

MILK MARKETS

CONSIDERATION OF WHETHER TO INITIATE
A COMMERCE ACT PART 4 INQUIRY INTO
MILK PRICES

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SUMMARY

Purpose

1. This document reports on the Commission's decision on whether or not to initiate an inquiry under Part 4 of the Commerce Act 1986 (the Act) into milk markets and the reasons for that decision.

Conclusions

2. The Commission considers that a full pricing inquiry is not warranted at this time into any of the milk markets considered. This decision is based on our analysis of the state of competition in the relevant markets and whether Part 4 could effectively solve any potential problems identified. Our conclusions are also strongly influenced by the parallel ongoing interdepartmental reviews of the Raw Milk Regulations¹ (the Regulations) and Fonterra's farm gate price.
3. The purpose of a Part 4 inquiry is to determine whether to recommend to the Minister that markets with little or no competition should be regulated to mimic outcomes in competitive markets. We have not needed to determine whether prices are too high to reach a conclusion on whether a Part 4 inquiry is warranted into any of the milk markets considered.
4. This summary explains our reasoning. We set out the markets in which price control might be contemplated. We describe the tests required for recommending price control, and how we have applied the tests to each market.

Relevant markets

5. The Commission has considered the following four markets:
 - markets for the supply of raw milk by farmers to processors (farm gate supply);
 - markets for the supply of raw milk by processors of raw milk to other processors (factory gate supply);
 - markets for the processing and wholesale supply of fresh processed milk (town milk) to retailers; and
 - markets for the retail supply of grocery items, including fresh processed milk.

Part 4 of the Act

6. The purpose of Part 4 of the Act is to promote the long-term benefit of consumers using regulation to promote outcomes that are consistent with outcomes produced in competitive markets.

¹ The Dairy Industry Restructuring (Raw Milk) Regulations 2001.

7. The Act sets out three tests which the Commission must be satisfied are met before it can recommend that the Minister regulate goods or services:
 - first, the goods or services are supplied in a market where there is little or no competition; and little or no likelihood of a substantial increase in competition (the Competition Test);
 - second, there must be scope for the exercise of substantial market power in relation to the goods or services, taking into account the effectiveness of existing regulation or arrangements, including ownership arrangements (the Other Constraint Test);
 - third, the benefits of regulation must materially exceed the costs of regulation (the Net Benefit Test).
8. The threshold for undertaking a Part 4 inquiry is high. It requires that “little or no competition” exists or is likely to exist in a market. Part 4 regulation is only imposed on firms with a high degree of market power, usually because of the natural monopoly characteristics of the industry in question (such as electricity or gas distribution).
9. For the Competition Test, the Commission must decide whether there is little or no competition in the relevant market, and little or no likelihood of a substantial increase in competition. Beyond this, we do not need to reach a definitive view regarding the level of actual or potential competition present in the relevant markets. Nor is it relevant that competitive conditions are not ideal. Similarly, it would not be appropriate for us to assess whether profit margins are inflated, if we are satisfied that one or more of the three statutory tests set out above are not met.

Supply of raw milk by farmers to processors (farm gate supply)

10. Independent processors have alleged that Fonterra is paying too much to suppliers for raw milk, damaging competition. We have not come to a view on this potential competitive problem in farm gate milk markets, because Part 4 would not be the appropriate remedy.
11. Part 4 provides for the regulation of the supply of goods or services. It was not designed to regulate the acquisition of goods and services in markets where the acquirer has a high degree of market power. For this reason, Part 4 cannot regulate the price and other terms on which Fonterra (or other processors) acquire raw milk from the farm gate.
12. Alternatively, if we were to consider the problem one of supply by Fonterra farmers rather than acquisition by Fonterra, we could not recommend regulation under Part 4 because individual farmers do not have market power.
13. In addition, we note that an interdepartmental team of officials with representatives from The Ministry of Agriculture and Forestry, the Ministry of Economic Development and The

Treasury is currently reviewing how Fonterra sets the farm gate milk price.² If the Government ultimately decides there are issues justifying further regulation under the Dairy Industry Restructuring Act 2001 (DIRA), we consider that this is likely to better address any issues than regulation under Part 4.

Supply of raw milk by processors of raw milk to other processors

14. We consider that the Competition Test is likely to be met in the markets for the factory gate supply of raw milk. There appears to be little or no competition, and little or no likelihood of a substantial increase in competition, in what is called factory gate supply. Little raw milk is traded voluntarily. Nearly all raw milk ([]) supplied to the factory gate is milk Fonterra must sell at a regulated price under DIRA and the Regulations. We consider it unlikely that alternative suppliers of sizeable, consistent quantities of milk throughout the year to the factory gate will develop in the medium-term.
15. However, given the Regulations, it is questionable whether Fonterra has scope to exercise substantial market power in relation to the supply of raw milk to other processors. The Regulations provide an access regime for raw milk and are designed to counter Fonterra's market power. It is premature for us to consider this matter further, given the uncertainty surrounding the outcome of the current interdepartmental review. This review may result in legislative reassessment of whether the current regulatory regime under DIRA and the Regulations achieves the goal of contestability. We anticipate that this review will result in any legislative changes Parliament may think necessary to achieve this goal. We assume that Fonterra's ongoing obligations to supply raw milk to independent processors, both in terms of the obligation to supply and terms of supply, will continue to be prescribed under this legislation. In these circumstances express and effective legislation would address the "scope for the exercise of substantial market power" by Fonterra. For this reason there would be such "Other Constraint" that there would be no case for the Commission to progress to a full Part 4 inquiry in respect of this market.
16. It is also difficult to confirm whether any net benefits might arise from additional regulation under Part 4 at this time due to uncertainty in the regulatory environment. This is because an interdepartmental team (see paragraph 13 above) is also currently reviewing the effectiveness of the Regulations. The Commission considers that changes to the Regulations that may be the outcome of the review could lead to a more effective form of regulation for this market than Part 4 could offer. Using Part 4 in conjunction with DIRA and the Regulations is unlikely to be the best solution to any problems in factory gate markets.

² See the memo from Iain Cossar, MAF, and Karen Chant, MED, to the Commerce Committee of 15 June 2011, paragraph 48. Available at http://www.parliament.nz/NR/rdonlyres/53817675-2A2A-4452-A591-F84B6FF848B5/194060/49SCCO_EVI_00DBSCH_INQ_10730_1_A193150_MinistryofE.pdf.

17. We also are mindful that:

- simultaneous reviews by public bodies considering remedies to the same problem is unlikely to be an efficient approach; and
- launching a full inquiry would be premature given that the Regulations are currently under review and may be amended.

Wholesale supply of fresh processed milk to retailers

18. The Commission considers that the Competition Test is not met in the markets for the wholesale supply of fresh processed milk to retailers. Fonterra Brands Limited and Goodman Fielder Limited compete to supply town milk in New Zealand. A few smaller operators also compete in this market, but provide a weak constraint on the larger operators. Retailers appear to be generally satisfied that Fonterra Brands and Goodman Fielder compete on price.
19. The current rivalry between Fonterra Brands and Goodman Fielder provides more than the threshold of “little or no competition” in the market. Therefore it would not be open to the Commission to recommend regulation of this market to the Minister.

Retail supply of grocery items, including fresh processed milk

20. Supermarket retailing is not an obvious candidate for price regulation as the Competition Test in Part 4 sets a high bar to pass. Typically regulation of market power is only desirable when a market has natural monopoly characteristics. Supermarket retailing does not exhibit the characteristics of a natural monopoly.
21. The Commission considers that the Competition Test is not met in the markets for the supply of grocery items, including fresh processed milk. The Foodstuffs (N.Z.) Limited and Progressive Enterprises Limited supermarket chains operate in competition in New Zealand. In addition, other smaller retailers place some constraint on the pricing of milk. The Commission understands that a significant proportion, [], of milk sold to end-consumers in New Zealand comes through smaller stores.
22. We note the recent experience in Australia, where Coles started a price war in January this year by cutting the price of its private label milk to \$2 for two litre bottles. This pricing has led to concerns about pressure on farmers’ margins and whether the pricing is “predatory”.³
23. It appears that New Zealand supermarkets have not priced milk as aggressively as in Australia. This may reflect that competition in the supply of groceries from supermarkets

³ The impacts of supermarket price decisions on the Australian dairy industry are being considered by the Australian Senate Economic References Committee.

is less intense than in Australia. Alternatively, it may suggest that the competition dynamic is different, and supermarkets are focused on competing on other products or aspects of their offering. We have not needed to assess this question, as we consider that the current level of competition in the New Zealand market is greater than the strict “little or no competition” threshold. Therefore it would not be open to the Commission to recommend regulation of this market to the Minister.

Our next steps

24. We will liaise with officials regarding the current interdepartmental reviews to ensure that they are aware of our analysis. We also intend to make a public submission to MAF’s consultation on potential changes to the Regulations.

OVERVIEW

Structure of report

25. This report is set out in the following sections:

- outline of the tests in the Act regarding price regulation;
- the key questions we have asked ourselves as part of this review;
- the alleged problems in milk markets;
- the parallel reviews by an inter-departmental team of officials;
- the relevant background;
- a detailed explanation of the relevant provisions in Part 4 of the Act and the questions we have been asking ourselves as part of this review;
- definition of the markets relevant to this review;
- an assessment of whether a Part 4 inquiry is warranted as regards each of the relevant markets:
 - raw milk at the farm gate;
 - raw milk at the factory gate;
 - town milk; and
 - supermarkets.

26. Appendix 1 summarises previous Commission decisions in relevant markets. Appendix 2 sets out the key elements of Part 4. Appendix 3 sets out the reasons for the relevant markets that we have identified.

Introduction to Part 4

27. Part 4 allows the Commission to recommend to the relevant Minister that regulation of certain products or services should be imposed.
28. Section 52G sets a series of strict thresholds that must be met for the Commission to be able to make such a recommendation:
- in the relevant market, there must be little or no competition, and little or no likelihood of a substantial increase in competition. Few markets will meet such a test. While it is not a strict requirement of the test, we note that Part 4 was targeted at “natural monopolies”, such as airports, gas pipelines and electricity distribution and transmission line businesses;
 - in addition, there must be scope for the exercise of substantial market power in relation to the goods or services taking into account existing regulation or arrangements; and
 - finally, the benefits of regulating the relevant goods or services in meeting the purpose of Part 4 must materially exceed the costs of regulation.
29. If the tests under s 52G are met, then the Commission must decide whether regulation should be recommended to the Minister and, if so, in what form.
30. Regulation can involve information disclosure, negotiate/arbitrate regulation, and price-quality regulation. Further details of the relevant legal provisions are set out below in paragraphs 116-131 and Appendix 2 below.

Key elements of this review

31. Under this review, the Commission has considered whether a full Part 4 inquiry is warranted. We have not addressed every question that would be asked as part of full Part 4 inquiry. We have focussed on:
- what are the relevant market definitions within which to study the goods and services that might be regulated?
 - does the available evidence suggest that the tests under s 52G may be met for any of the relevant markets?
 - is there any matter which would bear on the decision whether to recommend regulation or launch an inquiry?

Alleged problems

32. The Commission has received a variety of complaints about the dairy industry. Some complaints are that the price of milk is too high, and others that Fonterra's behaviour is adversely affecting downstream processors. These complaints are set out in more detail in paragraphs 107-114.
33. The Commission has received a number of complaints that Fonterra has breached Part 2 of the Commerce Act. For example, town milk processors have complained that their margins have been squeezed by Fonterra freezing its prices to supermarkets, while raw milk costs have continued to increase. Other processors have complained about Fonterra's farm gate price being "predatory" and this, with the associated reduction in share price, increases their costs, thereby damaging competition.⁴ This review has not considered these allegations specifically, as it has focussed on whether to launch a price-control inquiry under Part 4.

BACKGROUND

34. This section provides background to each of the functional markets associated with the supply of domestic milk in New Zealand (see Figure 3). We fully describe the defined markets in a subsequent section.
35. The key background facts are that:
- one dominant co-operative, Fonterra, collects and processes a high percentage of raw milk in New Zealand. Fonterra is regulated to avoid monopoly pricing in downstream domestic markets and to foster competition between different forms of vertical integration between farmers and processors;
 - there are parallel reviews being carried out by officials regarding the effectiveness of current regulation under DIRA and the Regulations; and
 - international dairy prices have increased substantially in recent years. This may explain all or some of the recent increases in domestic milk prices.
36. This section describes:
- the parallel reviews by officials;
 - the recent high commodity prices;
 - the retail supply of milk;

⁴ []

- the wholesale supply of “town milk”;
- the supply of raw milk, including existing regulation;
- how Fonterra sets its farm gate price; and
- recent complaints received by the Commission.

Parallel reviews

37. There currently are two parallel reviews being carried out by an interdepartmental team of officials from the Ministry of Agriculture and Forestry (MAF), Ministry of Economic Development and The Treasury:
- a review into the effectiveness of the Regulations; and
 - a review of Fonterra’s farm gate pricing and share pricing.
38. The Government announced on 13 October 2010 that the Regulations would be reviewed in 2011.⁵ On 19 July 2011, MAF issued a consultation document inviting feedback by close on 2 September 2011 on how the Regulations could be improved.⁶ The scope of feedback sought is wide, and includes:
- the objectives of the Regulations;
 - who is eligible to take regulated milk and for how long;
 - what quantity of milk can be taken; and
 - whether the Regulations are providing an efficient entrance pathway into the farm gate milk market for independent processors.
39. The second review is considering whether or not there is a problem with how Fonterra calculates its farm gate price and share price and, if there is, the nature of a possible response at a high level. This review started after the Commission’s review began. The group plans to report to Ministers within two months. However, MAF notes that the issues are complex and that a precise estimate of the timeframe is difficult.⁷

⁵ Hon David Carter, Minister of Agriculture, Address to Annual Fonterra Network Conference, 4 May 2011.

