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Commerce Commission

Decision No. 341

Determination pursuant to the Commerce Act 1986 (the Act) in the matter of an application for clearance of a business acquisition involving:

KIWI CO-OPERATIVE DAIRIES LIMITED

and

SOUTH ISLAND DAIRY CO-OPERATIVE LIMITED

The Commission:	P C Allport E M Coutts P R Rebstock
Commission Staff:	Bruce Cossill Paul Muysert
Summary of Proposed Acquisition:	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.
Determination:	Pursuant to s 66(3)(a) of the Act, the Commission determines to decline clearance for the proposed acquisition.
Date of Determination:	26 February 1999

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THE PROPOSAL

1. On 20 January 1999, the Commission registered a notice pursuant to s 66(1) of the Commerce Act 1986 ("the Act") seeking clearance 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 66(3) of the Act requires the Commission either to clear, or to decline to clear, a notice given under s 66(1) within 10 working days, unless the Commission and the person who gave the notice agree to a longer period. A determination was initially required by 3 February 1999. The applicant agreed to an extension of 12 working days, and a determination was then required by 19 February 1999. Kiwi then sought a further 5 working day extension, which the Commission granted. A determination is required by Friday 26 February 1999.

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

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

THE INVESTIGATION

6. The Commission contacted the following parties in investigating the proposed acquisition:
   - 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)
   - The New Zealand Dairy Board

7. 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 decision.

THE PARTICIPANTS

Kiwi Co-Operative Dairies Limited ("Kiwi")

8. 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 Hawke's Bay. Kiwi's 240 South Island suppliers are located around Christchurch and South Otago/Southland. In 1998 Kiwi processed about 10 % of the South Island milk solids.

9. Kiwi owns and operates the world's largest milk manufacturing site in Hawera, and a plant in Longburn in the North Island, and plants in Christchurch and Stirling in the South Island.

10. Acquisitions by Kiwi of 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.

11. 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 (Mainland);
    - Development and commercialisation of technology (Kiwitech);
    - 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);
    - Generation and sale of electricity (Kiwi Power).

12. 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")

13. SIDCO is a Christchurch based dairy co-operative company, involved in the purchase of unprocessed milk from 980 supplying shareholders in Canterbury and Southland.

14. 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;
    - Wholesale distribution of Pioneer and Cloverlea brands of cheddar and other cheeses within the Southland region.

15. 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")

16. 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 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.

17. 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 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")

18. 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 in 1998 at its only operating plant in Hokitika.

Other South Island Dairy Co-operatives

19. 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

20. 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 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
- Mainland Products Limited/South Island Dairy Farmers Co-Operative Limited, Decision 342, 12 May 1998.

21. 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 this information in this report.

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

23. 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 growth areas for dairy farming and milk production over the next few years.

24. Based on kilograms of milk solids processed each year, at present there are now three major co-operatives in the North Island - Northland, NZCDC and Kiwi, and three in the South Island – Kiwi, SIDCO and Westland. Tasman, Marlborough and Kaikoura are the other co-operatives in the South Island.

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

25. 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 within the next few weeks.

THE RELEVANT MARKETS

Introduction

26. 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.

27. 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.

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

29. 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 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 could exert market power.

30. 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.

31. In this case, when considering the market relating to the acquisition of raw milk, we are dealing with a monopoly acquirer, or monopsonist, and therefore the market definition and competition constraints relate to the behaviour within a market characterised by a

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

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 effect of a hypothetical 5% reduction in prices paid by the monopsonist.

32. 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".

33. Previous Commission decisions have discussed in depth the product, geographic and functional levels associated with markets in the dairy industry. Utilising definitions from these previous decisions, the potential areas of aggregation in the case of this application would be in the markets for the acquisition/supply of unprocessed milk, and the processing and supply of cheese.

The Market for the Acquisition/Supply of Unprocessed Milk

34. The proposal affects the market for supply of unprocessed or raw milk by dairy farmers to dairy co-operatives, who then process 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.

35. The principal issue in the current application is the extent of the geographic market. The options available appear to be either South Island or New Zealand. Narrower definitions are also possible, for example the South East of the South Island. The applicant submits the market should be defined as being New Zealand-wide, which is discussed at paras 62-66.

