ISSN NO. 0114 - 2720

COMMERCE COMMISSION

DECISION NO. 289

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

GOODMAN FIELDER LIMITED

and

DEFIANCE MILLS LIMITED

The Commission: Alan Bollard (Chairman of Division)
Terry Stapleton
Roger Taylor

Summary of the Proposal Acquisition: That Goodman Fielder Limited, or any subsidiairies of that company, acquire all of the New Zealand assets of the baking and milling operations of Defiance Mills Limited.

Determination: Pursuant to s 66(3)(b) of the Act, the Commission determines to decline to give clearance for the proposed acquisition.

Date of Determination: 14 April 1997

AUT/BA-G9/1
M2329

MEMORANDUM

To:	The Chairman Terry Stapleton Roger Taylor
From:	Andrew Brice Chief Investigator
Date:	14 April 1997 (Working day 22)
Subject	**Commerce Act 1986: Business Acquisition: Goodman Fielder Limited/Defiance Mills Limited**

Working Day 10: 25 March 1997 **Working Day 22: 14 April 1997**

Confidential material in this report is contained in square brackets

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THE PROPOSAL

1 On 11 March 1997, the Commission registered a notice from Goodman Fielder Limited (Goodman Fielder), seeking clearance for the proposed acquisition of all the New Zealand assets of the baking and milling operations of Defiance Mills Limited (Defiance).

2 The assets which are being offered for sale in terms of the proposal include:

- the leasehold and freehold real estate located in New Zealand from which any of the baking and milling operations of Defiance (the Businesses) are conducted;
- all plant and equipment and consumable stores used in the conduct of the Businesses;
- stock;
- the right, title and interest in and to all intellectual property used in the conduct of the Businesses;
- all customer information; and
- the goodwill of the Businesses and the full benefit of all material existing contracts.

PROCEDURES

3 Section 66(3) of the Commerce Act 1986 (the Act) requires the Commission either to clear, or to decline to clear, a notice given under s 66(1) within 10 working days, unless the Commission and the person who gave the notice agree to a time extension.

4 By agreement between the Commission and the applicant, the date for the Commission's determination on the proposed acquisition was extended three times: to 27 March; then to 10 April; and finally to 14 April 1997.

INVESTIGATION

5 Commission Staff discussed the proposal with a range of parties with interests in the wheat, flour, stock feed, bakery ingredients, and baked goods industries. These included farmers, flour millers, bread bakers, bakery ingredients suppliers, bakery product manufacturers and supermarkets. Written submissions were received from various parties, including Allied Foods Company Limited, Ernest Adams Limited, Griffins Foods Limited, Tegel Foods Limited, Woolworths (NZ) Limited, and a number of smaller bakery products suppliers. Additional information was sought, and obtained, from the parties to the proposed acquisition.

THE PARTICIPANTS

6 Goodman Fielder, a company listed on the Australian and New Zealand Stock Exchanges, is engaged in the manufacture of a diverse range of food products, predominantly in Australia, New Zealand, Europe and Asia. The company is organised into the following seven divisions:

- Milling and Baking;
- Edible Oils and Food Service;
- Cereals and Snacks;
- European Foods;
- Ingredients;
- Poultry; and
- International.

7 The New Zealand business operations of Goodman Fielder relevant to the proposed acquisition are organised through the following companies:

- Champion Mills Limited (Champion), which carries on the milling of wheat and specialty grains from four plants, and the distribution of bakery mixes;
- Quality Bakers New Zealand Limited (Quality Bakers), which produces bread and a range of other bakery products under various brands from 14 plants located in the North and South Islands; and
- Bluebird Foods Limited, which produces and distributes snacks, cereals, pasta, cake mixes, soups, vinegar and retail packs of flour.

8 Defiance, a company listed on the Australian Stock Exchange, is engaged in the milling of wheat and specialty grains and the manufacture of bread and other bakery products in Australia and New Zealand. Through its wholly-owned subsidiary, Defiance Food Industries Limited, the company is involved in milling at three plants in New Zealand; the manufacture and distribution of bakery mixes; bread crumb and sandwich making; and the

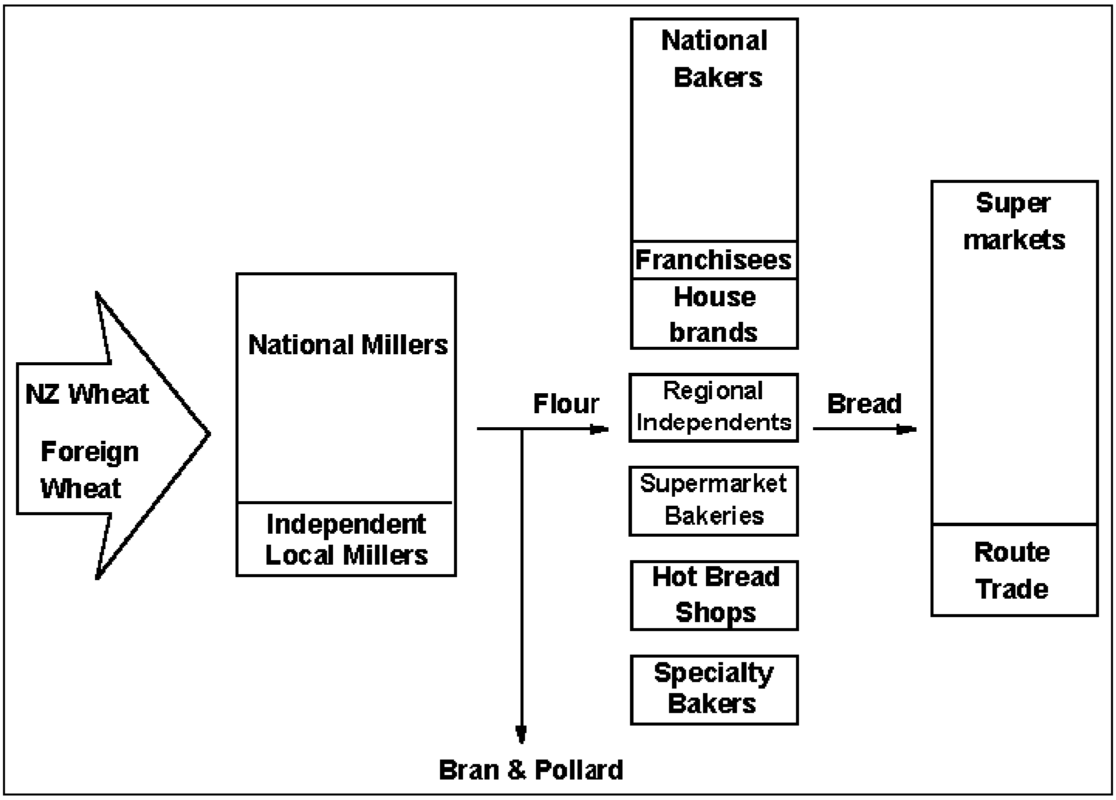
baking of bread and other bakery products at four plants for distribution under the "Countryfare" brand.

INDUSTRY BACKGROUND

9 In February 1987, the wheat and flour industries were deregulated. Prior to that, these industries had been subjected to a range of controls, which covered every aspect of wheat and flour production and distribution, including prices paid, and the purchase and distribution of wheat and flour-based products. Key changes brought about by deregulation include; the wheat and flour milling industries improving the quality and range of their production; industry movement toward greater vertical integration; and significant competition from imported wheat.

10 Figure 1 outlines the vertical structure of the wheat, milling, and baking industries.

Figure 1: Vertical Structure of Wheat, Milling and Baking Industries



Wheat Industry Background

11 There are two major categories of wheat grown in New Zealand: milling and feed. These categories have a different pricing structure, and are not generally interchangeable. However, milling wheat which does not meet mills' specifications can be sold for feed purposes. A wide variety of wheat cultivars are available, developed for specific uses (eg: bread, biscuits, pasta, and feed).

12 Around 250,000 tonnes of wheat are grown locally each year, although this fluctuates from season to season. Around 190,000 to 200,000 tonnes are milling grade wheat, with the balance predominantly used for stock-feed. Total wheat production declined following deregulation, from around 220,000 tonnes in 1987/88 to around 144,000 tonnes in 1990/91. However, it has since increased to the current level of around 250,000 tonnes annually.

