a business or shares if, as a result of the acquisition,—
>
> (a) That person or another person would be, or would be likely to be, in a dominant position in a market; or
>
> (b) That person's or another person's dominant position in a market would be, or would be likely to be, strengthened.
>
> (2) For the purposes of this section and section 48 of this Act, where 2 or more persons are interconnected or associated and together are in a dominant position in a market, each of them is deemed to be in a dominant position in that market.
>
> (3) For the purposes of this section and section 48 of this Act, a person is associated with another person if that person is able, whether directly or indirectly, to exert a substantial degree of influence over the activities of the other.
>
> (4) A person is not able to exert a substantial degree of influence over the activities of another person for the purposes of subsection (3) of this section, by reason only of the fact that—
>
> (a) Those persons are in competition in the same market; or
>
> (b) One of them supplies goods or services to the other."

171. Therefore, if Kiwi's merger with SIDCO would result in the merged entity becoming interconnected with NZDB as defined in s2(7), ie *subsidiaries* within the meaning of the Companies Act, or associated as in s47(3), ie able to exert a *substantial degree of influence* over NZDB's activities, and if via s47(2) of the Act, they together were dominant in any market, each of them would be deemed to be in a dominant position in that market. With the NZDB being dominant in the market for the acquisition of manufactured dairy products in New Zealand for export, this raises the question as to

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whether Kiwi might be acquiring a dominant position in the same market through merging with SIDCO.

172. This leads to an examination of the issue of shareholdings and restrictions imposed on co-operatives and the NZDB by the Dairy Board Act, to assess whether Kiwi would become either interconnected or associated with the NZDB as a result of this acquisition.

### Interconnected or subsidiary

*The Dairy Board Act 1961*

173. This Act establishes the New Zealand Dairy Board and defines its functions and powers. The New Zealand Dairy Board has a board of 13 directors, comprising two directors with commercial experience appointed by the relevant Minister on the Board's recommendation, and 11 directors each of whom has been appointed either by a co-operative company, or elected by a group of co-operative companies. The Fourth Schedule of the Act sets out the provisions applying to the directors of the NZDB. They relate to disclosures of interest, voting where a director has an interest, and the general duties and obligations of a director.

174. Following the enactment of the Dairy Board Amendment Act 1996, the ownership structure of the NZDB was altered to allow the NZDB to issue shares to supplier–owned dairy co-operatives on the basis of milk solids supplied to the NZDB. The shares are not tradeable or transferable, nor are they able to be hypothecated (mortgaged or used as security for a loan), and they have only very limited voting rights under the constitution in respect of the issue, holding, and dividends payable and other matters contemplated by the Dairy Board Act relating to shares. The shares carry rights to dividends and redemption rights, though the latter are enforceable as the NZDB must redeem shares to ensure that each company holds shares equivalent to its qualifying milksolids in export produce purchased by the NZDB.

175. Section 5 of the Companies Act 1993 states:

> "(1) For the purposes of this Act, a company is a subsidiary of another company if, but only if,—
>
> (a) That other company—
>
> (i) Controls the composition of the board of the company; or
>
> (ii) Is in a position to exercise, or control the exercise of, more than one-half the maximum number of votes that can be exercised at a meeting of the company; or
>
> (iii) Holds more than one-half of the issued shares of the company, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital; or
>
> (iv) Is entitled to receive more than one-half of every dividend paid on shares issued by the company, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital; or
>
> (b) The company is a subsidiary of a company that is that other company's subsidiary."

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176. The NZDB is of the view that there will be no interconnection between itself and any dairy co-operative, irrespective of shareholdings over 50% due to:

- the divorce between the governance provisions of the Dairy Board Act (which are still in place) and the rights or entitlements belonging to the shares;
- the Dairy Board, while a corporate, is not a company; and
- the shares as currently issued do not meet the definitions under s 5(1)(a)(iii) or (iv) of the Companies Act 1993, in that the shares issued under ss 15A and 15B of the Dairy Board Act are shares which carry no rights to participate beyond a specified amount in a distribution of either profits or capital.

177. However, this issue could be argued both ways. While some other rights attach to the shares, they are not linked to governance, determining dividends, calling general meetings or overruling the Board. The main function of the shares is to determine the allocation of the trading surplus of the NZDB in relation to the contributing co-operative's share of the qualifying export produce. A technical approach could suggest that there might be interconnection if a dairy co-operative was entitled to over 50% of the shares. On the other hand, there are strong arguments, based on the construction of the NZDB and the nature of the shares, to conclude that interconnection is unlikely to arise.

178. In any case, the merged entity's share entitlement, based on the milk solids figures in para 164, would be less than 50%.

*Conclusion on Interconnection*

179. The Commission has reached the preliminary conclusion that the merged entity would not be interconnected with the NZDB.

| Q3 | The Commission seeks comment on whether any dairy co-operative with entitlement to more than 50% of the shares in the NZDB would be interconnected with the NZDB, as this is relevant to the consideration of the appropriate counterfactual. |
|---|---|

**Association**

180. The next issue to consider is whether the merged entity and the NZDB would be associated in terms of section 47(3) of the Commerce Act 1986, as a result of the proposed acquisition. The question that arises is whether the merged entity would have the ability to exert a substantial degree of influence over the activities of the NZDB.

181. Section 2(1A) of the Commerce Act provides that "substantial" means real or of substance. In adjudication matters, this has been interpreted by the Commission that a "substantial degree of influence" means a "great or large influence".

182. The Commission has to decide whether the merged entity and the NZDB will become one head in the market, for the purposes of competition in that market. While for companies this may occur should the merged entity acquire over 50% of the shares,

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shareholdings at levels less than 50% may justify the same conclusion if the merged entity achieves the ability to influence the competitive behaviour of the NZDB. In determining what amounts to substantial influence the Commission has previously accepted the following start points, while also taking into account other influences:

- a shareholding between 30 and 50% is likely to give rise to substantial influence, without any other contributing factors;

- a shareholding of between 20 and 30% is likely to give rise to substantial influence only if there are "other factors". These other factors would include the distribution of other shareholdings, the ability to defeat shareholder resolutions, board representation, and the ability to influence the targets, management and policy;

- for shareholdings between 15 and 20% substantial influence is unlikely unless there are special circumstances; and

- shareholdings of 15% or under do not give rise to the necessary degree of influence.

183. All of these propositions are treated as being arguable, and depend upon their facts as to whether the requisite degree of influence exists or not. It is noteworthy that the majority of these cases and the presumptions relate to shareholdings or to other equitable holdings which provide similar powers to shares.

184. The Commission's guidelines for considering the issue of association were set out in some detail in *Air NZ Limited/Ansett Holdings Limited/Bodas Pty Limited,* Decision 278 (3/4/96) at paragraphs 181 and 182 where it said:

> "The Commission, in considering whether persons are associated in terms of section 47(3), has regard to all relevant factors and considers as a whole the total effect, actual or likely, of all the elements of the relationship between the parties. These factors include:
>
> (a) The historical basis of the relationship and reciprocal connections;
>
> (b) Actual and prospective shareholdings;
>
> (c) Board membership and representation;
>
> (d) Motivation and expectation of parties;
>
> (e) Any premiums or concessions paid or provided to pursue the relationship;
>
> (f) Distribution of other shareholdings;
>
> (g) Evidence of influence on management and/or policy.
>
> In summary, the Commission recognises that substantial influence can exist at a level short of absolute control. The Commission has to answer the question as to whether two enterprises can, for the purpose of commerce and competition be regarded as one."

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185. The Statement of Standard Accounting Practice 8 (SSAP8) deals with business combinations. The Standard deals with the accounting of the interests of a long-term investor in a company and their ability to influence the financial and operating policies of that company. It defines two general situations where a business combination should be accounted for a single economic entity, where control or significant influence is exercised. Its language and criteria are very similar to the issues raised by s 47(3).