⁶ <http://www.maf.govt.nz/portals/0/documents/news-resources/consult/review-of-raw-milk-regulations.pdf>

⁷ *Fonterra’s Farm Gate Price*, Iain Cossar, MAF and Karen Chant, MED,

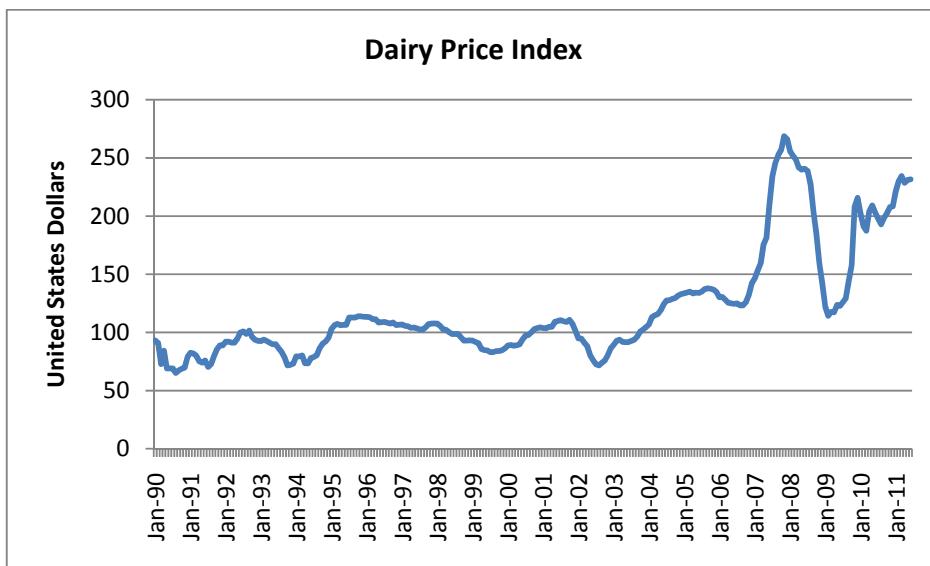
<http://www.parliament.nz/NR/rdonlyres/53817675-2A2A-4452-A591->

F84B6FF848B5/194060/49SCCO_EVI_00DBSCH_INQ_10730_1_A193150_MinistryofE.pdf

High commodity prices

40. As can be seen in Figure 1, international dairy prices have increased significantly in the last two years to levels approximately double their long run average over the last 20 years. High international dairy prices have been driven by strong global demand, especially from developing countries such as China.⁸ About 95% of New Zealand's dairy production is exported and, therefore, New Zealand's export earnings have increased considerably as international dairy prices have risen.

Figure 1 – International Dairy Prices



Source: Food and Agriculture Organisation Dairy Price Index⁹

41. This rise in international dairy prices is one facet of the recent strong rises in global commodity prices.
42. Figure 2 below compares changes in domestic milk prices¹⁰ and international dairy prices (converted into New Zealand dollars) since June 2006. Each set of prices has been rebased into an index, so that the price of that set was equal to 100 in June 2006.
43. The figure shows that domestic retail prices have been considerably more stable than international dairy prices. It also shows domestic milk prices have not increased in New

⁸ MAF, Situation and Outlook for New Zealand Agriculture and Forestry 2011, 14 June 2011.

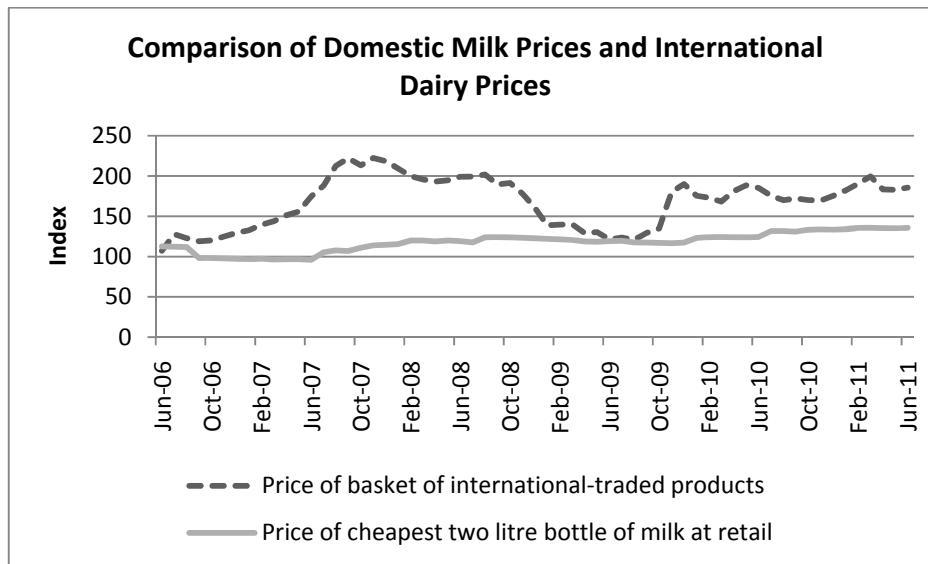
⁹ This index is based on butter, skimmed milk powder, whole milk powder, cheese, casein price quotations. Here, 100 is equal to the average prices for those products across 2002-2004 weighted by world average export trade shares. Prices are measured in US dollars.

¹⁰ Using Statistics NZ data for the cheapest standard homogenised milk available.

Zealand Dollars terms as much as international dairy prices. This can be explained in part by the following:

- the cost of raw milk is only about a quarter of the final retail cost of a two litre bottle of processed milk; and
 - this proportion is far less than the proportion of price for many internationally-traded dairy products accounted for by raw milk. For example, we understand that []% of the cost of milk powder delivered onto a ship is the raw milk cost.
44. So while there is likely to be a link between international prices of dairy products and retail prices of milk (and other dairy products), this link is unlikely to be one to one.

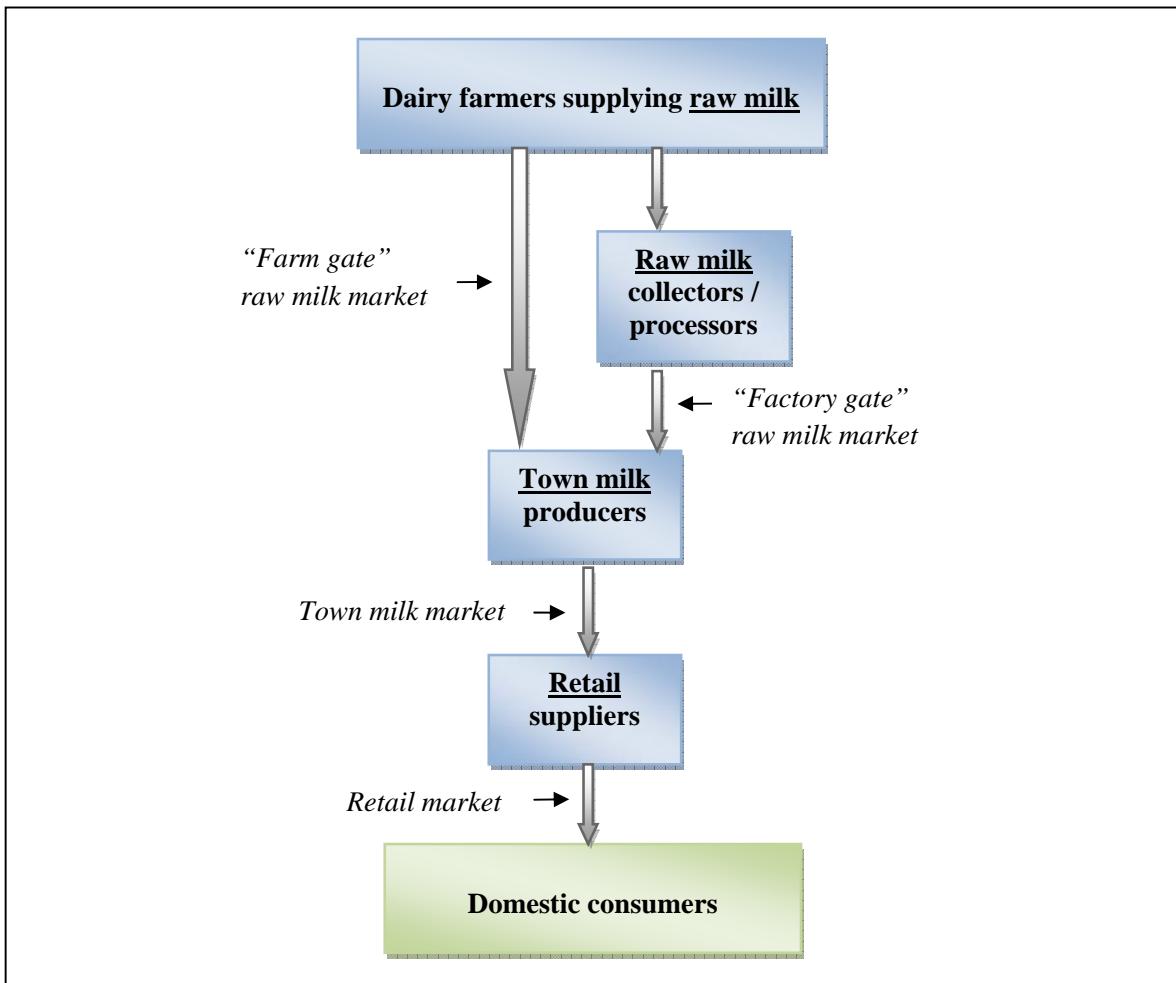
Figure 2 – Comparison of changes in domestic milk prices and international dairy prices



Source: FAO Dairy Price Index and Statistics New Zealand

45. High prices, or sharp rises in prices, will often reflect the fact that demand is high relative to available supply. This appears to be the case at the moment across a broad range of global commodity markets. Part 4 is not designed to address such situations: rather Part 4 is concerned with high prices that reflect the use of market power. Clearly there are global shifts in demand and supply, which likely explain some proportion of the increase in retail prices, and for which Part 4 would not be an appropriate or available response. But it is also possible that there may be competition issues at least partly responsible, for which Part 4 might be appropriate. In the remainder of this review we consider those possible issues.

Figure 3: Illustrative supply chain for domestic milk



Raw Milk

46. Raw milk is unprocessed milk. It is used in the manufacture of town milk and other dairy products, both those sold domestically, and those sold in international markets. The selling price of raw milk does not vary according to whether it will be an input into domestic or international market goods. Raw milk is supplied to processors either directly by farmers (at the "farm gate") or by Fonterra or other processors of raw milk (at the "factory gate").
47. Processors and farmers both have strong incentives to vertically integrate. Raw milk is highly perishable. Farmers therefore require certainty that their raw milk will be collected every day. Farmer co-operatives have developed in New Zealand, and many other countries, to collect and process milk to provide this certainty. Co-operatives collected 93% of milk in New Zealand in the 2009/10 season. Being a member of a co-operative

gives farmers the benefit of this certainty, and the benefit of joint ownership of the processing plant. Alternatively farmers may enter into contracts (for the season, or longer) with co-operatives and investor-owned processors to ensure the collection of their milk. Processors also require some certainty given the sunk costs involved.

48. In 2009/10, the New Zealand dairy industry had:¹¹
 - 11,691 dairy herds;
 - an average herd size of 376 cows;
 - total production of 1.4 billion kilograms of milksolids, or 16.5 billion litres of milk; and
 - about 95% of raw milk supplied in New Zealand was processed for the export market.

History and scope of DIRA regulation of raw milk markets

49. DIRA regulates certain aspects of Fonterra's behaviour in raw milk markets. Therefore, its history and scope is important for understanding raw milk markets.
50. DIRA, among other things, authorised the creation of Fonterra, which resulted in the amalgamation of the then two largest dairy co-operatives in New Zealand and the former New Zealand Dairy Board. As a result of the merger, it was considered that Fonterra would have a dominant market position in a number of domestic New Zealand dairy markets.¹² DIRA provides measures designed to mitigate the risks associated with that dominant position.
51. One of the purposes of DIRA is “to promote the efficient operation of dairy markets in New Zealand by regulating the activities of Fonterra¹³ to ensure New Zealand markets for dairy goods and services are contestable”.¹⁴
52. Subpart 5 of Part 2 of DIRA regulates dairy markets and imposes certain obligations on Fonterra. The purpose of the subpart is “to promote the efficient operation of dairy markets in New Zealand” (section 70). The subpart promotes a number of principles, under section 71, including:¹⁵
 - independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets;

¹¹ Livestock Improvement Corporation, 2009/10 New Zealand Dairy Statistics.

¹² Facilitation of the Proposed Dairy Industry Merger: Paper One (9 April 2001), Hon Jim Sutton, Minister of Agriculture, paragraph 19.

¹³ References to “new co-op” in the legislation have been replaced with “Fonterra”.

¹⁴ Section 4(f).

¹⁵ Sections 71(a) to (c).

- Fonterra must accept applications by new entrants and shareholding farmers to supply it with milk, as shareholding farmers; and
 - Fonterra must not discriminate between new entrants and shareholding farmers whose circumstances are the same.
53. To that end, subpart 5 sets out various rules that govern certain aspects of Fonterra’s behaviour,¹⁶ including:
- Fonterra’s obligation to accept applications to supply Fonterra with milk, and the right of shareholding farmers to cease or reduce the supply of milk (the open entry and exit regime);
 - a rule allowing Fonterra shareholding farmers to supply up to 20% of their weekly production to independent processors (the “20% rule”); and
 - rules ensuring that, at any time, at least a third of the milksolids produced within a 160 kilometre radius of any point in New Zealand is supplied either under contracts with independent processors, or under short-term contracts with Fonterra.
54. DDIRA also provides for the Regulations, which currently require Fonterra to supply up to 600 million litres of milk to independent processors at a regulated price. The supply of raw milk under the Regulations is discussed below in paragraphs 75-89.
55. The regulatory framework under subpart 5 is intended to foster sufficient actual and potential competition to ensure dairy markets, and Fonterra, operate efficiently. The Regulations provide an access regime for raw milk.¹⁷ In interpreting the regulatory framework the Courts have held that:
- the regulatory machinery in subpart 5 is focused on the promotion of competition both at the farm gate and in downstream markets; and
 - the concept behind the Regulations was that independent producers would be able to access raw milk at the same price as Fonterra, so that they could then compete in downstream markets.¹⁸ The Regulations are intended to constrain Fonterra’s ability to use its market power to raise raw milk prices.¹⁹ They were intended to deliver “a level playing field for all processors in relation to their raw milk costs” for competition by independent processors.²⁰

¹⁶ The Commission’s power under subpart 5 of Part 2 to determine disputes is described in the following section.

¹⁷ *Commerce Commission v Fonterra Co-Operative Group Ltd* CA175/05 4 May 2006 at (23).

¹⁸ *Fonterra Co-Operative Group Ltd v The Grate Kiwi Cheese Company Ltd* (2011) NZCA 67 at (4), (46).

¹⁹ *Commerce Commission v Fonterra Co-operative Group Ltd* (2007) 3 NZLR 767 at (13) and (40).

²⁰ *Ibid* at (2).