13 There are some 2,000 current wheat growers in New Zealand, although a number enter and depart the industry each season. The major wheat growing area is the wider Canterbury region, which accounts for around 80% of production. The remainder is grown in the Southland/Otago and the Wanganui/Manawatu/Hawkes Bay regions.

14 There is an annual requirement for about 340,000 tonnes of milling grade wheat. As New Zealand is not self-sufficient, wheat must be imported to meet shortfalls in local production. The volume of imports varies each season, depending on a range of factors, such as the size and quality of the local crop. In the 1995/96 season, around 150,000 tonnes of milling wheat were imported, mainly from Australia, but also from Canada.

15 Flour millers in the upper North Island primarily use imported wheat, while mills in the lower North Island generally use a blend of imported and locally grown wheat. South Island mills primarily use South Island grown wheat.

16 Over 90% of milling wheat is contracted by flour mills, either directly or through brokers. Mills put out contracts in the year prior to the crop being sown (usually between late March and early May), and growers must decide whether or not to accept the offer. Non-contracted wheat is sold on the open market.

17 The prices of locally grown wheat are based on Australian wheat prices (Australian Standard White), which in turn are linked to international prices. Wheat is subject to cyclical price fluctuations, which reflect supply and demand, and other factors, including the agricultural policies of the United States and the European Union. In 1996, there was a considerable spike in world wheat prices, which was reflected in higher prices received by growers from mills. In 1996, New Zealand milling wheat averaged about $290 per tonne, feed wheat averaged about $260 per tonne, and imported wheat of all types averaged about $365 per tonne (CIF value).

Flour Industry Background

18 New Zealand mills produce around 260,000 tonnes of flour annually. Flour milling is carried out by three millers operating in the North and South Islands.

- Champion;
- Defiance; and
- Allied Foods Company Limited (Allied), which is 100% owned by George Weston Foods Limited.

19 In addition, there are five smaller single mill companies operating in the South Island: Canterbury Flour Mills Limited (Canterbury Flour), South Canterbury Milling Limited

(South Canterbury Mills), Milligans Eclipse Flour Company Limited (Milligans), Harraway & Sons Limited (Harraways), and South Flour Limited (South Flour).

20 A summary of the industry participants, their ownership details, their locations, and the production levels of their mills is shown in Table 1.

Table 1: Flour Industry Participants
As at April 1997

Name	Ownership	Location	Total Production (tpa)	Total Potential Capacity (tpa)	Excess Capacity
Champion	Goodman Fielder	Auckland Palmerston North Christchurch Timaru	[		
Defiance	Defiance	Mt Maunganui Christchurch Dunedin			
Allied	George Weston	Auckland Wellington Rangiora		CONFIDENTIAL	
Canterbury Flour	Rivermill Bakery Limited	Ashburton			
South Canterbury Mills	Private	Temuka			
Milligans	Private	Ngapara			
Harraways	Private	Dunedin			
South Flour	50/50 Southern Arable Farmers/Private	Invercargill			]
TOTAL			**261,640**	**437,120**	**175,480**

21 Production figures in Table 1 are sourced from flour milling companies. Total potential capacity is calculated on the basis of flour mills working three shifts per day, six days a week, for 50 weeks of the year. Staff consider this to be an optimistic assessment.

22 As noted in Table 1, the flour industry is characterised by substantial surplus capacity, with most mills operating well below maximum capacity. However, capacity is a relatively elastic concept and depends on a range of factors, including the age of the plant, and the type of wheat milled. It must be noted that while all of the small South Island mills show considerable excess capacity, it is very unlikely that any of them will ever produce to their

full potential capacity. Thus the potential and excess capacity numbers shown should be regarded as essentially theoretical.

23 Broadly speaking, the industry segments flour sales into the categories shown in Table 2.

Table 2: Flour Industry

Source: Applicant and collated information. Tonnages are estimates only.

	Quantity Consumed (tonnes per annum)		
	North Island	South Island	Total
Industrial Bulk	123,000	46,000	169,000
Industrial Bagged (20-40 kg)	46,000	21,000	67,000
Retail Bagged (0.5-5kg)	18,500	7,500	26,000
Total	**187,500**	**74,500**	**262,000**

24 Industrial bulk flour is supplied in road tankers, or on pods aboard rail cars, to large users of flour, including plant bakeries, some larger in-store supermarket bakeries, biscuit manufacturers, and some large food manufacturers. Industrial bagged flour is generally supplied to wholesalers (eg: Davis Trading Company Limited), who on-sell to small bakeries and other small users, or direct to end users for the production of bakery and other food products (eg: Ernest Adams Limited). Retail bagged flour comprises packaged flour for household use, and is sold mainly through supermarkets and other retail grocery outlets.

25 Flour can also be categorised by type which tends to equate to use. Examples include bread flour, biscuit flour, and pastry flour.

26 Some flour is moved in bulk and bagged form from flour mills in the South Island to users in the North Island. It is not economic to transport flour from the North to the South Islands.

27 Apart from flour milled locally, flour is also imported - primarily from Australia. Currently, around 5,500 tonnes are imported into New Zealand annually. These imports are confined to industrial bagged flour, predominantly for supply to the Auckland region. The principal importer has been J C Sherratt and Company Limited (Sherratt), while the major users of imported flour have tended to be smaller bakers, and those requiring specialty flour.

28 The flour industry in New Zealand is characterised by a high level of vertical integration. There are currently three major vertically integrated groups and one smaller vertically integrated group. Each supplies a significant proportion of its output to bakeries within its own group. Goodman Fielder, Defiance, and Allied are the major groups, with Canterbury Flour being the smaller group.

Bran and Pollard Industry Background

29 Bran, pollard and broll are the major by-products of flour milling. During milling, around 78-80% of wheat milled is normally recovered as flour, and the other 20-22% consists of bran (the outside husk of the wheat grain), pollard (derived from the next layers), and a

small quantity of broll. Broll is the residual mixture of bran and pollard which cannot be separated by the milling process. In 1996, South Island mills produced around 31,000 tonnes of bran and pollard, and North Island mills produced around 42,000 tonnes.

30 Based upon information provided by the flour millers, bran and pollard sells for between $130 and $200 per tonne in the South Island, with the majority of it being sold at about $150 per tonne. In the North Island, bran and pollard sells for between $180 and $200 per tonne, with most of it being sold for about $180 per tonne.

31 The major users of bran and pollard are stock-feed producers. Tegel Foods Limited (Tegel), which contracts for all the bran and pollard produced by Champion, is the largest single user, purchasing approximately [ ] of total industry output. Purchases of bran and pollard represent around [ ] of Tegel’s total stock-feed ingredients.

Bread and Other Bakery Products Industry Background

32 There is a wide variety of bread and bread products produced in New Zealand. These include various types of packaged loaves produced by plant bakeries and some in-store bakeries, and specialty or novelty lines produced by in-store bakeries and hot bread shops.

33 Bread and related products are baked by Quality Bakers, Defiance and Allied, each with plants in both Islands.

34 There are three independent regional plant bakers who bake under franchise to Quality Bakers: Walter Findlay Limited (Walter Findlay), Gisborne; Northern Bakeries Limited (Northern Bakeries), Whangarei; and Freshbake Wairarapa Limited (Freshbake Wairarapa), each of which produce bread under Quality Bakers’ brands, and under Defiance’s brands, in their immediate locality.

35 There are two regional plant bakers:

- Rivermill Bakery Limited (Rivermill), the owner of Canterbury Flour Mills, which supplies bread in the upper North Island; and
- Yarrows (The Baker) Limited (Yarrows), a family-owned company, which supplies bread in the lower North Island.

36 Further details about the industry participants, their ownership, their plants, their locations, and their average weekly production volumes are provided in Table 3.

Table 3: Baking Industry Participants

	Key Bread Brands	Ownership	Number of Plants	Bakery Location(s)	Average Weekly Volume
Quality Bakers	Nature’s Fresh	Goodman	14	Auckland, Hamilton, Tauranga, Rotorua,	[ ] units

	Vogel's Homestyle Country Split Molenberg	Fielder		Palmerston North, Wanganui, New Plymouth, Wellington, Napier, Nelson, Christchurch, Timaru, Dunedin, Invercargill	
Quality Bakers' Franchisees	As above. Countryfare	Private	3	Gisborne Whangarei Wairarapa	[ ] units
Defiance	Countryfare	Defiance	4	Hamilton Wellington Christchurch Dunedin	[ ] units
Allied	Tip Top North's Burgen Ploughmans	George Weston	4	Auckland Wellington Christchurch Dunedin	[ ] units
Rivermill	Rivermill	Private	1	Huntly	[ ] units
Yarrows	Yarrows	Yarrow Family	1	Manaia (South Taranaki)	[ ] units

37 Bread is also produced by in-store bakeries owned by the major supermarket chains, and by hot bread shops. The applicant states that 72% of all supermarkets have an in-store bakery (ie: 242 out of a total of 338 outlets). Further, the applicant estimates that there are around 411 hot bread shops nation-wide.