36. 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, without the need for a transport levy. The *Kiwi/Tui* decision also reflected the presence of just two major co-operatives, one in the centre and one in the south of the North Island, covering the majority of the North Island.

37. In order to define the geographic extent of the market it is necessary to determine what 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.

38. Accordingly, to establish the extent of the geographic markets in this case, the following issues are discussed:

- 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

39. The *ssnip* test is used to assess substitutability. The test in this case is this: if a hypothetical monopsonist lowered the price it pays to its suppliers for raw milk by five percent, 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 boundary at which substitution of co-operatives by farmers, under this test, is no longer likely to occur.

40. 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 by a range of product standard cost models. The NZDB is presently moving towards a system of payment based on international market rates for actual production.

41. 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.

42. 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 annual total of the base payout and margin is considered by the suppliers when assessing their co-operative's performance.

43. 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 at $3.65 per kg of milk solids, a small co-operative producing high value products.

44. 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

45. Historically, for practical reasons, farmers tend to cluster around processing plants, which are few and spatially dispersed. Transport costs for raw milk can impact 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.

46. 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 at best insulated, not refrigerated. Insulation means that the milk must be delivered from refrigerated storage to the plant within about 24 hours. 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. Their common use is also discouraged to some extent by 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.

47. 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.

48. 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 a small plant in the Hawkes Bay.

49. 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 peak 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.

50. 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.

Acceptance of Milk by Substitute Acquirers

51. While the 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 the extra milk would provide 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.

52. 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 and other co-operatives' catchment areas. Christchurch to Hokitika is about 252 km, and the resulting merged entity and Westland would be separated by the Southern Alps.

53. 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

54. 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.

55. 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.

56. Therefore it could reasonably be concluded that, if certain conditions existed, Westland and the merged Kiwi/SIDCO 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

57. 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.

Marlborough

58. 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.

Tasman

59. 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.

Conclusion

60. 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.

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

New Zealand Market

62. Kiwi, however, submits that the market should be defined as New Zealand-wide because:

    - Kiwi has successfully conducted trials to move bulk milk inter-Island; and
    - A merged Kiwi/SIDCO would be prevented from exercising market power over its South Island suppliers by the competition at its border with NZCDC in the North Island.

63. 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.

64. No co-operative currently transports bulk unprocessed milk inter-Island throughout the season. Figures quoted for inter-Island rail transport of milk indicate the cost would be greater than the 17.5 cent per kg of milk solids calculated by the *ssnip* test.

65. 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.

66. 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 a New Zealand-wide market definition would currently be inconsistent with the Commission's substitutability test.

67. 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 108-121.

Conclusion on Extent of Geographic Market

68. The Commission concludes 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.

69. It is noted that, should dominance concerns arise with the market defined as South Island-wide, those concerns would be greater with any narrower geographic market definition.

70. 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

71. 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.

72. 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 conservatively narrow product market definition, a market power problem is unlikely to arise, as discussed below

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

Conclusion on Market Definition

74. 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; and

- the market for the manufacture and wholesale supply of cheese in New Zealand.

ASSESSMENT OF DOMINANCE

Overview

75. Section 66(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.

76. 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 ...

77. 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.

78. 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.

79. 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.

80. 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;

- 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.

81. 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).

82. 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

Market Shares

83. 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 in the South Island are as follows:

SOUTH ISLAND MARKET SHARE – AS AT 1998

Co-op	Mkg milk Solids	% SI milk Solids	Suppliers	% Suppliers
Kiwi	16.6	10.1	240	12
SIDCO	120	63.2	980	48
Kiwi / SIDCO	**136.6**	**73.3**	**1220**	**60**
Westland	24	13.3	350	17
Tasman	12	6.6	80	4
Marlborough	5	2.7	370	18
Kaikoura	3	1.6	30	1

84. 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 73.3% share of the market while facing competition from one other market participant with 13.3% market share.

Constraint by Existing Competition

85. 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 combined Kiwi/SIDCO 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', such that the decrease would be unprofitable.

86. 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

87. 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 that 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.

88. 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

89. 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.