Supply at the farm gate

- 56. Farmers supply raw milk to processors, who collect it from farms. Fonterra and other processors purchase it under supply agreements.²¹ This is referred to as “farm gate” supply. About 96-97% of raw milk is ultimately processed by the processor who collected it. About 95% of raw milk supplied in New Zealand is processed for the export market.
- 57. Most independent processors (apart from Tatua and Westland, which existed prior to the formation of Fonterra (see paragraph 62 below for more details)), have said that in order to attract farmer suppliers, they have had to pay a premium above Fonterra’s farm gate price.
- 58. Processors who exclusively produce town milk need a constant supply of raw milk all year round. For such processors, getting supply exclusively from farmers is problematic as most farmers have an uneven supply curve, with a glut of milk in October, less in the “shoulders” of the season and none in the winter.
- 59. Raw milk also can be purchased from farmers under the “20% rule”. Fonterra shareholder farmers are entitled, under the DIRA, to supply up to 20% of their weekly production to independent processors. Farmers may not allocate to independent processors in any month other than October a higher percentage of their weekly production than their average weekly allocation to independent processors in October. The milk allocated to independent processors also must be stored in a separate vat on the farm. Of the processors interviewed in relation to this review, only one purchased milk under the 20% provision.

Parties which collect and process raw milk

- 60. Fonterra is the largest milk processor in the world. It sells to more than 140 countries. Fonterra collects the majority of New Zealand’s raw milk (about 89% in the 2009/10 dairy season). It is required to accept applications for shareholding supply from anywhere in the country, with limited exceptions.²²
- 61. Fonterra is owned by its shareholder suppliers. It had approximately 11,000 shareholders in 2009/10.²³ Fonterra pays its shareholder suppliers by way of an annual payout. The payout is broken down, or unbundled, into a Milk Price (the farm gate price) and Distributable Profit (the dividend).
- 62. Tatua Co-operative Dairy Company Limited and Westland Milk Products Limited, also both co-operatives, were in existence prior to the formation of Fonterra.²⁴ Both also collect

²¹ In the case of co-operatives like Fonterra, the “purchase” could be viewed as an internal arrangement within the co-operative, splitting up the earnings from processed products into returns for milk supply as distinct from returns to collective ownership of the processing facilities.

²² Sections 94 and 95 of DIRA detail the exceptions.

²³ It also purchases some milk on a contract basis.

²⁴ Tatua was established in 1914 and Westland was established almost 70 years ago.

directly from their respective shareholder farmers. Neither Tatua nor Westland generally sell raw milk, nor supply processed fresh milk to the domestic market. In the 2009/10 season, Tatua collected about 0.8% of New Zealand's raw milk, and Westland collected about 3.2%.

63. Tatua and Westland both pay their shareholder suppliers by way of payouts as well. Neither unbundles the payout into a farm gate milk price and dividend portions. Both have nominal share values.
64. Tatua is located at Tatuanui, in the Waikato, and its shareholders are located immediately surrounding the plant. Westland's headquarters are in Hokitika on the West Coast. Historically, Westland's shareholders were all located within the boundaries of the West Coast Region. Westland recently has expanded to accept shareholders in the Canterbury area. At the present time, Westland brings regulated milk over the Southern Alps by train. During the 2009/10 season, Westland opened a new storage facility in Rolleston in Canterbury. It has plans to build a milk concentrating plant at Rolleston by 2012, which would make it more economical to take milk over the Southern Alps to Hokitika for processing.²⁵
65. Other recent entrants to the New Zealand dairy industry collected almost all of the remaining 7% in 2009/10:
 - Open Country Dairy Limited (approximately 4.1%),²⁶
 - Synlait Milk Limited (approximately 1.5%);
 - New Zealand Dairies Limited (approximately 0.80%).
 Less than 0.2% was collected by smaller processors, some of which are processors of fresh pasteurised milk.
66. Open Country Dairy produces a range of milk powders, milk proteins, milk fats and cheeses. The business commenced with Open Country Cheese Company Limited, starting production in 2004. Dairy Trust Limited took over Open Country Cheese in 2008, and the two companies became known together as Open Country Dairy. The company now has three sites, Waharoa, Awarua and Wanganui. It has a capacity of about 800 million litres of milk per annum. Open Country exports to around 45 countries worldwide.²⁷ Open Country is majority owned by Affco New Zealand Limited, which is ultimately owned by Talley's Group Limited.

²⁵ Otago Daily Times Online Edition, 16 April 2011.

²⁶ In the 2009/10 dairy season, Open Country Dairy Limited was two separate entities: Open Country Cheese Company Limited and Dairy Trust Limited.

²⁷ See <http://www.opencountry.co.nz/page/6-about-open-country>.

- 67. Synlait Milk Limited is a milk processor and marketer owned by Synlait Limited and Bright Dairy of China. Synlait Milk originated as a wholly owned subsidiary of Synlait Limited, a company established to own a group of farming businesses in the Canterbury region. It is located north of the Rakaia River in Canterbury. Synlait commenced production in 2008. It manufactures raw milk into milk powder and Anhydrous Milk Fat (AMF) as ingredients for dairy consumer companies or repacking under customer brands. Synlait plans to expand its specialised milk powder production facilities in the next 18 months. Synlait currently collects about 300 million litres of milk a year from 90 contracted suppliers. It intends to collect 500 million litres in the 2011/12 season from 140 suppliers.²⁸
- 68. New Zealand Dairies Limited is located in Studholme, and is majority owned by Nutritek Overseas Pte Limited. It was established in 2006. NZ Dairies makes milk powder for export, mostly to China, other parts of Asia, the Middle East and Africa.
- 69. Another entrant to the industry, Miraka Limited, will commence operation in 2011-12 and has signed up farmer suppliers for that season. It is building a plant at Mokai, 30 kms northwest of Taupo. Its immediate focus will be the production of milk powder. Miraka intends to take regulated milk during its start-up phase. Plant capacity will be over a million litres per day.²⁹ Miraka is supported by Wairarapa Moana, Taupopaki Trust, Waipapa 9 Trust, Hauhangaroa Partnership, Tauhara Moana Trust and Huiarau Farms. These organisations provide a supplier base to Miraka.
- 70. New Zealand Dairy Processing Limited is another new entrant that is processing raw milk into UHT milk and baby formula for export.³⁰ It commissioned a UHT plant in Tauranga in January 2011. Full processing capacity will be []. It does not have its own farmer suppliers at this time and relies on factory gate milk from Fonterra.

Fonterra's farm gate price

- 71. Fonterra sets the farm gate milk price using its Milk Price Manual. The manual calculates the price a notional efficient milk export business within Fonterra would pay suppliers. To do this, it calculates the revenues, at world prices, from a set of “reference commodity products” (primarily milk powder) and subtracts the processing and manufacturing costs of the notional commodity business, and then divides by the relevant quantity of raw milk. This has been called a “hypothetical efficient competitor” approach.
- 72. In simplified form, the farm gate raw milk price is calculated as follows:

²⁸ See <http://www.maf.govt.nz/Portals/0/Documents/news-resources/consult/regulatory-regime-fonterras-restructuring-submission.pdf>

²⁹ Ibid.

³⁰ NZ Herald, *Natural Dairy, blocked on Crafar Farms, still gets kiwi milk*, 21 June 2011.

Fonterra's Farm Gate Raw Milk Price

= Notional Revenue
 – Notional Opex³¹
 – Notional Tax
 – Notional Depreciation (Net of Revaluations)
 – Post-Tax Weighted Average Cost of Capital × (Notional Value of Fixed Assets plus Net Working Capital)

/ Total Milk Solids

73. The Milk Price Manual states that Fonterra's Board can pay an amount above the milk price derived according to the manual. Fonterra notes that the Board has not, to date, used its discretion to set a Milk Price above the price determined by the Milk Price Manual.³² Ultimately, Fonterra's total earnings limit the maximum feasible price that Fonterra could sustainably pay farmers (and similarly for other co-operatives), so world prices limit farm gate milk prices.
74. The farm gate and default milk prices for a season are not known until after the end of the season, up to 15 months after some of the milk has been supplied to or by Fonterra. Such a retrospective approach has been used historically by dairy co-operatives and is used currently by investor-owned and co-operative processors. The final farm gate milk price for a season is not known until the payout is announced, after the final product made from the milk collected during the season is sold.

Supply at the factory gate under the Regulations

75. Factory gate supply of raw milk is supply that is not purchased directly from farmers. Instead, it is purchased from another processor who has collected it from farms. In New Zealand, most of this supply comes from Fonterra.
76. The majority of sales by Fonterra at the factory gate are made under the Regulations, which stipulate that Fonterra must supply raw milk to independent processors³³ subject to certain conditions.³⁴

³¹ Fonterra refers to 'operating costs' as including tax and depreciation. The term 'opex' is used here to refer to operating costs net of depreciation and tax, consistent with the use of the term in the input methodologies set under Part 4.

³² Response to question 2, Questions for Fonterra of 26 April 2011, 4 May 2011.

³³ Regulation 3(2) records that the term "independent processor" is defined in s 5 of DIRA. That definition is as follows:

(a) ... a processor of milk or milksolids or dairy products who is not an associated person of []; and

(b) includes [] and any associated person of that company other than []

³⁴ Regulation 4 provides that Fonterra must supply raw milk to independent processors subject to regulations 5 to 15.

77. Fonterra is required to supply up to 600 million litres per season to independent processors.³⁵ This was equivalent to around 3.6% of New Zealand's total milk production in 2009/10.³⁶ Individual independent processors are limited to 50 million litres per season at the regulated price, except for Goodman Fielder, whose limit is 250 million litres per season.
78. The Regulations set out the default milk price payable by an independent processor for regulated milk if they do not agree a price directly with Fonterra.³⁷
79. The default milk price for a season is the farm gate milk price plus \$0.10³⁸ per kilogram of milksolids, plus the reasonable cost of transporting the raw milk to the independent processor.³⁹
80. The farm gate milk price is defined as the “total cost of milk divided by kilograms of milksolids”. The “total cost of milk” means the sum of all payments made by Fonterra⁴⁰ to shareholding farmers for the raw milk supplied to Fonterra less the total organic milk and winter milk premiums for the season.^{41,42}
81. When independent processors purchase milk at the default milk price, they initially pay the forecasted farm gate milk price plus 10 cents per kgms. Fonterra forecasts this price on the basis of what it thinks it will earn in world markets throughout the season. At the end of each quarter, the price is re-forecast by Fonterra, and a new price applies for each quarter.
82. At the end of the quarter, independent processors pay or receive from Fonterra a “wash-up” payment for any difference between the previous forecasted payments and the updated forecast or, if it is the end of the season, the actual default milk price at the end of the year. Independent processors have advised the Commission that, in recent times of rising

³⁵ Regulation 11.

³⁶ In 2009/10, 462 million litres of regulated milk was supplied by Fonterra, which is about 2.8% of total milk collected in New Zealand, and about 3% of the total milk collected by Fonterra in that year.

³⁷ Regulation 8(1) and (2).

³⁸ The 10 cent margin is intended to “represent the cost of a square supply curve” (Explanatory Note to the Dairy Industry Restructuring (Raw Milk) Amendment Regulations 2010). In essence, the Regulations allow independent processors to obtain up to 10% more raw milk in shoulder months (excluding winter months) than at the peak of the season in October. (This is the “October Rule” described at paragraph 85 below.) Milk in shoulder months is more valuable than milk in October. The 10 cent margin reflects this additional cost. (See page 14 of the MAF report on Dairy Industry Restructuring (Raw Milk Pricing Methods) Bill for further details.)

³⁹ Regulation 8(5) and (6). The wholesale milk price formula was amended on 1 June 2010 by the Dairy Industry Restructuring (Raw Milk) Amendment Regulations 2010. Prior to the change, the formula was not directly linked to Fonterra’s farm gate milk price. The previous formula for the wholesale milk price was:

(total payout + ‘Fonterra’ retention - annualised share value)

kilograms of milksolids

⁴⁰ Including interconnected bodies corporate of Fonterra.

⁴¹ Non-shareholders contracted to provide milk to Fonterra may not receive equivalent payments for their milk.

⁴² Regulation 3(1).

international milk commodity prices, they have often been left with large bills to pay. Although high world prices mean that exporting processors will generally have sold their production on favourable terms, they will be left in doubt about their ultimate input costs.

- 83. In order to avoid this uncertainty, some processors agree a price with Fonterra on a quarterly basis. Processors generally pay a premium to do this, and take the risk that the prices may fall.
[
]. The current interdepartmental review of the Raw Milk Regulations is considering whether “wash-up” payments should have a role in the default milk regime.
- 84. Processors also can reduce their exposure to price fluctuations by purchasing whole milk powder futures contracts on the NZX Dairy Futures Market.
- 85. There are limits on the volume of milk that an independent processor can purchase under the Regulations during certain parts of the season. These limits recognise that milk is most abundant during the peak of the season. The effect is to limit the volume of regulated milk an independent processor can require in the months other than October from August to May to 10% above the volume of milk required in October (the usual peak supply month).⁴³ This is colloquially known as the “October Rule”.
- 86. An independent processor must provide Fonterra with an estimate for the volume of milk it requires each day, at least three months, and again at least one week, before the supply of that milk is to occur. For winter milk that exceeds 20,000 litres in one day, an independent processor must provide Fonterra with an estimate at least 18 months prior to the supply and again at least one week prior. The one week estimates must be between 40% more and 40% less than the three (or 18, in the case of winter milk) month estimates.⁴⁴
- 87. The independent processor may require Fonterra to supply up to 120% of the one week estimate. Fonterra may require independent processors to buy up to 80% of the one week estimate.⁴⁵
- 88. Winter milk is costly to produce, and is most costly in the colder regions of the country. The Regulations provide for Fonterra to charge a premium for winter milk (milk supplied in June or July) equivalent to the premium it pays its farmers to produce that milk. These costs vary by island and are greater than \$2/kgMs in the South Island. This compares to a farm gate price of \$6.10 for the 2009/10 season.

⁴³ Regulation 8(3).

⁴⁴ Regulations 5, 6 and 7.

⁴⁵ Regulation 10.

89. Fonterra sets the price of its winter milk with the aim of obtaining just enough to meet the domestic demand for fresh winter milk. It is generally not profitable to have farmers produce milk in winter to manufacture commodity products with long-lives, such as milk powder or, to a lesser extent, cheese.

Other supply at the factory gate

90. Fonterra also sells raw milk outside the Regulations. Some purchasers may not have fulfilled the requirements of the Regulations, such as the notice provisions. Others may prefer not to take the regulated milk with its related risk of price increases and wash-up payments (as discussed at paragraph 83 above).
91. Some other processors supply raw milk at the factory gate from time to time. This seems to occur only by exception, often in situations where a processor is capacity-constrained.