38 Supermarkets account for around 70% of retail bread sales. In addition, they have an important role as operators of in-store bakeries, and as producers and/or purchasers of housebrand bread. Housebrand bread is contract baked by the major plant bakers on behalf of supermarkets, but sold under the supermarket's own brand name.

39 The balance of bread is sold through the route trade (eg: dairies and service stations), to institutional purchasers (eg: hospitals and prisons), and to the food service industry (eg: caterers).

THE MARKETS

Introduction

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

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

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

42 In a 1984 decision, the Commission, drawing upon the Australian Trade Practices Tribunal decision in *Queensland Co-operative Milling Association*[1], defined a market as:

> "a field of actual or potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive."[2]

43 Markets are defined in relation to product type, geographical extent, and functional level. With the first two dimensions, market boundaries are determined by testing for substitutability, in terms of the response to a change in relative prices of the good or service in question and possible substitute goods or services. A properly defined market will include products which are regarded by buyers as being not too different ('product' dimension), and not too far away ('geographical' dimension), and are thus products to which they could switch if a *s*mall yet *s*ignificant and *n*on-transitory *i*ncrease in *p*rice (*ssnip*) of the product in question were to occur. It will also include those suppliers currently in production who are likely, in the event of such a *ssnip*, to shift promptly to offer a suitable alternative product, even though they do not do so currently. Such suppliers have been referred to by the Commission as "near entrants".

44 The Commission's *Business Acquisition Guidelines* suggest the use of a *ssnip* test to provide a framework for testing for substitutability, and hence for determining the boundaries of a market as a matter of fact and commercial common sense.[3] In regard to product market definition, the following question is posed:

> *If the price of the product were to be raised by a hypothetical monopolist by a small yet significant non-transitory increase in price (say, five per cent) above the competitive level for at least a year, would so many buyers switch to buying alternative products (demand-side substitutability), or would so much additional*

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1 *Queensland Co-operative Milling Association*, (1976) ATPR 40-012 at 17,247.

2 *Edmonds Food Industries/WF Tucker & Co Limited*, Decision No. 84, 21 June 1984.

3 Commerce Commission, *Business Acquisition Guidelines*, 1996, at pp. 14-15.

supply be added by new suppliers switching their production to the product in question (supply-side substitutability), that the price rise would not be profitable?

45 If the price rise is profitable because little or no such switching occurs, then the product as defined has no close substitutes, and it falls within a separate product market. On the other hand, if the price rise is not profitable because of widespread switching, the products to which buyers switch can be considered to be close substitutes for the initial product. These products are then added to the initial product, and the new, enlarged, product definition is subjected to the same test. This process continues until no significant switching occurs in response to the increased price. The boundaries of the product market are therefore identified. The product market so arrived at should occupy the smallest range of products consistent with a hypothetical monopolist being able to exert market power, as defined by the *ssnip* test.

46 The *ssnip* test is also used to gauge the geographical extent of the market. The process starts by taking one small district or region as appropriate, and considering whether a hypothetical monopolist of the product in that area, if it were to impose a *ssnip* as defined above, would lose so many customers to suppliers of the product outside that area, that the price increase would be unprofitable. An absence of switching would indicate that suppliers outside that area cannot provide substitute products, in which case the area initially specified would constitute a separate geographical market for the product. On the other hand, the presence of widespread switching would show that suppliers in other areas could provide products which were effective substitutes and, therefore, that the geographical extent of the market is broader than the area initially specified. The test would then be repeated with the broader geographical area, and this process would continue until significant switching outside of that area in response to the price rise ceases. Once again, the geographical market for a product is the smallest geographical space in which a hypothetical monopolist could exert market power.

47 In practice, the process of defining markets is unlikely to be as precise and as scientific as suggested by the *ssnip* test. However, in the Commission’s view, the *ssnip* approach provides a useful framework for assessing the question of what other products, or products from other areas, are substitutable for the product in the area in question as a matter of fact and commercial common sense. The test simply provides a means by which judgements on a case-by-case basis, using whatever information happens to be available or can readily be generated, can be made. The issue remains one of substitutability in response to a price increase, and so evidence relating to the price elasticity of demand, the behaviour of buyers, the availability of technically suitable alternative products, transport and distribution costs, informed opinion from various sources, and overseas studies, will all be of assistance. This has been the approach used with regard to the present application.

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

The Relevant Markets

49 In its application, Goodman Fielder submits that the following are the relevant markets:

- The product market for the baking and distribution of bread products, in the following three geographic markets:
  - Northern Region - upper North Island (north of Taupo);
  - Central Region - lower North Island;
  - Southern Region - South Island; and
- The national market for the milling and distribution of (free) flour.

50 Staff will use the applicant's submissions as the starting point for their analysis of markets. In addition, Staff inquiries indicate that the following two further products are likely to be affected by the application:

- wheat; and
- bran and pollard.

51 Each of these areas of activity will be examined in turn, moving down the vertical chain from wheat to bread products.

Wheat Market Definitions

52 Milling wheat is not homogeneous; a substantial number of cultivars are grown. The bulk of the milling wheat grown is destined for use in bread baking. The other major category is 'biscuit' wheat. Because wheat is the only raw material input into the production of wheat flour, there are substitutes for wheat only to the extent that there are substitutes for wheat flour in downstream uses. There appear to be no practical substitutes for wheat flour in bread baking or in biscuit, cake, and pastry manufacture. It follows that milling wheat constitutes a separate product market.

53 In terms of geographic market, South Island grown wheat generally has a price advantage over imported wheat in the South Island, because of trans-Tasman shipping and other costs. As a result, very little wheat is imported into the South Island. The cost of shipping wheat across the Tasman has been estimated at $50-55 per tonne to the destination port. In addition, wheat imported from Australia has to be purchased through the monopoly exporter, the Australian Wheat Board, which adds on costs and margins which are said to raise the price significantly above what it would be if purchases were to be made directly from the farmers. The higher wheat purchase cost, combined with trans-Tasman transportation costs, results in North Island wheat prices generally being higher than South Island wheat costs. Imports are required in the North Island as relatively little wheat is grown there, even though it is the larger market for flour and has a somewhat larger flour output.

54 Staff therefore conclude that there are two wheat markets:

- the market for the production and acquisition of milling wheat in the North Island; and
- the market for the production and acquisition of milling wheat in the South Island.

Flour Product Market Definitions

55 Flour is the major output of the milling process. The principal users are bread bakeries, but substantial amounts are also used for making biscuits, cakes, pastry, and pizza bases. Flour is also sold in retail bags through supermarkets and other grocery outlets to consumers.

56 Looking first at the product market, it seems clear that a hypothetical monopoly supplier of flour would profitably be able to impose a *ssnip*, because of the lack of any close substitutes for flour to which buyers could turn. The product market is thus broadly one for flour. However, it would appear that this initial definition is too broad. There are a number of complications which suggest that there are several flour markets when viewed purely from the demand-side perspective. These complications are as follows:

- "tied" versus "free" flour;
- unit quantity differences; and
- flour categories.

"Tied" versus "Free" Flour

57 A feature of the flour industry is the presence of vertical integration between the main flour millers and the main plant bread bakeries. The uniform practice in the industry is that the main plant bread bakeries buy their flour only from the flour miller with whom they are vertically linked. About half of all flour produced is tied in this way, with the rest being sold to non-tied or free users. On this basis, the applicant argues that the market which should be the focus of competition concerns is that for free flour:

> The application of these two concepts of economic substitutability and commercial common sense to the flour market dictate that the appropriate confines of that market are external or "free" sales by the vertically integrated market participants and should not include their internal or "tied" sales. That is because the evidence is that there is no competition for the supply of flour to the vertically integrated bakeries . . . The commercial realities are that vertical integration has meant that internal or "tied" sales are not part of "the field of rivalry" between the competitors in the flour market. There is no prospect of substitutability for these sales. Schedule 2, paragraph 3.