186. SSAP8 sets out the following criteria, taken singly or in combination, for determining whether entities may be considered to be associates:

- ability to influence decisions as to dividends or other distributions;
- investor's interest in the voting power of the investee;
- board or governing body representation;
- participation, in other ways, in policy-making processes of the investee;
- material inter-entity transactions;
- written acknowledgment by investee that investor has significant influence;
- interchange of management personnel; and/or
- dependence on technical information or other intellectual property.

187. The Standard is useful both in showing the acceptance by a profession concerned with these matters, that where such influence exists, the entities should be regarded as a business combination, and in highlighting the particular factors that can be considered against particular fact situations.

188. While the terms of s 47(2) and (3) would be met in these circumstances, it is concluded that the ability to, directly or indirectly, influence the competitive behaviour of another company or party may also result from a wider and more varied set of factors than those set out above. The circumstances of each case will determine whether such influence does or could exist.

189. There are a number of variables that make it extremely difficult to reach an absolute conclusion as to the existence or otherwise, of any ability on the part of the merged entity to substantially influence the actions of the NZDB. It could be argued that the merged entity would be supplying 36.5% of the manufactured dairy products to the sole lawful exporter of dairy products from New Zealand.

190. However it should be noted that s47(4) states:

> "(4) A person is not able to exert a substantial degree of influence over the activities of another person for the purposes of subsection (3) of this section, by reason only of the fact that—
>
> (a) Those persons are in competition in the same market; or
>
> (b) One of them supplies goods or services to the other."

191. So the mere fact that the NZDB would be acquiring 36.5% of its goods for export from the merged entity does not of itself mean that the merged entity would be able to

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exert a substantial degree of influence over the activities of the NZDB for the purposes of section 47(3).

192. Turning to the limitations imposed on co-operatives on their level of influence over the actions of the NZDB, section 2D of the Dairy Board Act states as follows:

> "Where in this Act the Board is forbidden to take any action without the approval of qualifying companies holding shares, the Board shall not take the action unless the Board has obtained –
>
> At a meeting of duly authorised representatives of qualifying companies holding shares, the approval to the taking of the action of those qualifying companies … whose qualifying milksolids during the most recent complete season was, … more than 75% of the aggregate quantity of qualifying milksolids of those qualifying companies voting on the action (or such higher proportion of qualifying milksolids as the constitution or this Act may specify as being required to the taking of the action); or
>
> In writing, the approval to the taking of the action of those qualifying companies as defined above."

193. The merged entity would be entitled to appoint four directors to the NZDB, while NZCDC will retain the right to appoint five directors, Northland one, and the remaining co-operatives one.

194. It is also noted that major transactions and certain other actions by the NZDB (which are set out and defined in the Act) require the approval of all of the Board or of the dairy industry in total, and such transactions require the NZDB to obtain the approval of companies or organisations supplying at least 75% of the last season's, or the last two seasons', milk solids. This will continue to be the case until any legislative change occurs.

195. Section 12 sets out the procedures at meetings of the NZDB. Section 12(4) requires that at all meetings of the Board, the quorum necessary for the transaction of business shall be seven directors who shall include directors appointed or elected by at least three different co-operative companies or (as the case may be) groups of co-operative companies. Again, except for any as yet unknown legislative change to the Dairy Board Act, the status quo will continue if Kiwi merges with SIDCO.

196. The Fourth Schedule of the Dairy Board Act governing the role of directors, states that on appointment to the Board, directors are obliged to act in the interests of the Board and not in the interests of their appointing or electing co-operative.

197. Nor does being an influential player in an industry or a "market leader" mean that a party has the ability to exert substantial influence over another. The latter position is a more intimate relationship with the activities of the other person. It may be either direct or indirect but it must be demonstrable as an ability, either now or in the future, to influence the competitive behaviour of the other person.

198. While industry comments are inconclusive about the level of influence the larger co-operatives may have over the NZDB, this may well be an industry where how the business is actually done, by whom, and the informal links and ties between the industry participants are the mechanisms whereby any influence may accrue to the co-

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operatives. It is the special circumstances of the industry that may lead to a finding of substantial influence.

199. At this stage, independent comment from other co-operatives does not provide any examples of any particular co-operative exerting substantial influence over the actions of the NZDB.

200. Given the fact that, apart from there being a change to the legislation, the status quo will prevail post-merger regarding the manner in which directors are appointed to the NZDB and the quorum requirements for decisions by the Board, it is not clear that the merged entity would be able to exercise substantial influence over the NZDB's decisions.

201. In the end, a finding of substantial influence is not one that is tied solely to numbers of shares but is one of judgment on the basis of the answer to what is the likely future outcome of the acquisition together with the other interconnections between the parties. The manner in which directors of the NZDB are appointed and the influence they hold is also relevant, as are the statutory limitations on that influence.

*Conclusion on Association*

202. At present, with the current statutory regime, and the information available, the Commission does not consider that the merged entity would be in a position to exert a substantial degree of influence over the NZDB such that the two could be considered to be associated for the purpose of s47(2) of the Commerce Act.

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| Q4 | The Commission seeks comment on the ability of a dairy co-operative to exercise substantial influence over the activities of the NZDB, and the ways in which this influence might be exercised. |
| Q5 | The Commission seeks comment on the likely outcome of deregulation of the dairy industry, and how, in light of this proposed merger, deregulation could affect the ability of co-operatives to exercise substantial influence over the NZDB or any resulting deregulated entity. |

**Conclusion on Dominance in the Market for the Acquisition/Supply of Manufactured Dairy Products in New Zealand for Export**

203. The Commission has reached a preliminary conclusion that the proposal would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in the market for the acquisition of manufactured dairy products in New Zealand for export.

**CONCLUSION ON DOMINANCE**

204. Having regard to the factors set out in section 3(9) of the Commerce Act 1986 and all the other relevant factors, the Commission is not satisfied that the proposal would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in a market.

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## PUBLIC BENEFITS AND DETRIMENTS

### Introduction

205. Given the conclusion that the Commission is not satisfied that the acquisition would not result, or would not be likely to result, in the combined entity acquiring a dominant position in the market for the acquisition/supply of unprocessed milk in the South Island, the acquisition cannot be cleared under s 67(3)(a) of the Act. The Commission must therefore consider whether the proposed acquisition can be authorised under s 67(3)(b) of the Act.

206. The authorisation procedure requires the Commission to identify and weigh the detriments likely to flow from the acquiring of a dominant position in the relevant market, and to balance those against the identified and weighed public benefits likely to flow from the acquisition as a whole. It is important to note that the detriments may only be found in the market or markets where dominance is acquired or strengthened, whereas benefits may arise both in those and in any other markets. Only where the benefits clearly outweigh the detriments can the Commission be satisfied that the acquisition will result, or be likely to result, in such a benefit to the public that it should be permitted, and thus be able to grant an authorisation for the acquisition.

207. The principles used by the Commission in evaluating detriments and benefits are set out in: *Guidelines to the Analysis of Public Benefits and Detriments* (the Guidelines), a revised version of which was issued by the Commission in December 1997. The various issues raised have been discussed in a number of decisions by the Commission and the courts in recent years. In assessing both benefits and detriments, however, the focus has increasingly been on economic efficiency. The Court of Appeal stated in *Tru Tone Ltd v Festival Records* that the Act:

> "..is based on the premise that society's resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources."

208. The Commission considers that a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. In contrast, changes in the distribution of income, where one group gains while another simultaneously loses, are generally not included because a change in efficiency is not involved. The Commission is also mindful of the observations of Richardson J in *Telecom*[3] on the Commission's responsibility to attempt to quantify benefits and detriments where and to the extent that it is feasible, rather than to rely on purely intuitive judgement. This is not to say that only those gains and losses which can be measured in dollar terms are to be included in the assessment; those of an intangible nature, which are not readily measured in monetary terms, may also be relevant.