Town Milk Producers

92. Milk sold for fresh consumption in New Zealand is described as town milk.
93. Historically, town milk processors sourced raw milk from farms dedicated to supplying year-round milk for the town milk market. Manufacturing processors sourced their milk from different farms. The contracts with town milk farms provided incentives to produce year-round, and penalties for failure to meet quotas. The farms were generally located close to population centres.
94. Many town milk companies were acquired by manufacturing dairy co-operatives⁴⁶ following the deregulation of the town milk industry in 1993. The dairy co-operatives no longer have separate suppliers for town milk and manufacturing milk. Instead, co-operatives pay a premium for winter milk, which is necessary to produce town milk. The winter premium reflects the additional input costs associated with producing out-of-season milk. For the remainder of the year, no distinction is made between raw milk supplied for town or manufacturing purposes.⁴⁷ This means that there are no longer financial incentives to produce a flat milk supply curve. Far fewer farmers now produce a flat milk supply curve as a result. Rather some farmers schedule calving in order to produce a milk supply curve that peaks in the winter months. Town milk processors, if they were to source milk directly from farmers under this system, would have to purchase milk from different farms at different times of the year. Currently, town milk processors rely, to varying degrees, on factory gate milk to maintain a flat supply curve.

⁴⁶ Co-operatives who manufactured other dairy products, such as butter and cheese, from raw milk. Such manufacturers can, and often do, have more seasonal production patterns, due to the longer life of such manufactured products compared to fresh processed milk.

⁴⁷ Paragraph 91, Commerce Commission, *NewCo Draft Determination*, 27 August 1999.

Parties who supply town milk

95. Two processors supply the majority of the processed fresh milk in New Zealand: Goodman Fielder New Zealand Limited and Fonterra Brands Limited (a wholly-owned subsidiary of Fonterra).
96. Goodman Fielder processes about [] million litres of fresh liquid milk for domestic consumption. All of this milk is acquired in its raw form from Fonterra under the Regulations as discussed below.
 [

]
97. Town milk processors supply fresh pasteurised milk under their own branded labels. Fonterra Brands' branded labels include Anchor and Dairy Dale. Goodman Fielder's branded labels include Meadow Fresh and Cow and Gate. This milk is generally distributed through franchisees, who either deliver orders for Fonterra Brands or Goodman Fielder, or purchase and on-sell it (mainly to the route trade).
98. The supermarket chains in New Zealand (Foodstuffs and Progressive) also contract town milk processors to process "private label" milk for sale under the supermarkets' own labels.
 [

]
99. A few smaller town milk processors currently operate in New Zealand. In the North Island, Fresha Valley operates in Waipu in Northland. It has contract suppliers, and supplements that supply by purchasing milk from Fonterra in the winter months. Fresha Valley provides the Progressive stores north of Auckland with private label milk.
100. Green Valley Dairies Limited opened in June 2003 and is located on Marphona Farms, Mangatawhiri, south of Auckland. Green Valley collects organic milk from Marphona Farms, but also obtains factory gate milk from Fonterra. It processes both organic and non-organic milk. Green Valley also produces a range of milk and cream and does contract packaging and distribution. It distributes to the greater Auckland area and to Hamilton, rural Waikato, Coromandel, Tauranga, Rotorua, Hawke's Bay, Wellington, and Palmerston North.
101. Biofarm Products Limited collects organic raw milk and produces organic milk and yoghurt in Palmerston North on its own farm and under its own brand, on a small scale.
102. Zany Zeus, in Wellington, produces fresh organic milk, cheese and fermented products. It buys milk from various sources including
 [

].

103. Klondyke Fresh is a South Island raw milk processor and milk and groceries distributor. It sources milk from Fonterra. In addition to selling to businesses, it provides home delivery of milk.
104. Natural Dairy Products Limited is a small Canterbury-based manufacturer of dairy products in Leeston just south of Christchurch. It sources milk from Fonterra, []. It produces Al & Sons milk and ice cream.

The retail supply of milk

105. Milk is supplied to domestic consumers by supermarkets and retailers in the “route trade”. Route trade retailers include petrol stations, dairies, The Warehouse, produce shops and small grocers. In this report, we generally focus on supermarkets, while considering the competitive constraints from other retailers.
106. There are two main supermarket chains in New Zealand: Foodstuffs (N.Z.) Limited⁴⁸ and Progressive Enterprises Limited
 - Foodstuffs has three supermarket banners: Pak ‘n Save, New World and Four Square.⁴⁹ Foodstuffs operates 45 Pak ‘n Save stores, 132 New World stores and 282 Four Square stores;
 - Progressive has three supermarket banners: Countdown, Woolworths and Foodtown. Progressive operates 150 supermarkets made up of 77 Countdown stores, 48 Woolworths stores and 25 Foodtown stores.

Complaints

Competitors

107. Some independent processors have complained that Fonterra has been “inflating” the farm gate milk price at the expense of the dividend since the introduction of the Milk Price Manual and the “unbundling” of the payout.
108. They also link the “inflation” of the milk price to Fonterra’s move away from the fair share value. Fonterra moved away to using a “restricted share value” in 2009. This reflected that shares can only be owned by Fonterra’s suppliers. It resulted in a share price roughly 20% less than previously: from (\$4.52 to \$3.83). However, Fonterra has “fixed” the share price at \$4.52 until the restricted value exceeds that price.⁵⁰

⁴⁸ Foodstuffs operates as three separate entities: Foodstuffs (Auckland) Limited, Foodstuffs (Wellington) Co-operative Society Limited, and Foodstuffs South Island Limited.

⁴⁹ Foodstuffs also owns the retail brands Write Price, Shoprite, On the Spot and On the Spot Express.

⁵⁰ Some independent processors have submitted that the price would have increased to \$5.10 if the methodology had not been changed. []

109. Some independent processors have submitted that this has increased the cost of milk that they purchase at the farm gate in two, linked ways:
- the increase in Fonterra’s farm gate price at the expense of the dividend increases the price that independent processors must offer farmers to obtain supply; or equivalently
 - the reduced share price has reduced incentives for farmers to switch, increasing the price independent processors must offer.
110. Furthermore, some independent processors argue that, as the default milk price is based on the farm gate price, the default milk price has also increased further increasing their costs.
111. In particular, they have submitted that:
- Fonterra has the ability and incentive to distort the farm gate milk price and default milk price:
 - it is not effectively constrained by the Regulations regarding the default milk price;
 - it has the incentive to damage downstream competition to maximise its profits in those markets; and
 - it has the incentive to drive up the default milk price to maximise its profits;
 - the calculation to establish the farm gate milk price is systematically distorted by the assumptions used by Fonterra;
 - in particular, the “notional” approach used by Fonterra (as set out in the Milk Price Manual) is not justified and gives ample opportunity for Fonterra to “game” assumptions;
 - Fonterra can (and does) manipulate assumptions at the end of the season to maximise the farm gate milk price, with hindsight of how to apply assumptions to do so;
 - the alleged increase in Fonterra’s farm gate milk price is said to increase rival processors’ costs and harm competition from processors. The alleged increase in the farm gate price leads to an increase in the default milk price with a similar effect in downstream markets; and
 - the reduction of the share value (and the move away from the fair value share) has undermined the open entry and exit provisions of the DIRA. This is because a key reason why farmers switch away from Fonterra has been to recover share capital. The argument is that reducing the value of shares, reduces the incentive for farmers to switch away from Fonterra, undermining competition for farmers’ supply.
112. Some independent processors have linked the changes (in how Fonterra calculates its farm gate price, and the related reduction in share price) to reduced profitability for several

independent processors. In particular, they consider that small variations in raw milk prices could undermine the viability of investor-owned processors set up in recent years given the “high volume, low margin” nature of their businesses.

Consumers

113. Complaints from consumers generally have stated that the price of milk is too high, particularly in relation to the retail price of milk overseas, in particular in Australia.

Summary

114. Broadly, we have received two main complaints relevant to whether to launch a Part 4 inquiry:

- the retail price of milk is artificially high. If this is true, it could be because of excessive profits and lack of efficiency at one or more of the levels of the supply chain, reflecting a lack of competition at the relevant level. We therefore have assessed whether to initiate a Part 4 inquiry at each level of the supply chain; and
- the price that independent processors need to pay for raw milk is too high, as Fonterra is increasing the farm gate price at the expense of the dividend and, in a linked move, artificially reducing its share price. If this is true, it is possible that the difficulty in getting access could harm competition from independent processors in upstream markets for acquisition and downstream markets for processing and supply. This is therefore primarily an access problem. We consider below how Part 4 could address an access problem in markets for raw milk.

115. We consider below whether these complaints warrant the Commission launching a Part 4 inquiry.

PART 4 OF THE ACT

116. In exercising its powers under Part 4, the Commission must have regard to the purpose of Part 4. Section 52A of the Act states that the purpose of Part 4 is:

‘...to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
- (d) are limited in their ability to extract excessive profits.’

117. Section 52G of the Commerce Act sets out three tests which the Commission must be satisfied are met before it could recommend that the Minister regulate goods or services:

- first, the goods or services are supplied in a market where there is little or no competition; and little or no likelihood of a substantial increase in competition (the Competition Test);
- second, there must be scope for the exercise of substantial market power in relation to the goods or services taking into account existing regulation and arrangements (the Other Constraint Test); and
- third, the benefits of regulating the goods or services in meeting the purpose of Part 4 materially exceed the costs of regulation (the Net Benefit Test).

118. If these threshold tests are met, the Commission must then consider whether regulation should be imposed and, if so, in what form.⁵¹

119. Appendix 2 sets out the key elements of Part 4.

The Competition Test: s 52G(1)(a)

120. Regulation under Part 4 may only be recommended for markets where the Competition Test is met. The Competition Test contains two limbs:

- little or no competition; and
- little or no likelihood of a substantial increase in competition.

121. We consider these limbs in turn below.

Little or no competition

122. A market with little or no competition would be one in which the supplier or suppliers:

- are subject to little or no constraint from each of:
 - the rivalry from existing suppliers;
 - the threat of timely entry by new suppliers;
 - the countervailing market power held by others in upstream markets and downstream markets; or
 - the threat of substitution by other goods and services;⁵² and

⁵¹ Section 52I.

⁵² Porter M.E., On Competition, Harvard Business Review Book Series, Boston, MA, 1998, p. 86.

- are likely to exhibit characteristics consistent with a “natural monopoly”, although this is strictly speaking not a requirement for the imposition of regulation.
123. While the test does not require monopoly, a firm facing little or no competition would have the power to act independently of its competitors, customers or other constraints.⁵³

Little or no likelihood of a substantial increase in competition

124. The second limb of the Competition Test relates to the prospect of a substantial increase in competition such that regulation should not be imposed even though the first limb might be met:
- in practice, the second limb requires consideration of whether the root cause of market power in the market is durable. Given that regulation is likely to be imposed for a substantial period of time (up to 20 years),⁵⁴ the appraisal should not be limited to immediate or short term changes; and
 - the test covers entry, expansion and any other reason why the intensity of competition may change.
125. This limb, therefore, requires the Commission to consider whether a real and substantial change to one of the factors driving competition might well happen in the medium term.

The Other Constraint Test: s 52G(1)(b)

126. The Commission then must consider whether the suppliers of the goods or services have scope to exercise substantial market power, taking into account the effectiveness of “existing regulation” or “arrangements”. In the Commission’s view:
- the purpose of the test is to determine whether, notwithstanding that the Competition Test is met, regulation should not be imposed because suppliers are in some other way constrained or incentivised;
 - the concept of “scope” includes dimensions of both time (how often and for how long) and magnitude; and
 - the focus on the effectiveness of existing regulatory regimes and arrangements requires consideration of both their content, and how they have responded to previous supplier behaviour.

⁵³ While the Commission does not need to decide the precise boundaries of the competition test in this case, it considers that a firm subject to “little or no competition” would share many of the characteristics of a dominant firm as explained by Richardson J in *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1992) 3 NZLR 429 (CA) (the “Amps-A” decision) at 442.

⁵⁴ Section 52N.

127. The Other Constraint Test therefore requires the Commission to evaluate the constraint imposed by all of the potentially relevant regulatory and other arrangements, and consider whether suppliers nonetheless retain the scope to exercise their substantial market power.

The Net Benefit Test: s 52G(1)(c)

128. Under Part 4 of the Act the Commission is not required to consider the third threshold requirement, the Net Benefit Test, unless it considers that the Competition and Other Constraint tests are met.⁵⁵
129. As part of a full inquiry, the Commission must, as far as practicable:⁵⁶
- assess qualitatively all material long-term efficiency and distributional considerations;
 - quantify:
 - the material effects on allocative, productive, and dynamic efficiency; and
 - the material distributional and welfare consequences on suppliers and consumers; and
 - assess the direct and indirect costs and risks of regulation, including administrative and compliance costs, transaction costs, and spill-over effects.

Part 4 does not apply to the acquisition of goods or services

130. In the Commission's view it is clear from the text, design and legislative history of Part 4 that it was not intended to regulate markets for the benefit of the upstream suppliers where the acquirer of goods or services had a high degree of market power.

⁵⁵ Section 52G(2).

⁵⁶ Section 52I.

131. This view is held because the plain text of the legislation refers throughout to “suppliers”, which are regulated in the interests of “consumers”. The language is clearly different from the supplier/acquirer dichotomy used under the old Part 4, which could have permitted such regulation. If Part 4 was intended to deal with monopsony problems then one would expect to see substantially different provisions within the Part.

Interaction between DIRA and Part 4

132. A key issue in a full inquiry would be the interaction between DIRA and Part 4. This would be a factor in the assessment of the Other Constraints Test and the Net Benefits Test.

Differences in objectives

133. In theory, DIRA and Part 4 could be applied together. DIRA could provide the obligation for an access regime, and Part 4 could determine a regulated price.⁵⁷

134. However, the objectives of DIRA and Part 4 are different:

- DIRA seeks to promote contestability in New Zealand markets for dairy goods and services;⁵⁸ and
- the purpose of Part 4 is to promote the long-term benefit of consumers ... by promoting outcomes that are consistent with outcomes produced in competitive markets.⁵⁹ Competitive markets in this context means workably competitive markets.⁶⁰

135. In the Commission’s view, it is fair to presume that Parliament intended the two pieces of legislation to apply different competition tests. If Parliament had intended Part 4 and DIRA to apply the same competition tests, it would have used the language of ‘contestability’ when the new Part 4 was enacted in 2008. Whether or not applying these concepts would result in different regulated pricing principles⁶¹ and/or price is an open question and ultimately depends on the characteristics of the market in question. If we had proceeded to launch a Part 4 inquiry, we would have considered this question as part of that work.

Differences in the form of regulation provided for by legislation

136. DIRA and Part 4 provide for different forms of regulation. Thus, even if the same competitive standard applied (which as discussed above seems unlikely), the pricing methodologies / prices that result from the regulation are unlikely to be the same.

⁵⁷ Part 4 does not provide for an obligation to supply, as DIRA does.

⁵⁸ See paragraph 51 above and s 4(f).

⁵⁹ See paragraph 116 and s 52A.