58 Limiting the market to free sales is also said by the applicant to be consistent with the approach of the Courts and the Commission in that "the purpose of defining a market is to provide a framework in which the competition implications of economic activity can be analysed." Further, the applicant argues that because tied sales do not form part of the field of rivalry between competing flour producers, the effect of the proposed acquisition on competition in the market can necessarily relate only to free sales.

59 [ ], in a submission prepared by its counsel, argues to the contrary that while the Commission has recognised the existence, and effect on competition, of the tied arrangements in the flour industry in previous decisions, that recognition does not extend to

excluding the tied portion from the relevant market, nor of treating the tied portion as a further market. For example, in *Goodman Fielder/Wattie* (Decision No. 201A, 1987), the Commission stated:

> "... the implementation of tied arrangements between the merged group's flour milling and bread baking operations would foreclose entry to a substantial sector of the bread baking industry (including potential entrants). In effect, a new domestic flour miller would only be able to compete for supply to the independent bakeries which constitute 40% of the total North Island market."
>
> Paragraph 128

60 The focus here is clearly on vertical integration as a possible impediment to competition in the broader market. The market is not defined to include only the free sales. The same approach has been used by the Commission in decisions relating to markets in other industries. For example, in *Amcor/NZ Forest Products* (Decision No. 208, 1987), the Commission stated:

> "FCL ... said that the kraft paper option was low on its scale of priorities. In circumstances where, assuming the merger proceeds as presently planned, Kiwi and UEB purchases are tied [ ] to NZFP, only 37% of the conversion market would normally be available to a new entrant in the manufacture of kraft paper/board. In the circumstances, the Commission considers that FCL is not a potential competitor in this market ..."
>
> Paragraph 16

61 Similarly, in *Fletcher Challenge/NZ Forest Products* (Decision No. 213, 1987) the Commission stated:

> "In this market FCL stated that the logs from NZFP and FCL forests were used almost completely within their own group of companies and the volumes produced accordingly did not form part of what it described as a freely traded market. However, in considering whether, as a result of the takeover proposal, the merged concern would be in a position to exercise a dominant influence over the acquisition of logs in this market, regard needs to be had to the high market share held by the merged FCL/NZFP. A merged entity utilising 71% of the logs in the central North Island ... would mean that a prospective acquirer of logs would be denied access to a very high proportion of the available log volume. In the market for the acquisition of logs in this region, all purchasers of logs outside the merged company would only be able to obtain logs in 29% of the market and even within this small share of the market would be competing against FCL/NZFP for supply."
>
> Paragraph 17

62 This indicates clearly that the relevant market was considered by the Commission to be for tied and free logs combined.

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63 The ties between mills and bakeries within each of the vertically integrated groups need not be unbreakable. [ ] suggests that the ties may be broken or re-negotiated at any time. Inquiries by Staff have brought to light some support for these contentions, even though the breaking of such ties would seem to be an unlikely step for a firm which is part of a vertically integrated group to take. For example, in one case (Canterbury Flour/Rivermill), an 'arm's length' arrangement was described, under which the bakery could conceivably seek flour from other suppliers if the tied flour supplier was not competitive. Similarly, the applicant has informed the Commission that until four or five years ago, Quality Bakers' individual plants were free to seek price quotations for flour from outside sources.

64 Therefore, Staff have reached the view that it is appropriate to ignore the distinction between tied and free flour in defining the market, and to consider whether vertical integration with respect to tied flour is an impediment to competition in the market.

Unit Quantity Differences

65 The unit quantities of flour required by different users vary enormously. Plant bread bakeries and other large-scale users want their flour supplies delivered into silo only in bulk (ie: by road tanker or rail car pod) to minimise the cost of handling large quantities. Small users such as hot bread shops are equipped to handle flour in 20 kg to 40 kg bags only. Household consumers generally buy only small retail bags of one-half to five kilograms. As a result, a 20 kg bag, for example, would be rejected by virtually all bulk users, and by households, but would be welcomed by a small baker.

66 The three unit quantities are regarded by market participants as separate ‘market segments’ within the flour market. The prices in per tonne equivalent terms for the three unit quantities vary substantially, with bulk flour having the lowest price, and industrial bagged flour the next lowest. Yet such price differences do not, for example, encourage users of 20 kg bags to switch to bulk flour because the costs of switching, in terms of infrastructure and holding costs, would be prohibitive. Similarly, most household consumers would be interested in buying only retail bags. The switching costs for users appear to be such that flour in one unit quantity is not generally substitutable for flour in another unit quantity. A hypothetical monopoly supplier of any one of those unit quantities would likely be able profitably to impose a *ssnip*, because buyers would be unwilling to switch to one of the other unit quantities despite the higher price. In the view of Staff, therefore, each segment - industrial bulk, industrial bagged, and retail bagged - should be treated as a separate product market.

Flour Categories

67 Finally, flour is not a homogeneous product; there are a variety of flour types with different specifications. The number has grown from fewer than six at the large mills around the time of the industry’s deregulation in 1987 to as many as 60 for some milling operations today. Staff have been told that a large Australian flour miller produces some 200 varieties of flour. The specifications vary according to characteristics such as colour, moisture retention and protein content. The various specifications are produced using, or mixing (“gristing”), different varieties and specifications of wheat, and by adjusting the milling process. It is only possible for a large miller using modern equipment to produce a wide range of flours. A smaller miller using older equipment would normally produce a more limited range, and usually not at the high quality end of the spectrum.

68 Typically, large food manufacturers have their own specifications for the flour they use, which may be different to that required by all other users. In most circumstances, the amount of product differentiation appears to be small, and these flours could be produced by any of the major millers. However, this appears not to be the case with premium pastry flour. This flour is milled from the centre of the wheat grain, and so can constitute at most only 8% to 12% of the grain milled. Attempts to raise the proportion further cause the

balance of the flour output to become degraded, to the point where it cannot be used for any other purpose without being blended at additional cost.

69 There are three companies which use annually about [ ] tonnes of this premium pastry flour, although demand may grow with increasing manufactured food exports. It appears that there are no substitutes for this type of flour, and the number of producers is strictly limited by the need for a large throughput and modern production techniques. [ ]

Flour Geographic Market Analysis

70 The geographic extent of the flour market has now to be considered. In the South Island, flour is milled almost exclusively from South Island wheat, with some of that flour being shipped to the North Island.

71 In the North Island, flour is milled from wheat from various sources: the North Island (in small amounts); the South Island; and foreign imports. Flour milled in the North Island competes against both imported flour and flour milled in the South Island.

72 Flour can be imported from Australia at a freight cost of around $50 to $55 per tonne, baker's flour can in normal circumstances be delivered to an Auckland user at around $600 per tonne. The application (Schedule 3) provides details of annual shipments in excess of 30,000 tonnes from South Island mills to North Island customers. The average freight cost for Christchurch to Auckland shipment is estimated by the applicant at $80 per tonne, and for Christchurch to Wellington shipment at $60 per tonne. Back-loading advantages mean that it is less expensive to ship goods north than south.

73 Higher wheat costs, and the cost of freighting flour from the South Island or Australia, result in flour being more expensive in the North Island. The transport cost for flour is higher than that for wheat, although this is partially offset by the volume reduction of 20% to 22% in the milling process. The applicant quotes average flour prices as at 30 April 1996, as [ ] in Auckland, and [ ] in Christchurch, the differential no doubt reflecting the cost of transporting flour north between the two centres. Hence, it is likely that a hypothetical monopoly supplier of flour in the South Island would find it profitable to impose a *ssnip*, because South Island users would not find it economic to switch to sourcing their flour supplies either from the North Island or from Australia. A hypothetical monopoly supplier in the North Island, however, would have to contend with flour supplied from the South Island. This would suggest that the North and South Islands constitute separate geographic markets, but that South Island shipments should be treated in the same manner as overseas imports in the North Island market.

Flour Market Conclusion

74 Staff therefore conclude that there are the following flour markets:

- the market for the production and acquisition of industrial bulk flour in the North Island;
- the market for the production and acquisition of industrial bulk flour in the South Island;
- the market for the production and acquisition of industrial bagged flour in the North Island;
- the market for the production and acquisition of industrial bagged flour in the South Island;

- the market for the production and sale of retail bagged flour in the North Island;
- the market for the production and sale of retail bagged flour in the South Island;
- the market for the production and acquisition of premium pastry flour in the North Island; and
- the market for the production and acquisition of premium pastry flour in the South Island.