*The Counterfactual*

209. The benefits and detriments likely to flow from the proposed acquisition in the future have to be assessed against a counterfactual of what might otherwise happen in the

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[3] *Telecom Corporation of New Zealand Ltd v Commerce Commission* [ ] 3 NZLR 429,447.

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future in the absence of the acquisition. Thus, a comparison has to be made between two hypothetical future situations, one with the acquisition and one without. The differences between these two scenarios can then be attributed to the impact of the acquisition in question. In framing a suitable counterfactual, the Commission bases its view on a pragmatic and commercial assessment about what is likely to occur in the absence of the acquisition.[4]

210. Kiwi suggested in its application that the relevant counterfactual to the proposed Kiwi acquisition of SIDCO is the acquisition of SIDCO by NZCDC. The Commission agrees that this could be a possible outcome given the SIDCO Board's publicly stated preference for merging with NZCDC, together with the NZCDC Board's approval of the merger. However, this outcome depends upon the approval of 75% of the shareholders of both co-operatives at meetings which are expected to be held on or about 14 April. It is not clear whether the NZCDC shareholders in particular will approve the merger because of the threat that it might pose to the level of their payout, SIDCO having a lower payout than NZCDC.

211. A further consideration arises from the impact of a merger of NZCDC and SIDCO and whether such a merger would result in NZCDC acquiring a dominant position in the market for the supply/acquisition of dairy products for export. By virtue of that merger, NZCDC would be entitled to 58% of the shares in the NZDB.

212. Consequently, it could be argued that any merger between NZCDC and SIDCO might be likely to result in NZCDC becoming interconnected or associated with the NZDB by virtue of s2(7) of the Act, and therefore resulting in the acquisition of a dominant position by NZCDC via s 3(9) of the Act. Such an acquisition, in the absence of an authorisation, might be in breach of the Commerce Act and therefore could be unacceptable as a valid counterfactual.

213. A related issue concerns the possibility that the dairy industry may be deregulated. In a policy announced in the 1998 Budget, the Government required each of the export marketing boards to prepare plans for how they were to operate on the removal of their statutory backing at some unspecified time in the future. If and when such deregulation will proceed in the dairy industry, and what form it might take, is uncertain. The Government has yet to make a further policy announcement. It also has to be borne in mind that deregulation itself could have an impact on the nature of the public benefits and detriments associated with a Kiwi/SIDCO merger, regardless of the precise counterfactual used.

214. In the event that the statutory monopoly of the NZDB is removed through deregulation, it might be argued that (depending on the order in which the various transactions and developments occur) the deregulated NZDB would not be in a dominant position. For example, at least one co-operative has stated that exporting through an agent rather than the NZDB would be a viable approach in the event that deregulation proceeds in the manner just outlined. Consequently, even though its shareholding entitlement might result in NZCDC becoming interconnected with a

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[4] See the discussion in: Commerce Commission, *Decision No. 277: New Zealand Electricity Market*, 30 January 1996, especially page 16.

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deregulated NZDB company, NZCDC might not acquire a dominant position through its proposed merger with SIDCO.

215. On the other hand, it is possible deregulation might not go so far as to remove the single seller status of the Dairy Board, in which case a NZCDC/SIDCO merger, through interconnection or association, might still lead to NZCDC acquiring a dominant position.

216. The nature of likely changes in the near future, and their possible impact on the industry, remains speculative. This suggests that an alternative counterfactual which should be considered, based on the assumption that the NZCDC/SIDCO merger would not be able to proceed, is a continuation of the *status quo*.

*Conclusion on the counterfactual*

217. For the purposes of this draft determination, and to encourage comment, the Commission will employ the following two counterfactuals in assessing detriments and benefits:

- SIDCO being acquired by NZCDC; and
- a continuation of the *status quo*, with SIDCO remaining as an independent player.

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|---|---|
| Q6 | The Commission seeks comment on the appropriateness of the counterfactuals. |
| Q7 | The Commission seeks comment on the likely nature, timing, and impact of the deregulation of the dairy industry. |

**Detriments**

218. Given the dairy industry context in this case, detriment analysis has to be conducted in the light of the co-operative company form. The detriments are likely to arise from the loss of competition between Kiwi and SIDCO in the market for the acquisition/supply of unprocessed milk in the South Island. As noted above, the Commission uses an economic efficiency approach to the measurement of detriments. The assessment is carried out under the following headings: allocative inefficiency, productive inefficiency and dynamic inefficiency.

*Allocative inefficiency*

219. Subject to certain limited reservations, the economy’s scarce resources are allocated between alternative uses with maximum economic efficiency when, in any given market, the additional cost of producing the last unit of the good or service equals the price which a buyer is prepared to pay for that unit. In theoretical terms, that optimum point is found where demand equals supply. Using the general market diagram shown in Figure 1 (and ignoring for the moment the line labelled MFC), the intersection at point A of the competitive demand (D) and supply (S) curves for a particular product determines the optimum price and output of $P_c$ and $Q_c$ respectively.

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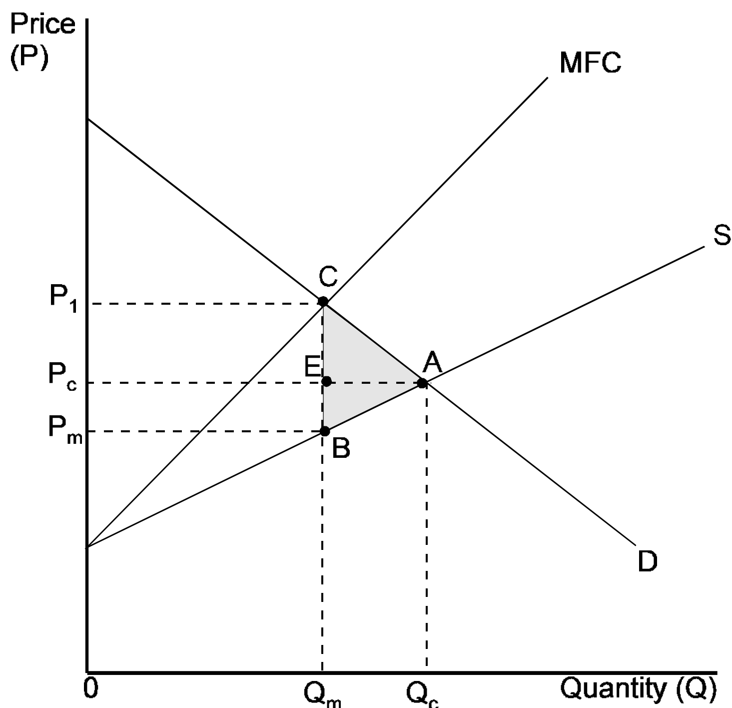
**Figure 1**




220. The outcome would be less than optimal if the arrangement were to result in too few units being produced (for reasons to be explored below), as shown in Figure 1 by the output $Q_m$. Here the price which buyers would be prepared to pay for one more unit ($P_1$) would exceed the cost incurred in producing that unit (equal to $P_m$), implying that the benefit to the economy from greater production of the product (as measured by buyers' 'willingness to pay') exceeds the sacrifice in terms of the resources used up (as measured by the costs of production). The shaded triangular area ABC thus represents the economic loss at $Q_m$ from the under-production of the product. This triangle is a measure of the detriment from the loss of allocative inefficiency which potentially could result from the loss of competition in the market.

221. In addition, the area in the Figure shown by $P_1CBP_m$ represents the size of the extra revenue transferred from buyers to suppliers through the higher price. Since what buyers lose by paying the higher price is exactly offset in dollar terms by the extra profit earned by suppliers, the social impact is generally taken to be zero.