⁶⁰ Competition is defined in section 3 of the Act as workable or effective competition.

⁶¹ By ‘pricing principles’ we mean the competitive standard or benchmark used to inform regulation of prices rather than the detailed pricing methodology.

137. Section 115 of the DIRA allows for regulations (among other things):

- requiring Fonterra to supply (among other things) raw milk, components of milk, and products derived from milk; and
- specifying the price(s) or pricing methodology to apply, as well as other terms of supply.

138. DIRA allows for regulations to impose a supply obligation on Fonterra, and provides considerable flexibility as to the form price regulation may take. Therefore DIRA specifically provides for regulation of access to milk, as well as the price. An access regime of this nature seems appropriate given the characteristics of the market, and in particular Fonterra's role as a dominant, forward integrated, supplier of raw milk.

139. Part 4 regulates the supply of goods and services, but does not incorporate any supply obligation. This is not consistent with the access regulation model provided for by DIRA.

Key elements of this review

140. Under this review, the Commission has considered whether a full Part 4 inquiry is warranted. To address that question, the Commission has assessed:

- what are the relevant market definitions within which to study the goods and services that might be regulated?
- does the available evidence suggest that the tests under s 52G may be met for any of the relevant markets?
- is there any matter which would bear on the decision whether to recommend regulation or launch an inquiry?

RELEVANT MARKETS

141. This section considers the relevant markets for the purposes of the assessment in this paper. The purpose of market definition is to define the area of close competition between firms. Market definition is an analytical tool for the purposes of analysing competition (and market power).

142. Section 3(1A) of the Act defines a market as:

‘...a market in New Zealand for goods or services as well as other goods and services that, as a matter of fact and commercial sense, is substitutable for them.’

143. In *Telecom Corporation of NZ Ltd v Commerce Commission* the High Court stated:⁶²

- a market is the area of close competition between firms and the field of rivalry between them; and
- within a market there is the possibility of substitution on both the demand and supply sides in response to a small yet significant and non-transitory increase in price (SSNIP), assuming all other terms of sale remain constant.⁶³

144. When defining the relevant markets, the Commission may consider five distinct characteristics or dimensions:⁶⁴

- the goods or services supplied and purchased (the product dimension);
- the level in the production or distribution chain (the functional dimension);
- the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic dimension);
- the temporal dimension; and
- the customer dimension.

145. However, as noted by the High Court in the *AMPs-A* case:

‘... []he boundaries [] should be drawn by reference to the conduct at issue, the terms of the relevant section or sections, and the policy of the statute. Some judgement is required, bearing in mind that “market” is an instrumental concept designed to clarify the sources and potential effects of market power that may be possessed by an enterprise.’⁶⁵

146. Defining markets is not a goal in itself. Markets should be defined in a way that best assists the analysis of the matter under consideration.

147. In this instance, the Commission is making a decision about whether or not to initiate an inquiry under Part 4 of the Act into the price of milk. Part 4 regulates goods and services supplied in markets where there is little or no competition. Therefore the markets of relevance in this situation are related to the supply, rather than the purchase of goods or services.

⁶² *Telecom Corporation of NZ Ltd v Commerce Commission* (1991) 4 TCLR 473, 501-502.

⁶³ For the purpose of determining relevant markets, the Commission will generally consider a SSNIP to involve a five percent increase in price for a period of one year. (See Commerce Commission, Merger and Acquisition Guidelines, page 15.) For assessing market definition in non-merger cases (e.g., allegations of anti-competitive behaviour), the relevant benchmark is the hypothetical competitive price rather than the prevailing price. Since it is usually unclear what the competitive price would be, the SSNIP test is primarily used in anti-competitive practice investigations as a conceptual framework for considering the various substitution possibilities, rather than as an empirical framework.

⁶⁴ Commerce Commission, Mergers and Acquisitions Guidelines, 1 January 2004.

⁶⁵ *Telecom Corporation of New Zealand v Commerce Commission*, HC WN AP279/90 (10 December 1991) at p 33, reported at (1991) 4 TCLR 473.

148. The Commission has identified the following relevant markets:

- regional markets for the supply of raw milk by farmers to processors;
- North and South Island markets for the supply of raw milk by processors of raw milk to other processors (factory gate supply);
- North and South Island markets for the processing and wholesale supply of fresh pasteurised milk (town milk) to retailers; and
- retail supply of grocery items in supermarkets, including a sub-market⁶⁶ for fresh processed milk (aggregate of local markets).

149. Appendix 3 sets out our reasons for identifying the above relevant markets.

150. The Commission considers that it is not necessary to rigorously define the relevant markets for the purposes of this review. We have relied on markets defined in previous investigations, and considered whether the evidence in this case warrants deviation from those previously defined markets. We do not believe that the conclusions of our analysis would be affected by using other reasonable possible market definitions.

151. We now consider whether a Part 4 inquiry is warranted in each of these markets.

FARM GATE RAW MILK MARKETS – WHETHER TO LAUNCH A PART 4 INQUIRY

152. This section of the report considers whether a Part 4 inquiry into the farm gate raw milk markets is warranted.

153. Our conclusion is that, whether or not there is a competitive problem in farm gate milk markets, Part 4 is not the appropriate remedy. Part 4 provides for the regulation of the *supply* of goods or services. It was not designed to regulate the acquisition of goods and services in markets where the acquirer has a high degree of market power. Accordingly, Part 4 cannot regulate the price and other terms on which Fonterra (or other processors) acquire raw milk from the farm gate. If we were to consider the problem one of supply by Fonterra farmers rather than acquisition by Fonterra, we could not regulate as individual farmers do not have market power. We consider it would not be appropriate to launch a Part 4 inquiry at this time into regional markets for the supply of raw milk by farmers. In

⁶⁶ The role of sub-markets has been accepted by the Courts, although it is acknowledged that caution must be exercised in its application. In *New Zealand Magic Millions Ltd v Wrightson Bloodstock Ltd* [] 1 NZLR 731 at 752, the High Court stated that although the position in New Zealand is different to that in America where it appears liability can attach as a result of dominance or market power in a sub-market, “There is no doubt...that the concept of a sub-market may be used as a convenient tool of analysis of the dynamics of a market.” Similarly, the High Court in *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406 concluded that there is a place for ‘sub-markets’. “Action within a submarket, or market sector, may have repercussions for the pleaded market as a whole.”

any event, we note that an interdepartmental team of officials is currently reviewing how Fonterra sets the farm gate milk price. If the Government ultimately decides there are issues justifying regulation, we consider that this is likely to better address any issues than regulation under Part 4.

MARKETS FOR THE SUPPLY OF RAW MILK AT THE FACTORY GATE BY PROCESSORS – WHETHER TO LAUNCH A PART 4 INQUIRY

154. This section of the report considers whether a Part 4 inquiry into the factory gate raw milk markets is warranted. For the purpose of this review, as discussed above, the Commission has defined North and South Island markets for the supply of raw milk by processors of raw milk to other processors.
155. We consider it likely that Fonterra faces little or no competition in the supply of factory gate milk in the North Island or the South Island. However, we consider it would not be appropriate to launch a full Part 4 inquiry into the factory gate market at this time. In summary, we consider:
 - given the Regulations, it is questionable whether Fonterra has scope to exercise substantial market power in relation to the supply of raw milk to other processors. The Regulations provide an access regime for raw milk and are designed to counter Fonterra's market power. It is premature for us to consider this matter further, given the uncertainty surrounding the outcome of the current interdepartmental review. This review may result in legislative reassessment of whether the current regulatory regime under DIRA and the Regulations achieves the goal of contestability. We anticipate that this review will result in any legislative changes Parliament may think necessary to achieve this goal. We assume that Fonterra's ongoing obligations to supply raw milk to independent processors, both in terms of the obligation to supply and terms of supply, will continue to be prescribed under this legislation. In these circumstances express and effective legislation would address the “scope for the exercise of substantial market power” by Fonterra. For this reason there would be such “Other Constraint” that there would be no case for the Commission to progress to a full Part 4 inquiry in respect of this market;
 - this uncertainty also makes it difficult to properly assess whether Part 4 would deliver net benefits;
 - regulation under Part 4 would overlap with regulation under DIRA and the Regulations. An interdepartmental team currently is also reviewing the effectiveness of the Regulations. The Commission considers it likely that the outcome of the review could lead to a more effective form of regulation for this market than Part 4 could offer. Using Part 4 together with DIRA and the Regulations is unlikely to be the best solution to any problems in factory gate markets; and
 - given the current interdepartmental review of the effectiveness of the DIRA and the Regulations:

- simultaneous reviews by public bodies considering remedies to the same problem is unlikely to be efficient; and
- launching a full inquiry would be premature given that DIRA and the Regulations may change shortly.

156. This section discusses:

- the Competition Test;
- the Other Constraints Test;
- the Net Benefits Test; and
- Other factors relevant to the appropriateness of launching a Part 4 inquiry.

Competition Test

157. In terms of existing competition, Fonterra is the only year around supplier of raw milk to the factory gate. Most of the milk supplied by Fonterra is supplied by obligation under the Regulations.
158. Other processors only supply milk at times when they cannot process it themselves. We estimate that Fonterra accounts for [] of the supply of raw milk to the factory gate in New Zealand.
159. In terms of potential competition, we consider it is not likely that alternative suppliers of sizeable, consistent quantities of milk throughout the year to the factory gate will develop in the medium-term.
160. In theory it might be relatively straightforward for an existing independent processor that already collects milk to supply raw milk to an existing town milk manufacturer or another processor. In practice, independent processors supply relatively little milk to the factory gate. Given the opportunity costs involved (see Appendix 3 paragraph 26 below), we consider independent processors will generally only supply raw milk to the factory gate at times when they have excess supply. We therefore do not consider they are likely to be a material competitive constraint on Fonterra's pricing in this market on a consistent basis. An alternative explanation would be that the price/convenience of default milk means that it is hard for rival suppliers to get business –
[].
161. Any new competitor in this market would need to contract with farmers and invest in infrastructure for the collection of milk for delivery at the "factory gate" (or direct to processors as is the case with Fonterra). We consider the only realistic candidates to

supply raw milk to the factory gate are current or future processors. Any future processor seeking to enter this market also would need to overcome the conditions of entry and expansion in one or more downstream milk processing and wholesale distribution markets.

162. We consider it likely that Fonterra has little or no competition in the supply of factory gate milk in both the North Island and the South Island. We also consider it likely that there is little or no likelihood of a substantial increase in competition in these markets. This is not a surprising conclusion given the intention of the Regulations was to address this issue of limited competition by ensuring independent processors could obtain raw milk at a regulated price.

Other Constraints Test

163. In assessing whether the tests in s 52G are met, the Commission must consider whether the suppliers of the goods have scope to exercise substantial market power, taking into account the effectiveness of “existing regulation” or “arrangements”.
164. Under the Regulations Fonterra must:
 - provide raw milk to independent processors (see paragraph 77 above); and
 - price that default milk at the farm gate price plus 10 cents per kgms (see paragraphs 78-82 above).
165. If the Regulations are effective at constraining Fonterra from having scope to exercise substantial market power in factory gate raw milk markets, then the Commission would not be able to recommend regulation to the Minister.
166. The Regulations require Fonterra to supply milk at the factory gate, which constrains Fonterra’s ability to exercise market power, including by refusing to supply. That leaves the question as to whether Fonterra is pricing milk above competitive levels. To assess this question as part of a full inquiry, the Commission would consider how Fonterra has priced farm gate milk in practice (given factory gate prices are based on farm gate prices). In particular, we would consider whether each of the following are consistent with workably competitive outcomes:⁶⁷
 - the pricing principles adopted by Fonterra in the Milk Price Manual, including the hypothetical efficient competitor approach used (see paragraph 71 above);
 - the detailed pricing methodology used by Fonterra in practice; and

⁶⁷ For a description of the Commission’s approach to those outcomes, see Chapter 2 of the Commission’s Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper of December 2010 for the Commission’s approach to these questions. Available at <http://www.comcom.govt.nz/input-methodologies-for-gas-pipeline-services/>

- Fonterra's application of the methodology.
167. We consider that the Regulations appear to offer some constraint on Fonterra's pricing in the factory gate market. However, the lack of transparency of Fonterra's model and the discretion Fonterra retains to set the price above those calculated by the Milk Price Manual may limit the effectiveness of this constraint. We have not reached a conclusion on whether the assumptions used in Fonterra's model would be appropriate to provide workably competitive outcomes.
168. It is premature for us to consider this matter further, given the uncertainty surrounding the outcome of the current interdepartmental review. This review may result in legislative reassessment of whether the current regulatory regime under DIRA and the Regulations achieves the goal of contestability. We anticipate that this review will result in any legislative changes Parliament may think necessary to achieve this goal. We assume that Fonterra's ongoing obligations to supply raw milk to independent processors, both in terms of the obligation to supply and terms of supply, will continue to be prescribed under this legislation. In these circumstances express and effective legislation would address the "scope for the exercise of substantial market power" by Fonterra. For this reason there would be such "Other Constraint" that there would be no case for the Commission to progress to a full Part 4 inquiry in respect of this market.

Net Benefit Test

169. A Part 4 inquiry would require a rigorous assessment as to whether the benefits of regulating the goods or services in meeting the purpose of Part 4 materially exceed the costs of regulation. In particular this would include a qualitative and quantitative assessment of the efficiency and distributional implications of regulation (see paragraphs 128-129). This section of the report does not undertake rigorous cost-benefit analysis. Rather it identifies those factors which suggest that a net benefit test would not be satisfied on the facts.
170. To assess the net benefits of regulation under Part 4, the Commission would compare the estimated costs and benefits with and without Part 4 regulation. The "without" situation would usually be the status quo, taking into account likely market developments. In this case, the current review of the DIRA regulatory regime is a relevant part of the status quo. That is, the "without" situation is the status quo including any changes to the Regulations, or DIRA, resulting from the current review. Accordingly, the situation without regulation under Part 4 may change. It would, therefore, be difficult to properly assess whether Part 4 would deliver net benefits with any certainty until the outcome of this review is known.⁶⁸

⁶⁸ Some of the observations below on the appropriateness of a Part 4 review would be relevant as part of a full net benefits analysis.