Bran and Pollard Market Definitions

75 In terms of the product market, bran and pollard (and broll) constitute one of the many ingredients used in stock-feed manufacturing. Stock-feed of various types is a mixture of those ingredients which deliver the required energy and nutrients in the lowest cost manner, sometimes determined by a linear programming model. Thus, other ingredients, or combinations of ingredients, are likely to be at least partial substitutes for bran and pollard. Nonetheless, a hypothetical monopoly supplier of those products would probably find it profitable to apply a *ssnip*, so that it is appropriate to consider the production and acquisition of bran and pollard as a separate product market.

76 An important characteristic of bran and pollard for determining the geographic extent of the market is that they are relatively low value products which, because of their bulk, are relatively expensive to transport for any significant distance. Hence, the *ssnip* test suggests that a hypothetical monopolist in the South Island would profitably be able to raise prices without inducing users to switch to supplies from the North Island, because the inter-Island freight costs would be expected to be high. Nonetheless, Staff understand that two South Island millers sent nearly 3,000 tonnes of bran and pollard, or 10% of the South Island production, to the North Island in 1996. This presumably reflects an imbalance between production and demand in the two Islands.

77 Staff therefore conclude that there are the following bran and pollard markets:

- the market for the production and acquisition of bran and pollard in the North Island; and
- the market for the production and acquisition of bran and pollard in the South Island.

Bread Market Definitions

78 The term “bread” covers a wide range of differentiated wheat- and yeast-based products: loaves which may be white; wholemeal; grain; or heavy; which may be sliced or unsliced; wrapped or unwrapped; as well as rolls, buns, sticks, and the like.[4] While at the margin, bread no doubt competes with other food items for the consumers’ grocery dollar, there are probably few if any close substitutes for most consumers. A hypothetical bread monopolist would probably be able profitably to impose a *ssnip*, suggesting that the product market should be defined no wider than bread.

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4 The focus here is on “bread” made predominately from wheat flour using yeast as an ingredient. Sales of other sorts of “bread” are tiny in comparison, and are not considered to be relevant.

Bread Product Market Analysis

79 The issue is whether the product markets are actually narrower. The applicant argues that the market is that for the "baking and distribution of bread products (includes bread loaves, buns and rolls)", as used by the Commission in *Quality Bakers/Klissers* (Decision No. 246, 1990). In contrast, in its submission, Allied puts forward the alternative view that there are "very significant differences" between the "plant" bread produced by Quality Bakers, Defiance, and Allied, and the bread products produced by in-store supermarket bakeries and hot bread shops. An important difference is:

> "the high volume, staple food nature of sliced, wrapped white and brown plant breads, which contrasts with the special purpose, taste and use characteristics of the products sold by in-store bakeries and hot bread shops."

Allied goes on to suggest that:

> "if the retail price of plant bread in New Zealand markets increased by 10%, there would be no noticeable switch by customers to the breads, buns and rolls produced by in-store bakeries and bread shops."

80 Supermarkets, where most bread is sold, uniformly take the view that packaged or plant bread falls in a separate market from the bread produced by in-store bakeries or hot bread shops. Foodstuffs (South Island) Limited said that it experiences no decrease in sales of plant bread when it opens an in-store bakery.

81 However, Staff note that some supermarkets bake their own packaged bread in their in-store bakeries which looks (apart from branding) identical to, and is clearly designed to compete against, the packaged plant bread. Such in-store bakeries operate in part like mini plant bakeries. Staff are aware of several supermarkets where the packaged bread baked in-store actually outsells the packaged bread bought in from the big three independent bakers. The former is priced so as to undercut the latter, and as a result has gained market share at the latter's expense. Other supermarkets have not pushed sales of their own packaged bread as hard in order to get specials from the independent bakers, with the consequence that the latter retain the bulk of sales. This evidence suggests strongly that the packaged bread from in-store bakeries is substitutable with that from the independent bakers. The two share the same characteristics outlined above in the quotation from the Allied submission.

82 A more difficult issue is whether specialty bread produced by in-store bakeries and hot bread shops should be placed in the same market. Staff have been unable to find any clear-cut evidence to decide the matter. For example, the demand for packaged bread appears to be relatively static, whereas the demand for specialty bread has been growing strongly in recent years, although this probably reflects changing consumer tastes rather than substitution on the basis of price. As explained earlier, the latter is the appropriate test for determining market boundaries. Industry opinion, apart from that of the applicant, favours specialty bread being in a separate market.

83 Certainly, there appears to be a high degree of differentiation between the standard white/brown packaged loaf (characteristics: relatively low price, low margin, keeping

qualities, sliced for convenience, "neutral" taste), and the specialty loaf from the hot bread shop (characteristics: relatively high price, high margin, perishable, aroma, low convenience, "interesting" taste). But the plant bakeries produce a range of loaf types covering wholemeal, grain, and 'heavy' health varieties which arguably fill in much of the 'gap' between the packaged and specialty loaves. It has been said that the move by plant bakeries into 'heavy' loaves, such as through the acquisition of Klissers by Quality Bakers in 1990, was a response to the competition posed by hot bread shops.

84 While market research suggests that each type of bread has its strong adherents, it seems plausible to suggest that the various loaf types form a "chain of substitutes", such that each adjacent pair along the chain are close substitutes, even though those at either end of the chain are not. If it could be assumed further that there is no "break" in the chain of substitutes, there would be only one bread product market. This would be consistent with the Commission's conclusion in the *Quality Bakers/Klissers* decision.

85 The alternative approach, favoured by Staff, is that there is a break in the chain of substitutes, such that packaged bread and specialty bread fall in different markets. The two products appear to differ substantially in terms of convenience, marketing channels, and pricing. Packaged bread is said to be used during the week for convenience for toast and sandwich making; consumers are very price conscious and show low brand loyalty. Specialty bread, on the other hand, is more likely to be purchased during the weekend for its "hot freshness" value, with convenience and price being given less consideration. In the *Goodman Fielder/Wattie* decision, the Commission considered that hot bread shops were:

> "aimed at a particular market segment and are not a clear substitute for the substantial convenience market share held by sliced bread."

86 Applying the *ssnip* test, Staff take the view that a hypothetical monopolist in the packaged bread market would be able profitably to impose a significant and non-transitory increase in price without losing a substantial volume of sales to specialty bread.

Bread Product Market Conclusion

87 For the purposes of analysis, Staff have reached the conclusion that there are two bread product markets, one for "packaged" bread and the other for "specialty" bread. The two terms are descriptive only, rather than definitive, but they do convey the essence of the distinction between the two markets. Packaged bread generally has the following characteristics: a sliced loaf, plastic wrapped, staying fresh for a few days, baked in a plant bakery or in-store supermarket bakery, and displayed on racks of trays for retail sale. Specialty bread is generally differentiated from packaged bread by the following characteristics: unsliced bread products in the form of loaves, rolls and sticks, often displayed in unwrapped form, for same day consumption, and baked in an in-store bakery or hot bread shop.

Bread Geographic Market Analysis

88 The geographic dimension of the bread product markets is influenced by the perishability of bread and by the cost of transporting the product long distances. Plant-baked bread stays fresh for about 18 hours before it begins to deteriorate. Long delivery trips are, therefore, undesirable because they reduce the shelf life of the delivered bread. They also make for

difficulty in supplying repeat deliveries during the day, which are important for supermarkets, especially when the brand is being "specialed". Transport cost is also a factor, although bread is transported quite long distances, such as from Christchurch to Nelson, and from Wellington to Gisborne. Yarrows believes that it has an advantage in its home base of Taranaki from being the local baker, a perception which it seeks to cultivate by sponsoring local sports teams.

89 The applicant suggests, following the Commission's view in the *Quality Bakers/Klissers* decision, that the bread market is split geographically into three areas: north and south in the North Island, and the whole of the South Island. This seems to reflect both the way in which the plant bakeries organise their operations and the east-west divide in the central North Island which raises transport difficulties in supplying one area from the other. Thus, Yarrows, whose single bakery is situated close to the boundary on the southern side at Manaia, sells only in the south-west region from Taranaki to Paraparaumu. Further expansion, in its opinion, would see it move southwards towards Wellington, not northwards towards Auckland. Similarly, the other single bakery operator - Rivermill at Huntly - sells bread no further south than Taupo. Although it is not possible to define the geographic market boundary precisely, Staff are of the view that the North Island can be divided into upper and lower geographic markets.