222. The present case concerns the potential detriment arising from the loss of competition between Kiwi and SIDCO in the market for the acquisition/supply of unprocessed milk in the South Island. The merged entity would obtain some degree of monopsony power through being the dominant buyer of a good or service in the defined market.[5] Monopsony is the equivalent on the demand side of the market to the monopolist on the supply side. While the latter is able to exert market power by raising the price of

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5 Roger D. Blair and Jeffrey L. Harrison, *Monopsony: Antitrust Law and Economics*, Princeton, N.J.: Princeton University Press, 1993, pp. 37-39.

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what it sells, a monopsonist has the potential to exercise market power by forcing down the price of what it buys. In both cases, the economic objection to the exercise of market power is the same: the restriction of output compared to the situation where the market is competitive leads to a loss of allocative efficiency.

223. Figure 1 can now be taken to represent the relevant market, where quantity is measured in kgs of milk solids, and the price is in cents per kg. The demand curve D is the derived demand for milk solids by the processors, and S is the supply from farmers. The competitive outcome would be at a price of $P_c$ and quantity of $Q_c$. Each of the many small processors would view the price of milk solids as effectively being fixed at the going market rate of $P_c$, and each would buy the quantity of milk solids required accordingly. In contrast, a single buyer or monopsonist would recognise that the quantity of milk solids it buys does influences the supply price; because the supply curve is upward sloping, the greater the quantity purchased, the higher the price. Consequently, in order to buy one more unit of milk solids, the monopsonist has to offer a slightly higher price to induce that unit to be supplied. However, in the normal course of events, that entails paying the higher price to all units purchased. As a result, the cost of buying one more unit - called the "marginal factor cost" (MFC) - is not just the price paid for it. Also included is the tiny increase in the price paid to all of the other units purchased. The MFC to the monopsonist of the last unit of milk solid purchased will thus exceed the price paid for that unit.[6]

224. The MFC curve which relates to the S curve is shown in Figure 1. When the supply curve is upward sloping, the associated MFC curve lies above it and slopes upwards at a faster rate. For example, when the last unit purchased is at $Q_m$, the price paid will be $P_m$ (point B), but the MFC will be $P_1$ (point C).

225. The monopsonist, if it is to maximise profit, will stop buying units of milk solids at $Q_m$. This is because the cost of additional units beyond that point, as measured by the MFC, would exceed the value to the firm of each of those additional units, as reflected in the demand curve. The monopsonist thus maximises profits by buying units up to the point where MFC equals demand (D). The extra monopsony profit or rent earned, formerly enjoyed by labour in the competitive outcome and transferred from them, is represented by the area $P_cEBP_m$.

226. To sum up, the monopsonist is expected to buy fewer units of the input, and produce a smaller output, than the socially optimal competitive outcome, leading to a loss of allocative efficiency represented by the triangular area ABC. The size of this triangle depends upon a number of factors:

- the price elasticity of demand and of supply (i.e., the responsiveness of buyers and suppliers respectively to changes in price) in the market;

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[6] It might be objected that if the monopsonist pushes up the price of milk solids slightly by buying one more unit, then the same must happen when a competitive buyer buys one more unit. While that must be correct, the impact of the very small increase in price is different in the two cases. For the competitive firm, the increase in the bill for the small number of units already purchased will be very small, so that the MFC will hardly be different from the price paid for the additional unit (the impact of the tiny increase in price will be spread across all of the many purchasers of milk solids). In contrast, the monopsonist, as the only buyer, will bear the full brunt of the slight increase in price which, over a large number of units purchased, will cause the MFC to be significantly higher than the price.

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- the extent to which the usage of the product falls below the allocatively efficient one; and

- the size of the market measured by the total outlay (represented by area $P_cAQ_cO$ in Figure 1).

227. In order to assess the possible detriment from the loss of allocative efficiency in the present case, consideration has to be given to how well the general theory of monopsony fits with the likely impact of the loss of competition between Kiwi and SIDCO in the market for the supply/acquisition of unprocessed milk in the South Island for processing into export products. Competition in the downstream market for the supply of export dairy products would not be affected. Farmers both supply raw milk and are shareholders in the entities of the industry which carry out the downstream processing – the dairy co-operatives – and marketing activities – the NZDB. They receive a bundled return for unprocessed milk and the surplus generated by the downstream processing and servicing activities, in the form of an NZDB "advance price", together with a margin from their respective co-operatives. Only the latter margin is under the control of the dairy company. If monopsony power is to be exerted by the combined entity, it can only be done through the size of the company margin, which is a small but significant component of the overall farmgate payout. Information from the NZDB for the five seasons from 1993/94 to 1997/98 shows that the Board's advance price ranged between 290 and 360 cents per kg of milksolids, with the additional weighted average company margin ranging between [ ] and [ ] cents. The latter formed between [ ] and [ ] of the total payout.

228. For the purposes of illustration only, suppose that the NZDB advance price is 313 cents – the unweighted average for the five year period mentioned - and the combined entities' margin is 15 cents (in recognition of the former Alpine and Southland co-operatives' lower margins), giving a farmgate payout of 328 cents. Assume that as the result of monopsony power the margin, and hence the payout, were to be reduced by one cent. SIDCO's milksolids production of 109,441,237 kg in 1997/98 can be used as the basis for estimating Kiwi South Island's production, assuming their 240 suppliers have the same average production as SIDCO's 980 suppliers (giving a Kiwi production of 26,801,936 kgs, and a total for the combined entity of 136,243,173 kgs). Further, it is assumed arbitrarily that both the demand and supply curves are of unit price elasticity. On the basis of these assumptions, the deadweight loss triangle would equal only about $4,200 per annum. The resulting transfer from farmer margin to company surplus would be about $2.73 million.

229. However, the magnitude of the potential loss from the exerting of monopsony power in the present case would depend upon the circumstances, including the constraints provided by the co-operative structure of the combined entity. The following factors are pertinent:

- Co-operatives are obliged to take all unprocessed milk supplies offered by existing shareholders. New suppliers appear to be accepted only on the basis that existing payout would not be diluted. The calculation involves taking into account the additional costs of tanker collection and of processing the extra milk, which have to be balanced against the value of the extra product produced together with the capital contribution of the new shareholder. There seems to be

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no reason to suspect that this approach to assessing new applications for supply would change with the merger. To this extent, the ability of co-operatives to determine the quantities of unprocessed milk which they will accept is rather limited.

- A related point is that co-operatives appear to have as a prime objective the maximisation of the margin paid to their farmer suppliers, where the margin may be characterised as an average surplus. This is a different objective to that of profit maximisation used in the conventional theory of monopsony, which may then be a poor predictor of the behaviour of co-operatives.

- The company margin is naturally regarded as a critical indicator of company performance by farmer shareholders. Its size also directly influences the return to their businesses, and their families' standards of living. A dairy company which reduces its margin faces likely shareholder backlash. The democratic structure of co-operatives results in directors (who are often farmers themselves), and through them the managers, coming under intense pressure when the margin slips relative to that of other dairy companies. At the same time, farmers would generally remain "captive" to their co-operative because of the constraints on their switching to another, with the only alternative option being the drastic one of exiting the industry altogether.

- Because the suppliers are also the shareholders, the effect of lower margins designed to increase profit merely results in larger surpluses being returned to shareholders at a later stage. The incentive to exploit market power by reducing the margin thus appears to be limited. It might be argued that the later disbursement of surpluses would impose a cost to farmers in terms of delay and the time value of money, but presumably such surpluses will have been invested in the meantime, and therefore will have grown in size.

- It is arguable that companies might have an incentive not to disburse surpluses in order to provide a "captive" source of investment funds, and that those funds could be used to make inappropriate investments. While the responsibility for poorly performing investments ultimately would rest with the directors, it is probably the case that as the company gets larger and more complex, the scope for audits to reveal poor performance, and for shareholders to have an effective input into decision-making, becomes less. Therefore a degree of investment inefficiency could arise.