171. However, we observe that there are reasons to consider that using Part 4 may not be the best remedy to any competition problem that exists.
172. The potential competition problem relating to the price of raw milk to the factory gate is primarily related to access (see paragraph 114 above). Raw milk is an essential input for manufacturing downstream products, such as fresh milk. To effectively compete in downstream markets with Fonterra, independent processors need access to raw milk.
173. As part of a Part 4 inquiry, the Commission would need to consider the effectiveness of Part 4 to address this particular access problem by itself. In particular, as Part 4 does not contain an obligation to supply, we would need to consider Fonterra's incentives to supply. As a vertically integrated company its incentives might be different from a non-vertically integrated company.
174. In any event, regulation under Part 4 would overlap with regulation under DIRA and the Regulations. Using Part 4 together with DIRA and the Regulations is unlikely to be the best solution to any access problem in factory gate markets:
 - splitting regulation of the supply of a good or service across two different legislative regimes would not be consistent with good regulatory practice;
 - there is a risk of regulatory inconsistency due to the different objectives of DIRA and Part 4 (see paragraphs 132-135 above);
 - as part of a full inquiry, we need to resolve the effect of any inconsistency between regulation under Part 4 and the Regulations. For example, if the Commission was minded to recommend price/quality regulation under Part 4 of factory gate raw milk markets, we would need to consider how this would interact with the default price of milk which is set at the farm gate price plus 10 cents per kgms under the Regulations; and
 - compliance costs are likely to be higher than under a single regime.

Other factors relevant to the appropriateness of launching a Part 4 inquiry

175. In deciding whether to launch a Part 4 inquiry, it is relevant to consider whether there is any matter which would bear on the decision whether to recommend regulation or launch an inquiry (see paragraph 140 above). For the reasons set out below we will not launch a Part 4 inquiry at this time.
 176. An inter-departmental team of officials are currently reviewing the effectiveness of the Regulations. We are mindful therefore that:
-

- simultaneous reviews by public bodies considering remedies to the same problem is unlikely to be efficient; and
- launching a full inquiry would be premature given that the Regulations may change shortly.

177. The Commission considers it likely that the outcome of the review could lead to a more effective form of regulation for this market than Part 4 could offer.

MARKETS FOR THE PROCESSING AND WHOLESALE SUPPLY OF FRESH PASTEURISED MILK (TOWN MILK MARKETS) – WHETHER TO LAUNCH A PART 4 INQUIRY

178. This section of the report considers whether a Part 4 inquiry into the town milk markets is warranted. For the purpose of this review, as discussed above, the Commission has defined the town milk markets as comprising the processing and wholesale supply of town milk (a) in the North Island and (b) in the South Island.
179. The Commission has concluded that a Part 4 inquiry is not warranted at this time. The reason is that the scope of current rivalry between Fonterra and Goodman Fielder exceeds the “little or no competition” standard in North Island and South Island town milk markets.
180. This section discusses the current state of the raw milk market in light of the Competition Test. We do not address other elements of the s 52G test.

Existing competition

181. Market shares for the town milk markets in the North and South Islands are set out in Table 1 below.

Table 1: Town milk market shares in North Island and South Island by volume⁶⁹

Processor	Volume of town milk sold on in North Island	Market share of North Island	Volume of town milk sold in South Island	Market share of South Island
Fonterra Brands	[]	[]	[]	[]
Goodman Fielder	[]	[]	[]	[]
Fresha Valley	[]	[]		
Green Valley	[]	[]	[]	[]
Klondyke	[]	[]	[]	[]
New Zealand Natural Dairy			[]	[]

Sources: data provided by town milk processors

182. As can be seen, Fonterra and Goodman Fielder account for more than 90% of town milk sales in each island.
183. Goodman Fielder has stronger brand loyalty for its Meadow Fresh brand in the South Island (perhaps even as far north as Taupo according to []) and Fonterra has stronger loyalty for its Anchor brand further north, particularly around Auckland.
184. Currently, the smaller players, mainly Klondyke and Natural Dairy in the South Island and Green Valley and Fresha Valley in the North Island, appear to be a limited constraint on Fonterra and Goodman Fielder.
[]

] The constraint from each processor probably varies to some

⁶⁹ Note: we have used volume rather than capacity, as one smaller town milk processor indicated that there was not one standard way for capacity to be calculated. Using capacity rather than volume may change the figures slightly, but the overall picture will likely remain substantially the same.

degree, but we have not needed to investigate this in detail to reach conclusions on the Competition Test.⁷⁰

185. The Commission interviewed a large number of players in town milk markets including the supermarkets, some large route trade customers and town milk processors:

- Supermarkets were generally satisfied with the alternatives open to them in town milk markets; although in some cases [].
- Customers in the route trade generally considered that there were alternative suppliers from whom they could buy. However, a few customers had concerns about their perceived lack of options, including in one case [] not tendering for a route trade customer's business.⁷¹
- Small processors of town milk commented on aggressive competition from Fonterra and/or Goodman Fielder brands, probably sold through franchisees, including selling below the relevant independent processor's cost. The Commission has investigated complaints of this nature in the past, and found in some circumstances that the franchisees were selling a bundle of products to route trade customers and were discounting the milk below their own cost. Comments about aggressive competition in the supply of town milk are not consistent with there being little or no competition in this arena.

186. The constraint from small processors in general appears to be weak and focuses on the region in which the supplier is based. However, in the Commission's view, the extent of current rivalry between Fonterra and Goodman Fielder exceeds the "little or no competition" standard in the North Island and South Island town milk markets.

⁷⁰ Fonterra has indicated that smaller town milk processors are a competitive constraint on its decision-making. []

⁷¹ [].

MARKET FOR THE RETAIL SUPPLY OF GROCERY ITEMS IN SUPERMARKETS – WHETHER TO LAUNCH A PART 4 INQUIRY

187. This section of the report considers whether a Part 4 inquiry into the retail milk markets is warranted. For the purpose of this review, as discussed above, the Commission has defined local markets for the retail supply of grocery products from supermarkets, and considered them at an aggregate level.
188. The Commission has concluded that a Part 4 inquiry is not warranted at this time. The reason is that the scope of current rivalry between Progressive and Foodstuffs exceeds the “little or no competition” standard in local markets (viewed at an aggregate level).
189. This section discusses the current state of the retail markets involving fresh processed milk in light of the Competition Test (set out in paragraphs 120-125). We do not address the other elements of the s 52G test.

Initial observations

190. Supermarket retailing is not an obvious candidate for price regulation; the Competition Test sets a high bar to pass. Typically regulation of market power is only desirable when a market has natural monopoly characteristics. Supermarket retailing does not exhibit these characteristics of natural monopoly.
191. Previous cases are not consistent with the proposition that there is little or no competition in supermarket retailing. As noted above:
 - while the Commission does not need to decide the precise boundaries of the competition test in this case, it considers that a firm subject to “little or no competition” would share many of the characteristics of a dominant firm as explained by Richardson J in the *Amps-A* case;⁷²
 - in 2001 the Commission was satisfied that Progressive did not have dominance in the local and national supermarkets markets identified and therefore granted clearance to a proposed supermarket merger.⁷³
192. However, despite these initial observations, in light of the complaints received, we have investigated the current state and scope of competition.
193. The following section is structured as follows:
 - a description of the role of fresh processed milk within the wider grocery offering of supermarkets;

⁷² *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1992) 3 NZLR 429 (CA) at 442.

⁷³ Decision 438, *Progressive Enterprises Limited and Woolworths (NZ) Limited* (13 July 2001).

- analysis of the intensity of existing competition; and
- analysis of the strength of constraint from outside the market.

Milk in supermarkets

194. Milk is a staple that supermarkets consider essential to stock. Supermarkets regard milk as a “known value item”, which means that customers generally know the (approximate) price of milk.
195. For the majority of customers, price appears to be a more important factor than branding.⁷⁴ A large majority of milk sold in supermarkets is private label milk, which is generally priced below the branded labels. Foodstuffs Wellington said that [] of the milk it sells is private label milk. Of that, [] is Budget brand, and the remainder is Pam’s. In contrast, Foodstuffs South Island said that [] of milk sold is private label, and Progressive said over [] is private label. The percentage of private label milk sold has increased in recent years, although this increase has plateaued. Therefore, price is the main parameter on which competition occurs between supermarkets for milk.⁷⁵
196. To understand how milk fits into supermarkets’ overall grocery offering, we have investigated whether margins on milk are more or less than the margins that supermarkets make on other products. Information supplied by supermarkets indicates that:
- Gross margins on milk ranges from [] to [] for a two litre bottle. Margins are higher for smaller bottles and enriched products.
 - Gross margins must cover store costs, wages for staff and other overheads. According to one supermarket operator, wages can range between [] of a store’s costs, depending on the business model used.⁷⁶ Progressive has estimated that its average cost of doing business is [].⁷⁷
 - The targeted margins are higher for milk than for general grocery items to contribute to chiller costs, food safety checks and the labour involved with moving milk and circulating it.⁷⁸
 - []
Progressive indicated that it targets a [].

⁷⁴ Other important factors include the expiry date of the milk and hygiene.

⁷⁵ More generally, price, quality, range and service are all parameters of competition between supermarkets. See *Commerce Commission v Woolworths* (2008) 12 TCLR 194 at 239.

⁷⁶ Telephone call of 20 April 2011 with Foodstuffs Wellington.

⁷⁷ Response of Progressive of 27 May 2011.

⁷⁸ Telephone call of 20 April 2011 with Foodstuffs Wellington.

197. Overall, this information indicates that supermarkets are not making materially more profits from milk sales than on sales of other grocery products.

Existing competition

198. We note that supermarkets compete across the basket of groceries. Market power in supermarkets would only be apparent by assessing competition for a basket of groceries, rather than focussing on one product.
199. However, we have focussed on milk for the purposes of this review. Both Foodstuffs and Progressive assert that the pricing of milk is competitive.
200. We have considered the following evidence of the extent of existing competition:
 - shares of supply;
 - pricing; and
 - constraint from outside the market.

Shares of supply

201. The table below shows the shares of the sub-market for the supply of fresh processed milk from supermarkets.

Table 2: Shares of supply of milk from supermarkets for the year 1 June 2009-31 May 2010

	Volume (millions of litres)	Share of supply (%)
Progressive	[]	[]
Foodstuffs Auckland	[]	[]
Foodstuffs South Island	[]	[]
Foodstuffs Wellington	[]	[]
Foodstuffs (total)	[]	[]

Source of information: Foodstuffs and Progressive

Note: Figures rounded to one decimal place

202. These shares are approximately the same as Foodstuffs' and Progressive's relative shares of the overall market for the supply of groceries from supermarkets.⁷⁹

Pricing

203. In Australia, Coles started a price war in January 2011 by cutting the price of its private label milk to \$2 for a two litre bottle. This pricing has led to concerns about pressure on farmers' margins and whether the pricing is "predatory".⁸⁰
204. We asked Foodstuffs and Progressive for their perceptions regarding the retail pricing of milk in New Zealand and the recent experiences in Australia. Foodstuffs indicated that it sells milk at an everyday low price because milk does not respond well to promotions, due to the demand inelasticity of the product. It is possible that competition may focus on other products.
- [] This is consistent with Progressive's submissions.
205. New Zealand supermarkets apparently have not priced milk as aggressively to date as in Australia or the UK. This may reflect that competition in the supply of groceries from supermarkets is less intense than in Australia. Alternatively, it may suggest that competition tactics may be different, and competition focuses on other products or aspects

⁷⁹ For example, see http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10637239.

⁸⁰ The impacts of supermarket price decisions on the Australian dairy industry are being considered by the Australian Senate Economic References Committee. We note that the ACCC has recently announced it does not consider the behaviour contrary to the Trade Practices Act.

<http://www.accc.gov.au/content/index.phtml/itemId/998776/fromItemId/142>

of their offering. Answering this question would require further analysis of pricing and profitability across supermarkets' whole grocery offering. Given we do not need to do this to reach a decision whether regulation under Part 4 could apply to the supply of groceries from supermarkets, we have not done so as part of this review.⁸¹

Constraint from outside of the market

206. In *The Warehouse* appeal, the High Court found that there was some competitive constraint from other retailers on supermarkets' decision-making.⁸²
207. Milk is one of a number of items that supermarkets monitor, at a head office level and at the individual store level, in order to check competitors' prices. The supermarkets have indicated that as well as keeping track of what rival supermarkets are doing, they also track other competitors.
- []⁸³ While we have some indication that supermarkets may respond to some degree to pricing by other retailers, we have not sought to quantify the frequency of this response for the purposes of this review.
208. As noted above, smaller competitors may provide a greater constraint on supermarkets' behaviour in pricing milk than other grocery items:
- this reflects the substantial volumes that are purchased from smaller retailers (we understand roughly a significant proportion (roughly []) of processed milk at the retail level is sold through shops other than supermarkets in New Zealand.)⁸⁴ This reflects the fact that milk purchases often need to be more regular than weekly/"main" shops;
 - it also reflects the price discounting of milk by some petrol retailers and some dairies. Smaller retailers appear to discount [].⁸⁵
209. We therefore consider that there is some competitive constraint from outside the market on supermarkets' pricing of milk. We do not need to reach a view on the strength of this constraint to reach a view on whether the Competition Test for recommending Part 4 regulation is met.

⁸¹ In particular, Progressive indicated that [] of non-organic, non-flavoured milk was sold on promotion in 2010. This compares to more than [] of products generally being on promotion.

⁸² Paragraph 199 of Woolworths Limited et al v Commerce Commission (2008) 8 NZBLC 102,128.

⁸³ []

⁸⁴ On the basis of information provided by [].

⁸⁵ Telephone call with [] of 6 May 2011. See also http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=10741283.

Conclusion on extent of existing competition within and from outside the market

210. Part 4 sets a high bar for a lack of competition before the Commission can recommend price regulation. There is competition between supermarkets generally. To some degree, there also is competition from outside the market, in particular regarding milk pricing. We consider that this competition currently exceeds the “little or no competition” standard.

Appendix 1: Previous Commission Decisions

Dairy

1. The Commission considered a wide range of dairy markets in the ‘NewCo’ Draft Determination dated 27 August 1999. The ‘NewCo’ Draft Determination related to the proposed merger of the New Zealand Dairy Board, eight co-operative dairy companies and Tasman Milk Products. The merger would have resulted in the merged entity acquiring up to 100% of the raw milk in New Zealand. The Commission’s draft determination was that the merger would result in a strengthening of a dominant position in each of the relevant markets. Its preliminary view was that it could not be satisfied that the public benefits of the merger outweighed the detriments. The application was subsequently withdrawn and legislation was enacted allowing for the creation of Fonterra.
2. After the formation of Fonterra, the Commission considered raw milk and town milk in a number of merger clearance decisions: Decision 396: *Mainland Products and Nelson Milk Company* (7 June 2000) and Decisions 428/454: *Mainland Products and Southern Fresh Milk Company Ltd* (18 May 2001/14 February 2002) and Decision 574: *Fonterra Co-Operative Group Limited and Kapiti Fine Foods Limited and United Milk Limited* (23 February 2006). Each of the decisions resulted in a clearance, except Decision 428. However, this transaction was cleared less than a year later on failing-firm grounds in Decision 454.
3. In the 2006 Mainland/Anchor brand swap investigation, the Commission concluded that the transactions were unlikely to substantially lessen competition in either the South Island or the North Island town milk market.