90 While the South Island has two main bread baking centres in Christchurch and Dunedin, there is no obvious divide which would prevent a bakery in one centre competing in the home territory of another. The whole of the South Island is therefore taken to be a separate geographic market. Staff inquiries suggest that the division of the country into the three geographic markets proposed by the applicant generally found favour amongst participants in the bread industry.

Bread Market Conclusion

91 Staff therefore conclude that there are the following bread markets:

- the market for the production and sale of packaged bread in the upper North Island;
- the market for the production and sale of packaged bread in the lower North Island; and
- the market for the production and sale of packaged bread in the South Island.

Conclusion On Relevant Markets

92 For the purposes of analysing the competitive impact of the proposed acquisition under the Act, Staff's view is that the following markets are relevant:

- the market for the production and acquisition of milling wheat in the North Island;
- the market for the production and acquisition of milling wheat in the South Island;
- the market for the production and acquisition of industrial bulk flour in the North Island;
- the market for the production and acquisition of industrial bulk flour in the South Island;

- the market for the production and acquisition of industrial bagged flour in the North Island;
- the market for the production and acquisition of industrial bagged flour in the South Island;
- the market for the production and sale of retail bagged flour in the North Island;
- the market for the production and sale of retail bagged flour in the South Island;
- the market for the production and acquisition of premium pastry flour in the North Island;
- the market for the production and acquisition of premium pastry flour in the South Island.
- the market for the production and acquisition of bran and pollard in the North Island;
- the market for the production and acquisition of bran and pollard in the South Island;
- the market for the production and sale of packaged bread in the upper North Island;
- the market for the production and sale of packaged bread in the lower North Island; and
- the market for the production and sale of packaged bread in the South Island.

ASSESSMENT OF DOMINANCE

93 Section 66(3) of the Act, when read in conjunction with s 47(1) of the Act, requires the Commission to decline to give clearance to a proposed acquisition if it is not satisfied that the proposed acquisition would not result, or would not be likely to result, in a person acquiring or strengthening a dominant position in a market.

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

> "... that person as a supplier or an acquirer, or those persons as suppliers or acquirers, of goods or services, is or are in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market..."

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

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

96 In reaching a view on whether a person is in a position to exercise a dominant influence in a market, the Commission considers the foregoing non-exhaustive factors and any other relevant matters that may be found in a particular case, such as entry barriers, the viability of imports and the existence of near entrants to the market.[5]

5 *Business Acquisition Guidelines*, 1996.

97 In *Port Nelson Ltd v Commerce Commission*[6], the Court of Appeal approved the following dominance standard adopted by the High Court (McGechan J):

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

98 A dominance assessment for each of the relevant markets follows.

Milling Wheat Markets Analysis

99 Markets have been identified for the production and acquisition of milling wheat in the North Island and the production and acquisition of milling wheat in the South Island.

Market Shares

100 Milling wheat market shares have been compiled from information provided by five of the larger millers and from an estimate of the wheat used by other millers. Goodman Fielder, Defiance, Allied, Canterbury Flour and South Canterbury Mills account for about 98% of milling wheat acquired in New Zealand.

101 The North and South Island market shares of the flour millers based upon the total tonnages of wheat milled for the year ended 31 December 1996 are shown in Table 4.

Table 4: Milling Wheat Market Shares
for Year Ended 31 December 1996

	North Island Mills							
	North Island Local		South Island Imports		Foreign Imports		Total	
	Tonnes	Share	Tonnes	Share	Tonnes	Share	Tonnes	Share
Goodman Fielder Defiance	[-							
Combined Entity Allied			CONFIDENTIAL					]
Total	**11,818**	100.0%	**39,741**	100.0%	**142,734**	100.0%	**194,295**	100.0%

Source: Applicant and collated information. Tonnages are estimates only.

6 *Port Nelson Ltd v Commerce Commission* [ ] 3 NZLR 554.

	South Island Mills					
	South Island Local		Foreign Imports		Total	
	Tonnes	Share	Tonnes	Share	Tonnes	Share
Goodman Fielder Defiance	[					
Combined Entity Allied Canterbury Flour S Canterbury Mills Other Mills			CONFIDENTIAL			]
Total	**140,417**	100.0%	**4,373**	100.0%	**144,790**	100.0%

Source: Applicant and collated information. Tonnages are estimates only.

102 In the North Island milling wheat market, Goodman Fielder and Defiance post-acquisition (the combined entity) would have a [ ] market share. It is noted that the combined entity would purchase [ ] of South Island produced wheat used for North Island milling. In addition, the combined entity would purchase [ ] of North Island produced wheat used for North Island milling (all of which is purchased by Goodman Fielder at present). The combined entity would also purchase [ ] of all foreign imports used at North Island mills.

103 In the South Island milling wheat market, the combined entity would have a [ ] market share, and the next largest purchaser, Canterbury Flour, would have a [ ] share. These shares are also reflective of purchases of South Island produced wheat ([ ] and [ ] respectively). No North Island wheat and only a very small amount of foreign wheat (ie: [ ] imported by Defiance), was used at South Island mills.

CONFIDENTIALCONFIDENTIAL

Constraints on the Combined Entity

104 Locally produced North Island milling wheat is not a significant portion of the North Island milling wheat market (ie: only 11,818 tonnes out of 194,295 tonnes, or 6%), and therefore there is no concern that any dominance in that segment could leverage into the entire North Island milling wheat market.[7] Additionally, North Island wheat growers can cease production of milling wheat and grow other crops (eg: barley).

105 Although it would purchase [ ] of South Island produced wheat, which is almost the sole source of wheat used for South Island milling (ie: 97%), the following two related factors suggest that the combined entity would be constrained from exercising a dominant influence in the South Island milling wheat market:

- growers could switch from the production of milling wheat and plant another crop, if the combined entity attempted to extract lower prices; and
- it is in the best commercial interests of the combined entity to encourage, rather than discourage, the production of milling wheat in the South Island, since the landed price of

7 *See Commerce Commission v Port Nelson Ltd* [ ] 5 NZBLC 103,762.

imported milling wheat in the South Island is substantially higher than South Island produced milling wheat prices (10% to 30% more).

Conclusion on Wheat Markets

106 **North Island:** As 73% of the wheat used in the North Island is from overseas sources, and North Island wheat growers could switch to other crops, it is unlikely that the proposed acquisition would result, or would be likely to result, in the acquisition or strengthening of a dominant position in the market for the production and acquisition of milling wheat in the North Island.

107 **South Island:** Although the combined entity's post-acquisition market share would be [ ], it is unlikely that the proposed acquisition would result, or would be likely to result, in the acquisition or strengthening of a dominant position in the market for the production and acquisition of milling wheat in the South Island. There would be adequate constraints on the combined entity.

108 Staff conclude that the proposed acquisition would not result, and would not be likely to result, in the combined entity acquiring or strengthening a dominant position in either the market for the production and acquisition of milling wheat in the North Island or the market for the production and acquisition of milling wheat in the South Island.

Flour Markets Analysis

109 The following eight flour markets have been identified as being relevant for the purposes of dominance assessment:

- the market for the production and acquisition of industrial bulk flour in the North Island;
- the market for the production and acquisition of industrial bulk flour in the South Island;
- the market for the production and acquisition of industrial bagged flour in the North Island;
- the market for the production and acquisition of industrial bagged flour in the South Island;
- the market for the production and sale of retail bagged flour in the North Island;
- the market for the production and sale of retail bagged flour in the South Island;
- the market for the production and acquisition of premium pastry flour in the North Island; and
- the market for the production and acquisition of premium pastry flour in the South Island.

110 The markets are discussed below. As they possess common features, efforts have been made in the various market analyses to avoid unnecessary duplication.

Markets for Industrial Bulk Flour

111 Industrial bulk flour is produced by flour millers predominantly for use by plant bakeries, but it is also used by other parties including some supermarket bakeries, pie and bun manufacturers, and pre-mix manufacturers. The four largest flour millers use a significant portion of their output for tied baking purposes and the remainder for free sales. The other flour millers do not have their own plant bakeries and sell all of their flour output to external parties.

Market Shares

112 Flour sales figures were obtained from the flour millers for the 1996 calendar year. According to those figures, the tonnages of flour supplied into the North and South Island industrial bulk flour markets and the percentages which those tonnages represent of each market are shown in Table 5.