230. In the light of the above, and with the information currently to hand, the Commission's preliminary assessment is that the allocative inefficiency arising from the Kiwi/SIDCO merger appears likely to be in the range from $0.5 to $2.0 million per annum.

| Q8 | The Commission seeks the views of parties on the potential for losses of allocative efficiency to arise from the proposed merger between Kiwi and SIDCO. Comments on any of the points raised above, and any other relevant points, are sought. |
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*Productive inefficiency*

231. A monopoly producer is normally considered to lack the competitive pressures to remain efficient in production. Organisational inefficiency may creep into its operations, and costs increase, because a satisfactory level of profit is assured even when the firm is less than fully efficient. When this generalisation is carried over to the co-operative dairy industry, and to a consideration of the effect of the dominance of the merged entity in the South Island market for unprocessed milk, the potential losses of productive efficiency could be relatively significant.

232. The portion of the merged entity's costs likely to be affected by market power are those related to the collection of unprocessed milk from farmer suppliers and its processing into dairy products, primarily for export. These costs form roughly 30% of the costs of operating a dairy co-operative, the balance being raw milk costs. The total costs of the combined entity can roughly be estimated by making the following assumptions: the turnover of SIDCO in 1997/98 ($493.8 million) is assumed to equal the company's total economic costs (which includes a "normal" return on capital); Kiwi South Island's costs are in the same proportion to SIDCO's costs as its supplier number is to SIDCO's number, i.e., 240 to 980 (giving a cost of $120.9 million for Kiwi South Island, and a total for the combined entity of $614.7 million); and that 30% of that estimated total cost comprises transport and processing costs ($184.4 million). The combined entity's milk collection and processing costs are thus estimated to be of the order of $184 million.

233. The potential impact on costs of production inefficiency arising from market power, and hence the size of the potential detriment, can be assessed by assuming that costs might rise by a given percentage as inefficiency takes hold. For the purposes of illustration, a one per cent decrease in productive efficiency would amount to about $1.84 million, and costs would increase by the same magnitude for each further percentage point decrease, or proportion thereof.

234. It is a matter of judgment as to the potential size of such productive inefficiency. Clearly, it is most likely to arise over time as the experience of operating in a market where there is an absence of effective competition causes the firm's internal checks and constraints to become less effective. The magnitude it might reach in time would seem likely to be influenced by various factors, including the following:

- The milk processing business of the co-operative faces competition in the downstream market for the wholesale supply of processed dairy products to the NZDB, in the sense that there is bench-marking opportunities between different companies, and the NZDB in turn faces considerable competition in overseas export markets. The competition in those downstream markets will provide a considerable incentive for dairy companies to keep down the costs of milk collection and processing. However, benchmarking opportunities at the company level would be reduced by the merger using the *status quo* counterfactual.

- The nature of unprocessed milk, and of dairy processing technology, provide little latitude for inefficiency to develop. Because of its perishability, milk has to be collected on a daily basis (sometimes every two days) from each farm and

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delivered promptly to the factory silo in tankers which are mostly neither insulated nor refrigerated. Hygiene standards are strict, and samples of all milk collected are tested. Further, technical constraints imposed by the nature of dairy processing - the automation and capital intensity – together with the sheer volume of milk supplied on a daily basis and limited storage, suggest that major problems would arise if inefficiencies were allowed to creep into either milk collection or processing. However, costs incurred at the management and administration levels might be more susceptible to productive inefficiencies.

- The competition between co-operatives in terms of payout margin would be expected to make them cost conscious. As noted above, the majority of the costs incurred in dairy processing comprises the cost of unprocessed milk. These costs are largely outside the control of the companies. Competition for payout through cost containment must then focus on the remaining, but substantial, 30% or so of costs which do fall under the company's control.

- Farmer shareholders may only be able to observe costs indirectly through the level of the company margin in the farmgate payout, but that would provide an imperfect indicator of costs because of the other influences on the size of the margin.

- As already noted, the democratic structure of dairy co-operatives provide avenues for dissatisfaction to be voiced, but farmers rarely have the ability to "vote with their feet".

235. After consideration of the above factors, and on the basis of the information received to date, the commission has reached the tentative view that productive efficiency losses are likely to be in the range of 0.5% to 2% of the combined entity's non-raw milk costs, or roughly between $0.9 and $3.6 million per annum.

| Q9 | The Commission seeks the views of parties on the potential for a dairy co-operative in a dominant position in milk collection and processing to suffer from an erosion of productive efficiency over time, the points raised above and any other relevant points. |
|---|---|

*Dynamic inefficiency*

236. Dynamic efficiency is concerned with the speed with which an industry adopts superior new technology and produces improved new products, the first allowing costs of supply to be reduced, and the second bringing the benefit of meeting buyer wants more fully. Competition is generally considered to act as a stimulus to dynamic efficiency, and market power as a retardant. It is generally believed that in an industry which has at least a significant scope for technological advance, the potential losses associated with market power are likely to be greater in the longer term in respect of dynamic inefficiency than they are in respect of the static forms of inefficiency (namely, allocative and productive) considered above.

237. The dairy processing industry arguably might be characterised as being moderately dynamic. In the past the industry was mainly a supplier of bulk products, with Britain being the major market. In more recent times, following Britain's entry into the European Community, and in recognition of the need to improve returns, the industry

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has taken major steps to diversify into new markets and into new, more specialised, higher margin products.

238. It is possible that the combined entity, because of the absence of competitive pressures and the inability of dissatisfied suppliers to switch to other co-operatives, might delay investment in new plant and equipment, and in technological improvements, compared to the pre-merger situation. However, this seems likely to be less of a problem in the geographic market in question, because the rapid growth in milk supply there is forcing the companies continually to invest in expanded capacity. This seems likely to continue whether the merger takes place or not. Moreover, the comments above in relation to productive inefficiency being constrained by competitive pressures in the downstream markets are also likely to apply to some degree with respect to dynamic efficiency.

239. In terms of new products, the NZDB's new product pricing system is designed to reward producers of products which attract higher margins on overseas markets. This should enhance the incentives for companies to diversify their product ranges. The scope for them to do so may depend upon the range of plant they have available, and the speed with which they can respond to NZDB pricing signals. It may be that market power in milk collection and processing may weaken the merged entity's response. Conversely, given that co-operatives' primary competitive focus is in overseas markets, it could be argued that this would drive co-operatives to seek greater economies of scale and efficiencies to compete effectively offshore. Therefore an increase in size of the co-operative as proposed, might enhance dynamic efficiency.

240. Based on the information so far to hand, the Commission has been unable to quantify the dynamic efficiency, or to form a view on whether the potential dynamic efficiency effects of the proposal would be positive or negative.

| Q10 | The Commission seeks comment on the likely effects on dynamic efficiency of the proposed merger, what effect competition in offshore markets might have on that dynamic efficiency, and the extent to which innovation might be eroded by dominance in the milk acquisition and processing market. |
|---|---|

*Conclusion on Detriments*

241. The Commission has reached the preliminary view, based on the limited information currently before it, that the potential detriments from productive inefficiency and allocative inefficiency are both likely to be moderate, and that from dynamic inefficiency is less certain but could be significant. Overall, the currently quantified detriments, excluding dynamic efficiency gains or losses, total between $1.4 and $5.6 million per annum.

**Public Benefits**

242. As part of Kiwi's application, NZIER has identified two groups of public benefits which they claim would flow from the acquisition of SIDCO, namely the preservation of competition, and productive efficiency gains. Each is now assessed in turn.