90. The restriction on time of the year switching can occur is not a major impediment in itself, although 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

91. For the purposes of assessing the road transport costs, Kiwi has submitted two costs of running a tanker. The first, being 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.

92. 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 very 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. This is the cost concept applied throughout this decision.

Constraint by Existing Competition – South Island

93. 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.

94. 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 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

95. 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. [

]

96. Westland has a moth-balled plant at Karamea. If re-opened it would deliver additional capacity of [ ] litres/day. If this occurred, 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 is in turn dependent on European subsidy levels.

97. Given 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 change.

98. 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.

99. 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 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 [

]

100. 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.

101. 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.

102. 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.

103. 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 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

104. 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 122-131 under *Constraint by New Entry.*

105. 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.

106. 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 contest approximately [ ] of the merged entity's suppliers in the Culverden area.

Conclusion on Constraint from Existing Competition

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

Constraint by Competition in the North Island

108. 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 deliver equal payouts to all their 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.

109. 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.

110. 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 equivalent 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.

111. The Commission considers these assumptions relate to the question of constraints on the exercise of market power.

112. So 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/SIDCO and NZCDC in the North Island is sufficient to constrain the co-operative.

Payouts to suppliers

113. 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 entities will accept SIDCO shareholders as full shareholders, without differentiation in share value, type or payout structure.

114. Legal opinion suggests that it is not likely to be simple for a co-operative to alter its payout structure, and that there are statutory mechanisms designed to protect shareholders. However, given the changes currently being introduced to the way the NZDB calculates its payouts to the co-operatives, the proposed equivalent payout to all merged-entity suppliers cannot be assumed to be permanent and unchangeable.

Constraint by Competition – North Island

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

116. 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.

117. 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.

118. Given the size of the merged entity if this proposed merger proceeds, 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.

119. 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.

120. 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

121. 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

122. When assessing previous applications involving the dairy industry, the Commission has 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 has been “extremely rare” and that amalgamations and rationalisation have characterised the industry. The underlying industry economics – economies of scale increasing over time with technology 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.

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

124. 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 in 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 in 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 were around $3.50.

125. 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 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 confidence in the long run viability of the factory is lost.

126. 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.

127. 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. In other words, that NZCDC or some other entrant 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.

128. 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 both the Chairmen of 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 that may never be economic.

129. The proposal of constructing a competing factory within the catchment of the proposed merger 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, that would be likely to adversely affect the performance of both the new entrant and the incumbent.

130. 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 from New Entry

131. 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

132. Kiwi has stated in its application that:

> "…[ ]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."

133. In most cases, 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 to suppliers, the supplier shareholders are potentially able to constrain these actions. Therefore, the issue is the degree of constraint offered by the co-operative structure.

134. 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.

135. 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.

136. 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.

137. 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.

138. 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.

139. 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.

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

Conclusion on Constraint from Co-Operative Ownership

141. In accordance with previous decisions, the Commission concludes that there are some elements of difference between co-operative and corporate structures, and the merged Kiwi/SIDCO 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.

Potential Substitutes

142. 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 long run 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.

143. 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 milking shed and more intensive fencing of the farm than is commonly used in some other forms of farming. Having invested, 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.

144. 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 Potential Substitutes

145. The Commission is not satisfied that the merged Kiwi/SIDCO 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

146. 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.

The Market for the Manufacture and Wholesale Supply of Cheese in New Zealand

147. The proposed acquisition would lead to some aggregation of market share in the market for the manufacture and 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.

148. The proposed acquisition falls within the second of the safe harbours outlined in paragraph 81 of this decision. None of the parties contacted as part of the inquiry have indicated any concerns in 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.

149. 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.

150. 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 Manufacture and Wholesale Supply of Cheese in New Zealand

151. 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 market for the manufacture and wholesale supply of cheese in New Zealand as a result of the proposed acquisition.

OVERALL CONCLUSION

152. 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.

DETERMINATION ON NOTICE OF CLEARANCE

153. Accordingly, pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission declines to give a clearance for the merger of the assets and business of Kiwi Co-Operative Dairies Limited and South Island Dairy Co-Operative Limited

Dated this day of February 1999

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The Commission