Table 5: Industrial Bulk Flour Markets for Year Ended 31 December 1996

Company	Tonnage of Bulk Flour Sold and % of Total			
	North Island		South Island	
Goodman Fielder Defiance	[			
Combined Entity Allied Canterbury Flour	CONFIDENTIAL			]
Total	**123,048**	100%*	**45,651**	100%

Source: Applicant and collated information. Tonnages are estimates only
* The difference between the total of these figures (99%) and 100% is simply rounding

113 Post-acquisition, the combined entity would have a [ ] market share in the North Island industrial bulk flour market and a [ ] market share in the South Island industrial bulk flour market. Allied would be the second largest competitor in both markets with significantly lower North Island ([ ]) and South Island ([ ]) shares.

<u>Constraint from Existing Competitors</u>

114 In the North Island industrial bulk flour market, the combined entity would face competition from both Allied and Canterbury Flour. Allied has some excess capacity available in the North Island ([ ] of the current market total), and its ability to increase production could act as a constraint on the combined entity. In addition, based upon its excess capacity ([ ] of the current market total), Canterbury Flour has a very limited ability to expand production and provide an additional quantity of industrial bulk flour to the North Island. Canterbury Flour produces a total of [ ] tonnes of flour per annum, of which almost [ ] is tied to Rivermill, a North Island bakery and its parent company. Its total flour production represents only [ ] of the total North Island industrial bulk flour market.

115 In the South Island industrial bulk flour market, Allied would have very little capacity available to produce more bulk flour ([ ] tonnes, equivalent to [ ] of the current market total). From its relatively small old mill, Canterbury Flour has a very limited ability to expand production. The other South Island flour millers are small but do have the potential to increase their total output. Canterbury Flour has demonstrated the ability of a small miller to become a more substantial market participant. The purchase of Canterbury Flour by an independent baker provided a major source of tied sales enabling it gradually to expand. However, such vertical integration advantages are not available to the remaining independent millers, who are likely to continue to have a localised impact.

116 In the context of the discussion on constraints by market entry in the Commission's *Business Acquisitions Guidelines*, it is stated that:

> "[ ]he Commission will not consider entry which might only occur at relatively low volumes or in localised areas to represent a sufficient constraint to alleviate concerns about market dominance."

Conclusion on Constraint from Existing Competitors

117 Staff believe that the competition currently provided by market participants and potentially provided by near entrants should be discounted as providing a sufficient constraint on the combined entity to alleviate dominance concerns in the market for the production and acquisition of industrial bulk flour in the South Island.

Constraints from Industrial Bulk Flour Imports

118 Three alternative scenarios were considered:

- foreign (Australian) bulk flour imports into either the North or South Islands;
- South Island bulk flour imports into the North Island; and
- North Island bulk flour imports into the South Island.

Foreign bulk flour imports into either the North or South Islands

119 Currently, there is no foreign bulk flour imported into New Zealand, and therefore foreign imports provide no actual competitive constraint on participants in the North or South Island industrial bulk flour markets. However, Staff have been advised by the applicant, and other parties, that some foreign bulk flour has been imported into New Zealand in the past. Goodman Fielder told Staff that, about eight years ago, Norths Bakery (Auckland) Limited imported one tonne bulk bags of flour for several months from Defiance, Australia. In addition, Staff understand that Norths Bakery (Wellington) Limited (which was acquired by Defiance) imported bulk flour from Australia some years ago. However, it may be significant that both were discontinued.

120 The applicant has identified several Australian flour millers as potential suppliers of foreign bulk flour to end users in New Zealand. These include George Weston Foods Limited, Manildra Starches Pty. Limited (Manildra), Water Wheel and Bunge (Australia) Limited (Bunge), all of which have plants relatively close to eastern Australian ports.

121 The applicant has provided a cost comparison between supplying bulk flour into an Auckland bakery from a domestic mill and by container from Australia. The costing data (inclusive of all identifiable costs), indicates that there is a cost per tonne differential of around [ ] in favour of supplying foreign bulk imports into a bakery [ ] at the present time, but at other times is expected to be lower.

122 The cost analysis also indicates that it would not be possible to land Australian bulk flour into a bakery in Christchurch, and compete effectively against the locally milled product. The cost differential in favour of the domestic product is around [ ] at the present time, but at other times is expected to be higher.

123 On the basis of information provided by the applicant, it appears that the technology is currently available to import foreign bulk flour. There are various ways in which foreign bulk flour could be transported using sea freight, including:

- ISO containers with plastic liners and fitted with aerated pads (required to keep the flour from settling at the bottom of the container);
- 1 tonne bulk bags;

- fixed shipping containers (ie: a tank aboard a vessel); and
- pods similar to those used to transport flour by rail transport within New Zealand.

124 The most cost effective and internationally proven method appears to be ISO containers and liner bags (eg: Powertex Sea Bulk and Powerliner systems).

125 It is necessary to have specialised equipment to discharge the bulk flour from a container into a customer's storage silo, such as a container tipping unit.

126 Plant bakers, as well as other bulk users of flour, require a regular and on-going supply of product to maintain throughput. To ensure security and quality of supply, and to allow for longer lead times when importing foreign bulk flour (minimum of two weeks from Australia according to the applicant's Coopers and Lybrand report), it would be necessary to carry higher inventories, thereby incurring higher costs. Bulk imports would also be susceptible to possible port disruptions and delay.

127 The cost of imported flour is likely to be subject to pricing fluctuations and foreign exchange movements.

128 It is clear that a move to using foreign bulk flour imports represents a significant change in current industry practice. However, such an approach appears technically viable, though this is tempered by the difficulties and extra costs in maintaining security and quality of supply.

<u>Conclusion on foreign bulk flour imports into either the North or South Islands</u>

129 After considering all aspects, including the applicant's financial analysis and the applicant's Coopers & Lybrand report, Staff conclude that foreign bulk flour imports into the North Island industrial bulk flour market may act as a potential constraint on the combined entity.

130 However, in the South Island industrial bulk flour market, foreign bulk flour imports are not considered commercially viable. Therefore, Staff conclude that foreign bulk flour imports into the South Island industrial bulk flour market will not act as a potential constraint on the combined entity.

<u>North Island imports of South Island bulk flour</u>

131 Defiance is supplying bulk flour from its Christchurch mill to its tied bakery, and to Griffins, in the North Island.

132 Canterbury Flour transports bulk flour in pods loaded on rail cars for delivery to its parent company, Rivermill, which operates a plant bakery at Huntly. Currently, Canterbury Flour is supplying around [ ] of bulk flour annually to Rivermill. Although the company is not supplying bulk flour to other end users, it appears to have the capability to do so.

133 Allowing for freight costs (around $80 per tonne between Ashburton and the upper North Island), Canterbury Flour appears to compete effectively on price with mills based in the North Island. Canterbury Flour's continued success in being able to compete effectively against North Island mills is dependent on its ability to continue securing supply to its tied

bakery outlet, which provides it with a sufficient base to cover costs. However, the company has limited excess capacity and its flour is not suitable for all applications.

Conclusion on North Island imports of South Island bulk flour

134 Having regard to the above factors, Staff conclude that South Island bulk flour imports into the North Island industrial bulk flour market may act as a constraint on the combined entity.

South Island imports of North Island bulk flour

135 There is currently no bulk flour moved from the North Island to the South Island.

136 Although bulk flour can be, and is, moved from the South to the North Islands, transport costs associated with moving flour in the opposite direction make it uneconomic. For example, it costs around $140 per tonne to transport bulk flour from Auckland to Christchurch, compared to around $80 per tonne for movements in the opposite direction. These factors, combined with the lower delivered price of flour from South Island mills, account for the absence of flour moved in bagged or bulk form from the North to the South Islands.

Conclusion on South Island imports of North Island bulk flour

137 Taking into account the transport costs and the higher milling costs incurred by North Island mills, Staff do not consider that North Island bulk flour imports into the South Island industrial bulk flour market would act as a constraint on the combined entity.

Constraint from Potential Competitors

138 Entry conditions, including the nature and height of any entry barriers, must be determined before the threat of new entry, which might constrain the conduct of the combined entity, can be properly evaluated.