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*Preservation of Competition*

243. Kiwi claims that its merger with SIDCO would avoid the loss of competition in the market for the acquisition of export dairy produce should NZCDC merge with SIDCO. It is alleged that such a merger would push NZCDC's share of total milk solids to 58%, which would give it effective control over the NZDB on its anticipated deregulation. However, this would raise the question as to whether any competition issues would arise from a NZCDC/SIDCO merger, and thus whether it can be taken as the appropriate counterfactual for the present application. It is also noted that the *status quo* counterfactual would result in a similar degree of preservation of competition.

244. It is not clear whether NZCDC might become either interconnected or associated with the NZDB, should NZCDC merge with SIDCO. If necessary, NZCDC could seek clearance or authorisation from the Commission to merge with SIDCO. Further, the shareholders of either NZCDC or SIDCO might vote against the proposed merger.

245. In any case, the benefits or detriments arising out of that event have not been quantified to the Commission. At this stage, so far as assessing the public benefits of the proposed merger, the Commission has formed the preliminary view that this is unlikely to constitute a valid benefit claim.

| Q11 | The Commission seeks comment on the likely future structure of the NZDB or any deregulated entity, and the impact on competition that the proposed merger would likely have in a deregulated dairy industry. |
|---|---|

*Productive Efficiency*

246. Increases in productive efficiency are claimed to arise from three broad effects of the proposed merger. Firstly, the combined entity would benefit from a more efficient use of the joint production facilities, through greater flexibility in altering product mix and managing peak milk flows. This would permanently reduce production costs relative to the counterfactual situation, facilitate the production of product mixes yielding higher returns, and allow investment in new capacity to be deferred.

247. The Commission asked the applicant why such benefits could not be attained now through market transactions between the participants. The applicant responded that while such transactions were feasible in principle, they were difficult in practice to negotiate. It is difficult to get agreement on pricing and the sharing of the benefits, and there are problems with permanent staff at a plant when production is diverted elsewhere. A floating staff which can move between the plants is really needed. Also, such agreements may result in sensitive company information being revealed to the partner, which may be used against it at a later date. Finally, lengthy negotiations brought to a successful conclusion may be overturned at Board level. Thus, it would appear to the Commission that the rationalisation benefits claimed may only be realised through a merger, and hence can be evaluated as potential public benefits.

248. Secondly, the elimination of the duplication of certain activities which are currently carried out by both Kiwi and SIDCO, such as in marketing and milk and product quality testing, would lead to further ongoing cost savings. Again, the Commission

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would accept in principle that such savings could constitute public benefits. However, at least some of these savings are likely to accrue in the NZCDC/SIDCO merger counterfactual, and benefits can only be accepted to the extent that they exceed those in the counterfactual. Moreover, it might be argued again that some of these benefits could be realised through market transactions between the companies at no cost to competition, rather than through a merger.

249. In relation to the likelihood of such savings being realised, it was pointed out by Terry Norwood (CEO of Westland) that the collection areas of Kiwi and SIDCO, being adjacent, would allow for genuine economies to be realised by the combining of the two operations, whereas the economic benefits of an NZCDC purchase of SIDCO were less clear. This suggests that a Kiwi/SIDCO amalgamation is likely to be in a position to realise economies relative to either counterfactual. However, the Commission needs to have detailed supporting evidence of such economies, and to be able to test them with other industry participants, in order to be able to place any weight on the claims made.

250. Thirdly, it is claimed that Kiwi's relative size and financial position allow it to obtain various inputs at lower prices than SIDCO, so that the SIDCO portion of the combined entity would benefit from Kiwi's greater buying power. While the Commission accepts that this is likely to be so in principle, the extent to which such gains could be treated as public benefits has to be questioned on two grounds. The first ground is that similar benefits would be expected to accrue in the NZCDC/SIDCO counterfactual, and those benefits might possibly be greater given that NZCDC is rather larger than Kiwi. If the benefits were larger, a negative public benefit would be generated using the NZCDC/SIDCO counterfactual. The second ground is that such economies may only be pecuniary economies. Since the lower prices paid by the buyer with "purchasing power" are matched by the lower revenues received by the corresponding suppliers, the outcome is merely a transfer of wealth from one to the other, without any net social gain, unless it can be shown that suppliers are able to make input savings. For example, it is conceivable that there might be savings to suppliers in meeting bulk orders.

251. Within the broad savings categories outlined above, the applicant claims to have identified a number of specific production cost savings in negotiations with SIDCO as part of the merger due diligence process. These are summarised in Table 2, although the figures for the individual items are regarded as confidential. SIDCO has confirmed that such negotiations were held, that the scope for making synergy gains was canvassed, and that the figures are (with a few minor exceptions) as agreed. This adds credence to Kiwi's benefit claims, given that the SIDCO Board has in the event recommended a merger with NZCDC. The total savings claimed for a five year period from 2000 to 2004 amount to $58.4 million in nominal terms, or to $47.7 million in present value terms (discounted at 10%).

252. On a general level, the pattern of savings may be questioned. With four exceptions out of the fourteen claimed, relating mainly to deferrals of capital expenditure, the annual savings over the five years for each of the savings categories are constant. The implication is that in each of these cases, all of the available savings are secured in the first year, and are then held at that level over the subsequent four years. On the basis of experience with other mergers in other industries, this pattern seems implausible.

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The integration of two firms post-merger does not always proceed smoothly; unexpected difficulties can arise; tensions can build up between the acquiring and the acquired entities; and differences in organisation, practices and cultures can delay management from attending to implementing measures to secure the anticipated benefits. As a result, cost saving measures are likely to be implemented gradually and sequentially, so that cost savings build up gradually, both in individual categories and in total.

253. When SIDCO was asked about the probability of the proposed merger generating the claimed savings, in the light of overseas experience that two-thirds of mergers fail to deliver, it was pointed out that the industry had had a lot of previous experience with mergers. It is noted that one merger had typically followed so quickly upon the heels of another that it was difficult to analyse whether any particular merger had yielded the benefits expected of it. It was suggested that the usual pattern was that the merged entity would struggle for a year or two as efforts were made to capture the expected benefits, but that the gains would be realised in the end. It was also suggested that some of the gains (e.g., product mix flexibility) would be realised from the outset. These comments could indicate that not all savings will be realised from the outset.

Q12 The Commission seeks comment about projected and achieved efficiency gains made by co-operatives with respect to other recent mergers. In particular, information is sought on efficiency gains from mergers made some time ago, such as the merger of Kiwi and Tui.

254. It has to be recognised that many of the cost savings are unlikely to disappear at the end of the five year period, as implied by the five year time horizon in Table 2, which sets out benefits according to information supplied by Kiwi and SIDCO. Some may continue in perpetuity, albeit at increasingly discounted values when the time value of money is taken into account. The same applies to the detriments, however, but a five year time horizon is probably sufficient given future uncertainties. For the purposes of analysing the claimed benefits, the Commission has generally accepted the figures as presented, making adjustments to those items as considered appropriate.

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TABLE 2
Production Cost Savings Claimed by the Applicant
for the Years 2000-2004 ($000s)

| **Saving** | **Years** | | | | |
|---|---|---|---|---|---|
| | **2000** | **2001** | **2002** | **2003** | **2004** |
| 1. Product mix flexibility | [ | | | | |
| 2. Christchurch plains drier | | | | | |
| 3. Plains drier capex deferral | | | | | |
| 4. Purchasing | | | | | |
| 5. Bar coding | | | | | |
| 6. Dairy laboratories | | | | | |
| 7. Insurance | | | | | |
| 8. Interest rate margin | | | | | |
| 9 Corporate salaries net of redundancies | | | | | |
| 10. Other corporate overhead | | | | | |
| 11. Clerical savings net of redundancies | | | | | |
| 12. Other rationalisation | | | | | |
| 13. SIDCO local market | | | | | |
| 14. Capex deferral at Stirling | | | | | ] |
| TOTAL | 9,621 | 10,071 | 10,582 | 13,550 | 14,618 |
| PRESENT VALUE | 9,621 | 9,155 | 8,745 | 10,180 | 9,984 |

255. The figures in Table 2 are taken from the report by NZIER (p. 10) written on behalf of the applicant. Explanations on their derivation have been provided by a further brief report provided by the applicant, together with discussions with the applicant, as well as with SIDCO. Useful background information has been provided by other dairy industry participants.