Supermarkets

4. Until 26 May 2001 s 47 of the Act prohibited acquisitions that were likely to result in “dominance” or a strengthening of dominance in a market. The amended s 47, as it currently stands, prohibits acquisitions that would result in a substantial lessening of competition in a market.
5. In Decision 438, *Progressive Enterprises Limited and Woolworths (NZ) Limited* (13 July 2001), the Commission granted Progressive clearance to acquire Woolworths as it was satisfied that once divestments were made, Progressive would not have dominance in the local and national markets identified.
6. However, because of uncertainty about whether the old “dominance” test or the new “substantially lessen competition” test applied, Foodstuffs challenged the clearance decision in the High Court and the Court of Appeal.

7. The Court of Appeal held that the substantial lessening of competition test applied. That led to a second application by Progressive for clearance. In Decision 448, *Progressive Enterprises Limited and Woolworths (NZ) Limited* (14 December 2001) the Commission declined to grant clearance under the new test. Subsequently, the Privy Council held that the relevant test was dominance⁸⁶ and Progressive acquired Woolworths NZ.
8. In Decisions 606/607, *Foodstuffs (Auckland) Limited, Foodstuffs (Wellington) Co-Operative Society Limited, and Foodstuffs South Island Limited; and (separately) Woolworths Limited and The Warehouse Group Limited* (8 June 2007), the Commission considered the proposed acquisitions of The Warehouse Group Limited by each of Foodstuffs and Progressive. It declined both applications for clearance. These were subsequently appealed to the High Court and Court of Appeal. The latter upheld the Commission decision.

⁸⁶ As discussed earlier, the competition test in a Part 4 inquiry “little or no competition” appears in substance to be close to the concept of dominance.

Appendix 2: Key elements of Part 4

1. Part 4 of the Commerce Act provides for the regulation of the price and quality of goods or services in markets where there is little or no competition, and little or no likelihood of a substantial increase in competition.⁸⁷
2. Part 4 also requires the Commission to determine input methodologies, setting out the rules, requirements, and processes applying to the regulation of goods or services.
3. The Commission’s interpretation of the purpose of Part 4 is as follows:⁸⁸
 - the central purpose is to promote the long-term benefit of consumers in markets where there is little or no competition and little or no likelihood of a substantial increase in competition; and
 - this central purpose is to be achieved by promoting outcomes consistent with outcomes produced in workably competitive markets, such that the regulatory objectives set out in s 52A(1)(a)-(d) of the Act occur.
4. The regulatory instruments under Part 4 provide the mechanism through which the Commission is to promote outcomes consistent with those produced in workably competitive markets. The Commission’s interpretation of the purpose of Part 4 (including discussion on workable competition and workably competitive market outcomes and Part 4) is set out in further detail in Chapter 2 of the Commission’s *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper* of December 2010 (see footnote 88 for a link).

Types of regulation available under Part 4

5. The Commission provided an overview of the types of regulation available under Part 4, and the role of input methodologies, in its *Input Methodologies Discussion Paper*.⁸⁹ Part 4 provides for three types of regulation:
 - information disclosure regulation;
 - negotiate/arbitrate regulation; and

⁸⁷ Section 52.

⁸⁸ For a description of the Commission’s approach to those outcomes, see Chapter 2 of the Commission’s Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper of December 2010 for the Commission’s approach to these questions. Available at <http://www.comcom.govt.nz/input-methodologies-for-gas-pipeline-services/>

⁸⁹ Commerce Commission, *Input Methodologies Discussion Paper*, 19 June 2009. This paper relates in particular to the application of Part 4 to airports, electricity lines businesses, and gas pipeline businesses. However, it also provides a general overview of the regulatory options available under Part 4 (see in particular section 3.2 and Chapter 4).

- price-quality regulation.
6. The purpose of **information disclosure regulation** is to ensure that sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met.⁹⁰ Under information disclosure regulation:
- suppliers of regulated goods or services must publicly disclose certain information, and supply a copy of that information to the Commission. To meet the statutory purpose of information disclosure, information disclosure requirements must request sufficient information to enable any interested person to assess whether the supplier is acting in a way that promotes the long-term benefit of consumers;
 - suppliers would also have to supply to the Commission any additional statements, reports, agreements, particulars or other information that the Commission requires so that it can monitor whether they have complied with their disclosure obligations; and
 - in addition to monitoring compliance, the Commission must publish a summary and analysis of disclosed information.⁹¹ The purpose of this summary and analysis is to promote a greater understanding of the performance of individual regulated suppliers, their relative performance, and the changes in performance over time.
7. **Negotiate/arbitrate** regulation is intended to encourage a supplier and its customers to reach agreement, through negotiation, on the supplier's prices and quality standards during a specified regulatory period, and to provide for binding arbitration if negotiation is unsuccessful.⁹² The Commission sets the terms of the arbitration.⁹³ This form of regulation is most appropriate in markets where a single supplier provides goods or services to a small number of large and well resourced consumers, (such as an airport supplying services to airlines).
8. If negotiate/arbitrate regulation applies to regulated goods or services, s 53I(1) requires the Commission to determine, among other things:⁹⁴
- the parties to the negotiation or arbitration;
 - the matters the parties must agree on or which, failing a negotiated settlement, must be covered by compulsory arbitration. This includes the prices and quality standards associated with the regulated goods or services;
 - the timeframes for negotiation (which may include voluntary arbitration), and for compulsory arbitration should the parties fail to agree on all matters identified by the Commission; and

⁹⁰ Section 53A.

⁹¹ Section 53B.

⁹² Section 53G.

⁹³ Section 53H.

⁹⁴ Section 53I.

- the terms of any compulsory arbitration. The Arbitration Act 1996 does not apply to compulsory arbitration under Part 4, although the Commission may choose to apply any provisions of that Act in setting the terms of compulsory arbitration.⁹⁵
9. In addition, s 53I(2) allows the Commission the flexibility to “include in the determination any other matters it considers necessary or desirable to promote the purpose of negotiate/arbitrate regulation.”
10. Broadly, **price-quality regulation** determines:
- the maximum prices that suppliers may charge, or maximum revenues they may recover; and
 - quality standards suppliers must meet.
11. Default-customised price-quality regulation directly constrains prices by:
- setting a starting price for regulated goods and services (in respect of each supplier); and
 - determining a CPI-X price path for the regulatory period, that prices for regulated goods and services may not exceed.
12. This form of regulation also specifies quality standards for the regulated goods or services, to ensure that, regulated suppliers do not respond to the cost-reducing incentives of the CPI-X price path by lowering service quality below the level demanded by consumers.
13. The regulatory period for price-quality regulation may be between four and five years.⁹⁶ Before the end of each regulatory period, the Commission must reset the starting price and price-quality path for the next regulatory period.
14. Part 4 provides for two types of price-quality regulation: default/customised price-quality regulation; and individual price-quality regulation. **Default/customised price-quality regulation** is intended to provide a relatively low-cost way of setting price quality paths for suppliers of regulated goods or services. Under this approach the Commission sets a default price-quality path, which automatically applies to suppliers of the regulated goods or services. Suppliers may apply for a customised price-quality path that better meets their particular circumstances. Where a supplier is subject to **individual price-quality regulation**, the Commission has greater flexibility to set the price-quality path for that supplier, “using any process, and in any way, it thinks fit”, but must use the input methodologies that apply to the supply of those goods or services.⁹⁷

⁹⁵ Section 53J.

⁹⁶ Section 53M.

⁹⁷ Section 53ZC.

Role of Input Methodologies under Part 4

15. Input methodologies are intended to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of services under Part 4.⁹⁸
16. For goods or services that are the subject of an inquiry, the Commission must determine input methodologies as soon as practicable after the Commission is satisfied that the Competition Test and Constraint Test are met.⁹⁹
17. Section 52T(1) provides that the Input Methodologies relating to particular goods or services must include, to the extent applicable to the type of regulation:¹⁰⁰
 - cost of capital; asset valuation, depreciation and revaluations; cost allocation; and tax treatment (s 52T(1)(a));
 - pricing methodologies (s 52T(1)(b));
 - regulatory processes and rules (s 52T(1)(c)); and
 - matters relating to proposals for a customised price-quality path (s 52T(1)(d)).
18. Among other things, as far as practicable, every input methodology must set out the above matters “in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier”.¹⁰¹
19. The wording of s 52T(1) suggests that not all input methodologies will apply to all types of regulation. In its *Input Methodologies Discussion Paper*, the Commission set out its views on the relationship between input methodologies and regulatory instruments.¹⁰² In summary:
 - in the context of information disclosure regulation, the Commission considered that the matters covered by input methodologies in s 52T(1)(a) – with the exception of some matters listed in s 52T(1)(a)(iii) – appear to be most relevant to the disclosure of financial performance measures. The key financial performance measure is return on investment, which depends on actual revenue received from the supply of regulated goods or services, and on the value of assets used to supply the goods or services;
 - in the context of price-quality regulation, the Commission considered that those matters in s 52T(1)(a) appear to be most relevant to the setting of maximum revenues,

⁹⁸ Section 52R.

⁹⁹ Section 42U(3).

¹⁰⁰ Section 52T.

¹⁰¹ Section 52T(2).

¹⁰² See also *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper* of December 2010, paragraphs 2.8ff.

either at the beginning of, or for the entire, regulatory period. In addition, input methodologies covering matters specifically relating to customised price-quality path proposals (i.e., s 52T(1)(d)) are relevant;

- matters relating to the way prices are set—s 52T(1)(b) and parts of s 52T(1)(a)(iii)—are particularly relevant under price-quality regulation; and
- section 52T(1)(c), which relates to regulatory processes and rules, sets out only two examples of what these processes and rules might relate to, namely:
 - the specification and determination of prices (including pass-through costs), which could potentially relate to any regulatory instrument; and
 - the identification of circumstances in which price-quality paths may be reconsidered, which clearly relates to price-quality regulation.

Appendix 3: Relevant Markets

1. The most common tool for assessing the scope of markets is the “hypothetical monopolist” or SSNIP test. Applying this test, it is necessary to determine whether a hypothetical monopolist could impose a SSNIP in a profitable manner. At the heart of this test is substitutability on both the demand-side (will customers switch?) and supply-side (will businesses switch production?). The principal focus is usually on the demand-side.
2. The test starts with the narrowest possible market. If imposing a SSNIP would be profitable, then this is the relevant market. If it is not profitable, then the market is widened and the test re-applied, until it is passed.
3. The following explains these questions with reference to the geographic dimension of market definition:
 - on the demand-side, can a business in a chosen geographic area increase prices without significant numbers of consumers switching to a nearby supplier of a substitute good or service?
 - on the supply-side, can the business increase prices without attracting other firms into the same geographic area?
4. If the answer to all of these questions is “yes”, then it is likely that a hypothetical monopolist in the relevant area could profitably impose a SSNIP. The relevant geographic dimension therefore is likely to be the area tested. If the answer to one or both of these questions is “no”, then the area would be increased in size and the test re-applied.

Farm gate raw milk market

5. This product involves the supply of raw milk by farmers to processors. Based on the analysis in this section, the Commission defines the dimensions of the raw milk market as follows:
 - product dimension: the supply of farm gate raw milk by farmers to processors;
 - geographic dimension: regional; and
 - temporal dimension: no differentiation on the temporal aspect of raw milk.

Product dimension

6. As previously noted, the vast majority of raw milk is collected by processors, predominately Fonterra (with 89%), directly from farmers without being on-supplied to another processor. We consider that there are no close substitutes for raw milk.

7. The Commission has previously considered whether or not raw milk should be further differentiated based on its:¹⁰³
 - quality characteristics, such as somatic cell counts, cooling properties, and protein and fat content; and
 - supply patterns (year around production compared to less “flat” production), cow breeds and farming methods (e.g., organic).
8. Although the Commission recognised that some differentiation exists within the raw milk market, it chose to define a market for raw milk without further differentiation.
9. Market participants interviewed during this review generally support the Commission’s previous approach with one exception. There is some indication that it is more difficult to switch from non-organic to organic farming than may have been assumed in previous Commission decisions (in which organic milk was not a material issue). However, including or excluding organic milk would not make any material difference to our analysis, as organic milk is a small proportion of the milk collected in New Zealand. For the purposes of this analysis, we have included organic milk in the relevant product market.

Geographic dimension

10. The Commission has previously considered that the raw milk market is based on catchment areas within 100-150 kilometres of processing plants.¹⁰⁴ In long thin catchment areas an outer limit for the transportation of milk might be 250 kilometres.
11. Raw milk is a bulky and perishable product. While it is technically possible to transport raw milk over a large distance within New Zealand, the significant transport costs compared to the price of the product mean that transporting farmers’ raw milk regularly over long distances is generally considered uneconomic.
12. During this inquiry, Fonterra indicated that the geographic scope of this market should be defined as the North Island and the South Island.¹⁰⁵ Raw milk is moved within each island (and sometimes across the Cook Strait) in a variety of circumstances. For example, Westland has been getting milk from Canterbury for a number of years, and Fonterra moves milk between regions to optimise the use of its processing plants.¹⁰⁶

¹⁰³ Paragraphs 84-94, Decision No 574 Fonterra Co-operative Group Limited and Kapiti Fine Foods Limited and United Milk Limited of 23 February 2006.

¹⁰⁴ Paragraph 142, *ibid*.

¹⁰⁵ Fonterra also noted that “market definition often depends on the issue in question... a proper consideration of market definition would require a much more detailed analysis”. Fonterra submission, dated 26 April 2011.

¹⁰⁶ *Ibid*.

13. The Commission has considered what substitution possibilities exist for farmers in the event of a small but significant decrease in the price for raw milk. Farmers located within two processors' catchment areas are likely to have substitution possibilities, provided that both processors are willing to accept their supply.¹⁰⁷ In some cases, processing plants' catchment areas have increased, for example:
 - Fonterra moves milk by train from the Wairarapa to Taranaki for processing;¹⁰⁸
 - Fonterra installed a milk concentration plant at its Tua Marina plant on the South Island around 2006. This allows milk to be concentrated to roughly half its volume prior to transport to the Clandeboye plant;
 - Westland moves milk by train from Canterbury to Westland for processing; and
 - Westland has recently announced plans to build its own milk concentration plant at Rolleston.¹⁰⁹ This may result in more inter-regional transport of milk in the future.
14. These examples show that farmers and processors which collect raw milk appear to have increasing flexibility to move milk over longer distances to processors. The extent to which it would be economic for smaller market participants to use these technologies is less clear.
15. The Commission previously has considered that overlapping catchments may provide for Island-by-Island markets.¹¹⁰ That is because farmers located in the overlapping regions would essentially protect other farmers from price decreases as dairy co-operatives historically paid equivalent amounts per kilogram of milksolids (kgms) to all their suppliers. However, in another more recent decision, the Commission has adopted a conservative approach and defined regional markets.¹¹¹
16. For this review, the Commission considers it is appropriate to use the area 100-150 kilometres around processing plants as a conservative assumption for the geographic dimension of the market. However, we note that adopting broader Island-by-Island geographic markets would not significantly impact on the analysis undertaken below.