256. To encourage comment from other parties, the Commission now provides what information it has gathered about each of the cost savings listed in Table 2.

Product mix flexibility

257. The applicant claims that the bringing together of the plants owned by the merging entities would allow additional off-peak flexibility "to produce more outputs with the highest current payout, while still delivering the overall contracted product mix."

258. It would appear that off-peak milk flows could be shifted either north or south between the four sites. A "pecking order" of plants could be established based on the current and expected prices for different products. As milk starts to flow at the beginning of the season, it would be allocated first to the highest ranked plant, which would be brought into production first. As milk flows gradually increase through the "spring flush", plants lower down the pecking order would progressively be brought into production. This process of allocating milk to the highest margin products would

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be done providing the margin differential on those products more than compensates for any increase in transport costs in getting the milk to the relevant plant.

259. The figures in row 1 of the table relate only to the transfer of milk between the Edendale and Stirling sites. This is because the two sites are only 90 kms apart, so that milk can be diverted from one to the other relatively easily. Indeed, the diversion of Stirling's west Otago milk to Edendale could be done at no extra transport cost. Edendale produces mainly cheese, milk powder and casein, and Stirling cheese and whey protein concentrate. Milk was hypothetically allocated between the two sites so as to produce a joint product mix which maximised return, assuming NZDB prices as at December 1998. Because the cheese price was relatively low, returns were maximised by diverting Edendale's cheese milk into casein or powder, followed by the diversion of some of Stirling's milk to Edendale. The Commission was shown a graph which revealed frequent and substantial divergences in the prices of different products. The additional returns so calculated were halved in recognition that such opportunities do not always exist. The applicant considers that further gains are possible from diverting milk between Stirling and Clandeboye, although the greater distance and transport costs would only yield an advantage when product prices differ significantly.

260. The Commission accepts that this claim seems plausible, but has not had the opportunity of reviewing the detailed calculations involved. Nonetheless, it seems clear that there are substantial revenue gains possible in diverting milk between plants in order to produce the higher margin products. It also seems that such diversions are difficult to organise through market transactions. The Commission has allowed the full amount of [ ] per annum, which, should this merger proceed, would accrue when the proposed merger is compared with either counterfactual.

Christchurch plains drier

261. This claimed saving stems from the fact that SIDCO's large Clandeboye drier is used to manufacture some wholemilk powder but mostly skimmilk powder, with the latter having butter milk as a by-product. Consequently, the unit is also used to produce buttermilk powder. When a plant switches production from one product to the other, it has to be stopped and fully washed, which means that production is lost for 3-4 hours and cleaning costs are incurred.

262. Kiwi's Christchurch (plains drier) is small and old and had been planned for closure. However, with the merger it could be used to process the Clandeboye buttermilk into powder, leaving that plant free to concentrate on wholemilk and skimmilk production. The Clandeboye drier would thus benefit from plant specialisation economies (longer runs of single products), and the present output losses and cleaning costs would be avoided. This would involve trucking buttermilk from Clandeboye to Christchurch, but SIDCO trucks are already travelling that route empty to collect milk from its northern catchment area.

263. Again, the Commission has not been able to evaluate the detailed estimates of savings, but notes that the savings were calculated not by Kiwi, but by SIDCO. It is not clear whether a market transaction could achieve similar savings in this case, although this seems doubtful given the discussion above. The Commission has

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allowed the full amount claimed of [ ] per annum, which, should this merger proceed, would accrue when the proposed merger is compared with either counterfactual.

Plains drier capex deferral

264. It is claimed that the reduction in interruptions in 252 above would allow investment in new capacity at Clandeboye to be deferred. Because the Clandeboye drier would not have to stop and start, another 700,000 litres of capacity is created, giving a net gain of approximately 600,000 litres. This extra capacity would allow capital expenditure to be deferred in years 2003 and 2004, with a consequent saving in depreciation and interest payments. Capital deferral in those two years is estimated at $18 million, with depreciation and interest rates at 6.7% and 7% respectively. The figures for the years 2000-2002 in Table 2 reflect smaller plant "tweaking" investments.

265. The Commission has allowed the full benefit claimed of approximately [ ] per annum, which, when the proposed merger is compared with both counterfactuals, would accrue under either.

Purchasing

266. This item covers the enlarged entity's ability to gain lower prices on purchased inputs. SIDCO pointed out that as Kiwi is twice the size of SIDCO, it was able to secure significantly better deals on items such as fuel and packaging. The former Otago Cheese Company had experienced significant savings on purchased inputs – on items such as chemical cleaning, packaging and fuel (petrol and diesel) - from being part of a large company since the Kiwi takeover. One example was a saving of [ ] cents/litre on diesel.

267. The applicant claims that discussions with SIDCO and with suppliers found that savings could be made through price reductions for cleaning chemicals, rennet, fuel and rail transport. The expected savings have been itemised for these four "big ticket" items, but it is expected that a similar level of savings could be gained on a number of lesser items.

268. However, as noted above, such savings would not count as a public benefit to the extent that the economies are pecuniary only. Suppliers may gain some savings from supplying larger orders to a single buyer, and Kiwi may gain from better use of resources.

269. More importantly, as such savings are likely to occur in the NZCDC/SIDCO counterfactual, they cannot then be claimed as a public benefit. SIDCO considered that NZCDC would be able to achieve the same, if not better, savings because of its greater purchasing power.

270. In conclusion, should this merger proceed, no public benefit would arise when compared with the NZCDC/SIDCO counterfactual. The Commission has allowed 25% of the claimed benefits amounting to [ ] per annum, as an estimate of the

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public benefits of the proposed merger, when compared with the *status quo* counterfactual.

Bar coding

271. It is claimed that inventory management savings would be made possible by replacing SIDCO's manual system with Kiwi's bar coding system. The system involves using a scanner to check pallets into and out of the warehouses, allowing easier and faster location of product and inventory control, and avoiding the documentation and potential for errors in a manual system. When spoken to, SIDCO agreed that it would be able to take advantage of Kiwi's sophisticated warehousing system. SIDCO had spent [ ] million on its own system without coming up with a workable solution.

272. The claimed saving stems from reducing staff by five. No allowance appears to have been made for the extra investment in equipment needed. In any case, a merger with NZCDC would offer a similar advantage to SIDCO in bar coding. With respect to other IT developments, NZCDC has also developed its own IT system, which would replace (and lead to the writing off of) SIDCO's developing system. Kiwi is said to be behind both in IT development.

273. The Commission concludes that, should this merger proceed, there would be no benefit in this category when this merger is compared with the NZCDC/SIDCO merger counterfactual. The Commission has allowed 80% of the claimed benefits amounting to [ ] per annum, as an estimate of the public benefits of the proposed merger, when compared with the *status quo* counterfactual.

Dairy laboratories

274. This claimed saving stems from the rationalisation of dairy laboratories in the merged entity. Kiwi's current laboratories at Stirling and Christchurch would be closed, with all milk and product samples being processed through the Clandeboye laboratory. This laboratory was originally set up by the Alpine and Southland co-operatives prior to their merger to form SIDCO, to process their combined requirements, and that of third parties. However, no third parties availed themselves of the offer, but the laboratory continues to test the Edendale samples, which are delivered by courier. The Commission understands that it has automated processing.