¹⁰⁷ As noted previously, DDIRA requires Fonterra to accept share-backed farmer supply, provided certain conditions are met.

¹⁰⁸ Meeting with Fonterra, 6 May 2011.

¹⁰⁹ Otago Daily Times, 16 April 2011.

¹¹⁰ For example, NewCo draft determination, paragraphs 158-170.

¹¹¹ Paragraph 142, *Fonterra/Kapiti*.

Temporal dimension

17. The Commission previously has considered that it is not necessary to define a temporal dimension of raw milk. The Commission considered that on the demand-side, seasonal supply is unlikely to be a close substitute for winter milk supply. In contrast, on the supply-side, switching from seasonal milk supply to winter milk production is possible within a two year time frame by altering calving times. The Commission does not consider a separate market necessary for the purposes of this inquiry.

Factory gate raw milk market

18. The factory gate raw milk market is a secondary market that involves the supply of raw milk by processors to other processors. In the *Fonterra/Kapiti* merger clearance, the Commission considered whether ‘regulatory arrangements had caused the primary {farm gate} and secondary {factory gate} milk markets to merge, such that acquiring milk directly from farmers might be a close substitute for acquiring milk at the wholesale level from a dairy co-operative’.¹¹²
19. The Commission concluded that the conservative approach was to retain the narrower market definitions relating to the farm gate and factory gate markets. The Commission considers that retaining these narrow definitions for its current analysis is appropriate, as it is the more conservative option.
20. The factory gate market represents around 3% of milk collected in New Zealand.¹¹³ Nearly all of it is supplied under the Regulations.
21. Based on the analysis in this section, the Commission defines the dimensions of the raw milk market as follows:
 - product dimension: the supply of factory gate raw milk by processors of raw milk to other processors; and
 - geographic dimension: the North Island and the South Island.

Product dimension

22. This is a wholesale market for supplying raw milk to processors, which operates between processors.

¹¹² Paragraph 129.

¹¹³ In 2009/10, it represented 2.8%.

23. Acquirers of milk from the farm gate, which have transport networks, are likely to consider acquiring milk at the factory gate as a close substitute.¹¹⁴ However, switching from factory gate to farm gate milk likely involves significant costs. These costs include:
 - managing the seasonality of milk supply;
 - collection and transport of milk to the factory;
 - managing multiple suppliers; and
 - the risks associated with both obligations to accept supply and supply disruptions.
24. Processors may choose to purchase in the factory gate market to avoid dealing with the factors listed above. They also may wish to supplement their supply from farmers. As well, new entrant dairy companies may find it easier to attract farmers if they already have some production and sales arrangements via supply from the factory gate market. They are also likely to achieve economies of scale in processing more quickly.
25. For those acquirers without collection capabilities, such as industrial customers and smaller and/or newer purchasers of raw milk, farm gate supply of milk may not be a close substitute for factory gate supply.
26. Processors have indicated that they would supply raw milk to other processors at the factory gate, if it more than covered the opportunity costs of not processing the milk and selling the final product themselves. However, in practice, independent processors appear to supply limited quantities of raw milk to the factory gate.¹¹⁵ Interviews with independent processors indicate that they tend to supply to the factory gate only when faced with lack of processing capacity.¹¹⁶ This limits the supply available outside that which Fonterra must supply under the Regulations.
27. While this market is substantially smaller than the farm gate market, it is important from a competition perspective in maintaining the viability of town milk companies that require flat supply schedules, as well as providing essential fresh dairy inputs for other manufacturing companies such as chocolate, ice cream and beverage manufacturers that do not wish to undertake their own collection of milk.

¹¹⁴ Paragraph 131, *Fonterra/Kapiti*.

¹¹⁵ We note that prior to the creation of Fonterra, the factory gate market was “very small relative to the size of the New Zealand dairy industry. In general, the markets appear to be thin, with transactions taking place in response to particular needs and commercial opportunities”. Para. 325, *NewCo Draft Determination*, 27 August 1999.

¹¹⁶ For example, [].

Geographic dimension

28. Trade in the factory gate market generally takes place between processors within close proximity of one another. Indeed, we understand that Fonterra generally transports factory gate raw milk direct from farms to independent processors' plants.
29. However, as in the farm gate market, it is often commercially viable for trade to take place over greater distances. For example, the Commission understands that Synlait profitably sent its milk from Canterbury to Westland for processing for a season while its plant was being commissioned. Therefore, for the purposes of this analysis, the Commission considers that North Island and South Island markets are the most appropriate geographic markets. We note, however, that narrower regional markets would be unlikely to affect our analysis significantly in this case.

Processing and wholesale supply of fresh pasteurised milk (town milk)

30. As explained below, the Commission defines the dimensions of the town milk market as follows:
 - product dimension: the processing and wholesale supply of fresh pasteurised milk (also referred to as "town milk"); and
 - geographic dimension: the North Island and the South Island.

Product dimension

31. The Commission has previously considered a market for "town milk" or fresh processed milk regardless of brand, flavouring and composition. This market included a variety of milk types including flavoured fresh milks, cream and soy milk.¹¹⁷
32. The following evidence suggests that substitution between fresh processed white milk and other milk products is limited and that fresh processed milk is likely to be in a distinct market:
 - the Commission also notes that most competition authorities have previously defined fresh processed milk as a discrete product market;¹¹⁸
 - a recent study in the UK found that demand for fresh processed milk is inelastic;¹¹⁹

¹¹⁷ Paragraph 98, *Fonterra/Kapiti*.

¹¹⁸ For example, see the summary of the ACCC's reasoning regarding its informal review of the proposed acquisition of the assets of Perfection Dairies Pty Ltd and its subsidiaries (February 2008), the UK Competition Commission decision on *Arla/Express* (October 2003) and European Commission Decision No. COMP/M.5046 *Friesland Foods / Campina*, (June 2008) para. 207.

¹¹⁹ Dr Howard Smith and Dr John Thanassoulis, *The Milk Supply Chain Project*, January 2008, University of Oxford, pages 35-39.

- we also note the recent experience in Australia. It appears that the price cuts since January 2011 have marginally increased demand. This has led Professor Stephen King to observe that the demand for milk is relatively inelastic over a six to twelve month period. However, in an interim report in May 2011, the Senate Economic References Committee considered it was too early to reach any conclusions on the elasticity of demand of milk;¹²⁰ and
 - the Commission's discussions with the supermarkets during this review have supported this view. The supermarkets have stated that milk is unresponsive to price promotions. The supermarkets stated that consumers do not purchase more milk when it is less expensive. Further, price increases in recent times have had little or no appreciable effect on demand for fresh processed milk.
33. In light of the above, the Commission considers it likely that there are no close substitutes for fresh processed milk. In particular we consider that fresh milk is not a close substitute for flavoured fresh milks, cream and soy milk from customers' perspectives.¹²¹ We also consider it unlikely that powdered milk is a close substitute, based on our discussions with supermarket retailers and town milk processors. We therefore adopt a product market of fresh processed milk.
34. In the *Fonterra/Kapiti* merger clearance decision, the Commission also considered that various categories of fresh processed milk products, such as standard, light, trim and enriched milk, and private label and branded milk products formed a chain of substitution for many customers.¹²² In addition, it appears that town milk processors could switch production between these categories of milk products in response to a relative change in prices.
35. Adopting a product market of fresh processed milk is consistent with the evidence gathered by the Commission during this review. We therefore consider that the fresh milk products are likely to be within the same market, consistent with the Commission's previous approach.¹²³

¹²⁰ "The impacts of supermarket price decisions on the dairy industry – second interim report", particularly para. 2.19-2.23.

¹²¹ It is not easy to switch from producing soy milk to producing and wholesaling fresh processed milk, or vice-versa, so these are not supply-side substitutes. Producing cream appears to be complementary to producing trim milk – it is a by-product – rather than a supply-side substitute. We have not considered the extent of supply-side substitutability between supply of flavoured milk and fresh processed milk. However, provided that the focus of this inquiry is on fresh milk, we do not consider including flavoured milk in the product dimension.

¹²² Paragraphs 98-99, *Fonterra/Kapiti*.

¹²³ We note that exclusion of enriched milks from the market definition would not materially alter the conclusions of our preliminary analysis. This is because enriched milk makes up a very small proportion of milk sold in New Zealand. Similarly the addition of goats' or sheep's milk would not make any material difference to the analysis in this report.

Geographic dimension

36. The Commission has previously defined the geographic extent of the market for the processing and wholesale supply of town milk as being island-wide, with separate North and South Island markets.¹²⁴
37. During this review, Fonterra indicated that the geographic scope of this market is nationwide.¹²⁵ Although some processors are regionally focussed, Fonterra and Goodman Fielder sell nationally. Fonterra also indicated that [].
38. Customers increasingly prefer national contracting for specific milk products. In particular, some large retail customers of the fresh milk companies, (e.g. supermarkets and petrol stations), prefer to deal with a small number of suppliers for administrative and product consistency reasons and are encouraging a trend towards national supply contracts. Customers who contract nationally have indicated that there are advantages to doing so:
 - it saves the costs associated with multi-sourcing; and
 - it allows a common experience for customers across all outlets.
39. However, other customers, such as BP, have separate North and South Island town milk supply arrangements. Progressive has split its private label contract between [] and []. The latter provides private label milk for [] and the former provides own-brand milk to the remaining stores. Each of the three main Foodstuffs entities purchases milk on behalf of its members.
40. From the supply side, relatively small volumes of fresh processed milk are transported across Cook Strait. Generally, these are niche products, that only justify manufacturing runs at one plant nationally, or products transported to cover plant outages. Consistent with previous decisions, the Commission considers that the appropriate geographic dimensions are North Island and South Island.
41. The Commission also notes that a processor competes more weakly the further from its plant(s) that it supplies, as it will need to recover its transport costs. Some smaller players have limited supply footprints. For example, Fresha Valley – which is based in Northland – sells as far south as South Auckland. Smaller players therefore may provide more of a regional constraint than Island-wide constraint.

¹²⁴ Paragraphs 33-37, Decision 428, *Mainland / Southern Fresh* of 18 May 2001 and paragraphs 187-193, *NewCo Draft Determination*.

¹²⁵ Fonterra submission, dated 26 April 2011.

42. Having regard to the above, the Commission sees no reason to vary from its previous approach of using South Island and North Island markets for the processing and wholesale supply of town milk for the purposes of this review.

Grocery Retailing

43. Grocery retailing includes the retail supply of fresh processed milk in supermarkets. Roughly two-thirds of fresh milk supplied at the retail level in New Zealand is sold through the main supermarket chains. As explained below, the Commission defines the dimensions of the retail market as follows:
- product dimension: the retail supply of grocery items from supermarkets; and
 - geographic dimension: an aggregation of local markets.

Product dimension

44. In previous supermarket merger decisions, the Commission has defined multiple separate local retail markets for grocery items in supermarkets throughout New Zealand.¹²⁶
45. In Decisions 438/448, the Commission considered that supermarkets can be differentiated from other retailers by their ability to meet consumers' requirements for price and service. For instance, corner dairies and service stations are likely to be able to offer a convenient service to some consumers, but are unlikely to be able to offer the range of products and the generally low prices available in supermarkets. On the other hand, supermarkets are unlikely to provide customer assistance which is often available for specific products in specialty stores.
46. In Decisions 606/607, the Commission also recognised that there were two broad types of grocery shopping trips being:
- “the main shop” typically conducted once per week for the majority of grocery items that are likely to be required by consumers during the following week. The main shop is almost always conducted at supermarkets rather than at a series of specialty stores which were considered to offer a low competitive constraint on supermarkets; and
 - “the top up shop” for additional small purchases between main shops. As the Commission focused on supermarket shopping in Decisions 606/607, the type of stores where consumers conduct top up shops was not examined in any detail.
47. The Commission therefore used a product market for the supply of grocery products from supermarkets in the context of the proposed supermarket mergers then under consideration.

¹²⁶ See Decisions 438/448 *Progressive Enterprises and Woolworths* (13 July 2001) and Decisions 606/607 *Foodstuffs (Auckland) Limited, Foodstuffs (Wellington) Co-Operative Society Limited, and Foodstuffs South Island Limited; and (separately) Woolworths Limited and The Warehouse Group Limited* (8 June 2007)

48. In this case, we have considered whether it would be appropriate to use this product market or a product market focussed solely on milk. Foodstuffs has submitted that we should adopt a market for the retail supply of milk as the focus of this inquiry is competition for the supply of fresh processed milk.
49. We consider this point has some merit. Any competition analysis should have regard to the fact milk purchases are a significant part of “top-up shopping”. A greater proportion of milk is likely to be bought as part of “top-up shopping” than other grocery products, given its perishability. Competition from smaller retailers therefore may be a stronger constraint on the supply of milk from supermarkets than other grocery products.
50. However, in the context of this inquiry, we have not obtained evidence that would warrant deviating from the market definitions previously adopted. We therefore use a product market for the supply of grocery products from supermarkets. We have had regard to retailers of groceries outside of this market definition. We consider this is a conservative approach, as it is more likely than the alternative to give rise to competition concerns.
51. We however adopted a sub-market for the retail supply of fresh processed milk from supermarkets to reflect the key focus of this inquiry.

Geographic dimension

52. In previous decisions the Commission concluded that the geographic scope of the market for the retailing of grocery items in supermarkets is local as a customer would only travel to an alternative supermarket within a short distance. It therefore defined multiple local markets within a five kilometre radius.¹²⁷
53. We consider that the geographic market for the supply of top-up groceries also is likely to be local. For the purposes of this review, the Commission does not consider it necessary to form a definitive view regarding the geographic scope of the market. Given the nature of this inquiry, we have adopted a pragmatic approach and assessed competition at a national level, by aggregating local markets.

Conclusions on relevant markets

54. In assessing this inquiry, the Commission has identified the following relevant markets:
 - retail supply of grocery items in supermarkets (aggregate of local markets), including a sub-market for fresh processed milk;

¹²⁷ Ibid.

- North and South Island markets for the processing and wholesale supply of fresh pasteurised milk to retailers;
- North and South Island markets for the supply of raw milk at the factory gate by processors to other processors; and
- regional markets for the supply of raw milk at the farm gate by farmers to processors.