275. The intention with the merger is to close Kiwi's laboratories at Stirling and Christchurch, and to process all samples through Clandeboye. The courier from Edendale could pick up the Stirling samples on the route north. It is unclear whether the costs of couriering samples from Christchurch to Clandeboye have been incorporated in the claimed savings. The applicant has stated that since Kiwi acquired Tui, the Tui laboratory at Pahiatua has been closed and testing was centralised on the Hawera site.

276. The bulk of the claimed savings are labour costs, with the remainder said to relate to fixed cost savings from better utilisation of Clandeboye equipment. In this case, the Commission has allowed 50% of the claimed benefits, amounting to [ ] per annum,

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which would accrue when the proposed merger is compared with either counterfactual.

Insurance

277. Dairy company insurance covers insurance over product (preshipment insurance, negotiated for the industry as a whole), plant and business interruption. Savings in insurance are claimed for the latter two items. These savings appear to arise from reductions in insurance risk from the pooling of risks (this is certainly the case in the business interruption category), and so can be regarded as a real (i.e., non-pecuniary) economy. Should this merger proceed, as similar savings would arise when the proposed merger is compared with the NZCDC/SIDCO counterfactual, no public benefit could be claimed, but when compared with the *status quo* counterfactual, the Commission considers 100% of the claimed savings would occur, amounting to [ ] per annum.

Interest rate margin

278. This is the saving estimated to arise from the refinancing of SIDCO's current borrowings at the lower interest rates enjoyed by Kiwi. According to SIDCO, both Kiwi and NZCDC have Standard and Poors ratings, but SIDCO does not. Kiwi allegedly has a good Euro dollar deal with no foreign exchange rate exposure. The advantage is said to be one-quarter of one per cent on interest rates. This can be regarded as a real economy engendered by the superior risk profile of larger companies.

279. Similar savings are likely with the NZCDC/SIDCO merger, so this claimed benefit does not apply when the proposed merger's benefits are compared with that counterfactual, but when compared with the *status quo* counterfactual, the Commission considers 100% of the claimed savings would occur, amounting to [ ] per annum.

Corporate salaries net of redundancies

280. It is claimed that there will be savings in corporate salaries less the cost of the corresponding redundancies, stemming from the closure of SIDCO's Christchurch head office and the laying off of all staff. SIDCO is said to have agreed that all of its staff would go. Their functions would be taken up by Kiwi staff based in Hawera and Dunedin.

281. It seems likely that, when the proposed merger is compared with the NZCDC/SIDCO merger, lesser savings would be made, reducing the size of the public benefit. Therefore, the Commission has allowed 50% of the claimed benefits, amounting to [ ] per annum. When the proposed merger is compared with the *status quo* counterfactual, the Commission has allowed 80% of the claimed benefits, amounting to [ ] per annum.

Other corporate overheads

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282. Further savings in other of SIDCO's corporate overheads are claimed to arise from the closure of its Christchurch head office, based on its budgeted amounts for those items for this year. These include directors' expenses, rent, legal fees, audit fees, printing and stationery, telephone, travel and entertainment. The single biggest item is directors' expenses, which has been estimated on the basis that SIDCO's expenses in full would be saved. In practice it is anticipated that some SIDCO directors will join Kiwi's Board, while an equivalent number of current Kiwi directors will retire. It is not anticipated that there will be any expansion in Kiwi's corporate overheads should it take over the company.

283. It seems likely that, when the proposed merger is compared with the NZCDC/SIDCO merger, lesser savings would be made, reducing the size of the public benefit. Therefore, the Commission has allowed 50% of the claimed benefits, amounting to [ ] per annum. When the proposed merger is compared with the *status quo* counterfactual, the Commission has allowed 85% of the claimed benefits, amounting to [ ] per annum.

Clerical savings net of redundancies

*284.* It is further claimed that savings of about ten redundant positions, primarily for accountants, receptionists and typists, would be made at the Edendale, Stirling and Clandeboye sites. In part it seems that this would arise through the rationalisation possibilities raised by the merger, in part from rationalisation possibilities from the Alpine/Southland merger not yet worked through, and in part from changing views about the appropriate staffing at the plant level vis a vis the head office. Only the first of these would potentially count as a public benefit. The Commission has allowed 25% of the claimed benefits, amounting to [ ] per annum. When the proposed merger is compared with both counterfactuals, such benefit would appear likely to a similar degree with either counterfactual.

Other Rationalisation

285. [

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286. [

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287. [

]

288. However the Commission is not inclined to accept such savings without evidence of the viability of the rationalisation proposal as a whole.

SIDCO local market

289. Savings in marketing and distribution costs are claimed from subsuming SIDCO's "Cloverleaf" cheese brand within Kiwi's "Mainland" brands. It is understood that the "Cloverleaf" brand is a small South Island brand positioned at the lower end of the market. As such it could be marketed by Mainland, which is a major domestic wholesaler of cheese. The savings are stated to have been calculated by SIDCO, and are mainly labour savings from the closure of SIDCO's small packing plant. Presumably, Mainland might incur some additional costs itself in marketing and distributing the new brand, although these are not mentioned.

290. When comparing the proposed merger with the counterfactuals, as this benefit would not appear to be possible in the NZCDC/SIDCO counterfactual, it would likely accrue under either counterfactual. The Commission has allowed about 80% of the claimed benefits, amounting to [ ] per annum, when the proposed merger is compared with either counterfactual.

Capex deferred at Stirling

291. It is claimed that without the merger, both the Edendale and Stirling sites would be expanded, and would have individually to manage the excess capacity problem associated with lumpy additions to capacity in combination with a gradual growth in milk supply. With the merger, the two sites could be treated as one for the purposes of managing spare capacity. Milk could be diverted between the sites so that, for example, Stirling was held at full capacity working, and all milk supply growth was directed to Edendale, which could then be expanded to match that growth. The result, it is claimed, is that there would be a closer match over time between milk supply and plant capacity, leading to desirable deferrals in capital expenditure

292. At the same time, it is claimed that the increments to expansion at Edendale could be made larger, and therefore more efficient, because larger additions to capacity are proportionately less expensive than smaller additions.

293. When the proposed merger is compared with the counterfactuals, such benefits would apply with either. However, the Commission has not been able to review the supporting calculations, although they have been verified by SIDCO. It also appears that expansion might be forced on Edendale as Stirling is close to full capacity on its present site. The Commission has allowed 40% of the claimed benefits, amounting to [ ] per annum, when the proposed merger is compared with either counterfactual.

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*Conclusion on Public Benefits*

294. As indicated above, the Commission could not accept some of the claimed benefits, either because they are likely to be pecuniary economies, or because they would be incurred in the counterfactual. However, for benefit claims not falling in those categories, the Commission gains some comfort from the figures having been reviewed and verified by SIDCO as part of the merger due diligence process. As a result of the review of the information currently available, the Commission has reached the preliminary view that the benefits from the merger are likely to be substantial. In annual terms they could be of the order of $6.3 million for the NZCDC/SIDCO counterfactual, and $8.4 million for the *status quo* counterfactual.

295. The detriments have been quantified to be of the order of $1.4 to $5.6 million per annum, excluding any dynamic efficiency impacts. When the benefits and detriments of the proposed acquisition are compared with either counterfactual, it is likely the Commission would be satisfied that the public benefits of the proposed acquisition, estimated to be either $6.3 or $8.4 million per annum depending on which counterfactual is accepted, would be likely to outweigh the competitive detriments.

Q13 The Commission seeks detailed comment on the nature, extent and likelihood of the above public benefits as claimed.

**THE DRAFT DETERMINATION**

296. On the basis of the information available to it to date, the Commission has reached the preliminary view that it can be satisfied that the public benefits of the proposed acquisition are likely to outweigh the competitive detriments.

297. If these conclusions are confirmed following consideration of submissions on this draft determination, the Commission is likely to grant an authorisation pursuant to section 67(3)b) of the Commerce Act.