Entry Conditions

139 The following entry conditions to the bulk flour markets were identified:

- There are presently 16 flour mills in New Zealand, many of which have some excess capacity, particularly in the North Island. Overall, there is considerable excess capacity in the industry.
- Milling equipment is freely available. However, to enter the industrial bulk flour markets on a scale that would constrain the combined entity, it has been suggested that a plant of eight tonnes per hour capacity would be required, involving capital expenditures of as much as $20 million. These expenditures would be only partly sunk, as while the milling equipment may have no alternative use in New Zealand, some may be sold internationally.
- The main participants in the industrial bulk flour markets are vertically integrated, such that most of their bulk flour is sold to their own plant bakeries. A new entrant would have difficulty competing for these currently “tied” sales. Unless a new entrant also

opened a plant bakery it would not have this guaranteed source of sales, and would find itself competing with the combined entity for a limited amount of "free" sales. In other words, to be sustainable, entry at two levels, milling and baking, would likely be required; however, there is excess capacity at both levels.

- Food manufacturers and bakers are reluctant to switch providers because of the importance of flour quality to the reputation of their products and because changes to recipes would probably be required. Goodman Fielder and Defiance have built reputations for quality flour, which is a difficult barrier for a new entrant to the bulk flour markets to overcome.
- A new entrant would have difficulty attaining the necessary market shares to reduce its unit costs to a level where it could be competitive with the combined entity.
- A new entrant might expect a competitive response to its entry by the combined entity. For instance, the combined entity might selectively reduce its prices for a sustained period, perhaps to the level of marginal costs, in order to protect its market shares from any new entry.

140 In conclusion, the barriers to entry to the industrial bulk flour markets are cumulatively high, forming a strong disincentive to market entry.

Conclusion on Constraints from Potential Competitors

141 Before the Commission will consider that new entry will provide an adequate constraint on a combined entity so as to allay dominance concerns, such entry must be shown to be *l*ikely, of sufficient *e*xtent, *t*imely and *s*ustainable (the "*lets*" test).[8]

142 Staff do not believe that new entry to the South Island industrial bulk flour market is likely, since a new manufacturer or bulk importer would not have "a reasonable prospect of achieving a satisfactory return on its investment",[9] should it decide to enter the market. Given the barriers, entry would appear to be unprofitable at present and for the foreseeable future. The market is small and there is much excess capacity. Accordingly, the prospect of new entry to the South Island bulk flour market is unlikely and will not be discussed further.

143 While new entry to the North Island industrial bulk flour market by way of manufacture is also considered unlikely, Staff believe that foreign bulk imports into the North Island may be feasible and may be of a sufficient extent to constrain the combined entity.

144 With respect to whether potential entry would be timely, the Commission considers that entry which cannot be achieved within two years from initial planning is unlikely to be sufficiently timely to allay dominance concerns. Staff are unaware of any plans to enter the North Island industrial bulk flour market by way of foreign imports, but consider that such entry may occur within two years.

145 Regarding the sustainability of potential entry by foreign imports, fluctuations in wheat prices and currency exchange would pose problems, but there may nevertheless be a lasting economic incentive for entry into the North Island industrial bulk flour market.

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8 Business Acquisition Guidelines, at pp 19-20.
9 Business Acquisition Guidelines, at p. 19.

Constraint by Suppliers

146 Milling wheat used in the production of bulk flour is readily available in New Zealand and from overseas. Staff do not believe that suppliers of wheat will constrain the combined entity. All flour millers pay substantially similar prices for milling wheat.

Constraint by Acquirers

147 As much of the bulk flour supplied in each market would be sold to the combined entity's own plant bakeries, constraint by these acquirers is not likely. [ ]

148 Other acquirers of bulk flour would be able to exert little constraint on the combined entity, particularly in the South Island market, due to the dearth of alternative sources of bulk flour.

Conclusion on Industrial Bulk Flour Markets

149 **North Island:** Based on the ability of existing competitors to expand production, and given some potential for imports, Staff conclude that the proposed acquisition would not result, and would not be likely to result, in the combined entity acquiring or strengthening a dominant position in the market for the production and acquisition of industrial bulk flour in the North Island.

150 **South Island:** In view of the height of the barriers to entry, the lack of either existing or potential competition, the non-viability of bulk foreign or North Island imports, and the lack of suppliers or acquirers who would act as a constraint on the combined entity, Staff conclude that the proposed acquisition would result, or would be likely to result, in the combined entity acquiring a dominant position in the market for the production and acquisition of industrial bulk flour in the South Island.

Markets for Industrial Bagged Flour

151 Industrial bagged flour is sold to commercial flour users, including in-store supermarket bakeries, hot bread shops, food manufacturers and, to a very limited extent, plant bakeries.

Market Shares

152 Flour sales figures were obtained from the flour millers for the 1996 calendar year. According to those figures, the tonnages of flour supplied into the North and South Island industrial bagged flour markets and the percentages which those tonnages represent of each market are shown in Table 6.

Table 6: Industrial Bagged Flour Markets

for Year Ended 31 December 1996

Company	Tonnage of Bagged Flour Sold and % of Total			
	North Island		South Island	
Goodman Fielder Defiance	[			
Combined Entity Allied Canterbury Flour S Canterbury Mills South Flour Milligans Sherratt (Importer) Other Imports	CONFIDENTIAL			]
Total	**45,710**	100%	**20,810**	100%

Source: Applicant and collated information. Tonnages are estimates only

153 The combined entity would have a [ ] market share in the North Island industrial bagged flour market and a [ ] share in the South Island industrial bagged flour market. Canterbury Flour would be the second largest competitor to the combined entity in the North Island market with a [ ] share. Allied would be the second largest competitor in the South Island market with a [ ] share.

Constraint from Existing Competitors

154 In the North Island industrial bagged flour market, the combined entity would face competition from Canterbury Flour, Allied and imports. Allied has excess capacity available in the North Island, and its ability to increase production could act as a constraint on the combined entity.

155 In the South Island industrial bagged flour market, Allied has very little capacity available to produce more industrial bagged flour. Likewise, Canterbury Flour has only a very limited ability to expand its production. The remaining independent South Island flour millers are too small to be considered legitimate threats to enter the South Island industrial bagged flour market on any significant scale, and the quality of their flour for commercial uses has been questioned.

Conclusion on Constraint from Existing Competitors

156 Staff conclude that existing competitors in the North Island industrial bagged flour market would constrain the combined entity.

157 There is no reason to believe that the existing competitors in the South Island industrial bagged flour market may properly be considered, individually or collectively, as a sufficient constraint to allay dominance concerns with respect to the post-acquisition conduct of the combined entity. The combined entity's nearest competitor in the South Island, Allied, has only a [ ] market share and is operating at nearly full capacity. Other competitors are small, produce a limited range of flours, and the consistency of their products has been questioned by users. Transport costs make shipment of North Island bagged flour to the

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South Island uneconomic. Staff conclude that there is no indication that the combined entity would be constrained by the threat of a competitive response by existing market participants in the South Island industrial bagged flour market.

Constraint from Industrial Bagged Flour Imports

158 In the 12 months ending 31 December 1996, total flour imports amounted to around 5,500 tonnes. All of these imports were landed in bagged form (predominantly 25 kg bags from Australian mills). The major importer of flour in recent years, Sherratt, is currently importing around [ ] tonnes of flour per annum from Bunge. This flour is supplied almost exclusively into the Auckland region. Customers of Sherratt include Ernest Adams, and a number of smaller flour users, including hot bread shops.

159 Defiance is importing around [ ] tonnes of flour from its Australian mills. These are generally specialty flours and are not produced domestically. In addition, [ ]

160 Imports of bagged flour can be made with relative ease in 20 foot ISO containers. Further, there appear to be a number of flour mills in Australia which are capable of supplying bagged flour direct to New Zealand purchasers. These include Manildra and Waterwheel.

161 On the basis of information supplied by the applicant and flour importers, bagged flour imports can currently be landed into the upper North Island at prices which are highly competitive with product supplied by North Island mills. Indeed, some of the prices which have been quoted recently indicate that bagged flour could be purchased from some Australian mills and delivered into customers' premises in Auckland at prices significantly below those offered currently by local mills.

162 One of the principal reasons for the current competitiveness of bagged flour imports is the spike which occurred in world wheat prices during the middle of last year, leading New Zealand flour millers to pay higher contract prices for wheat from domestic growers. Subsequently, world wheat prices dropped significantly, and overseas flour millers can now supply flour at more competitive prices based on lower world wheat prices, than local flour millers tied into higher domestic wheat prices.

163 Also, as noted by Goodman Fielder, wheat available to Australian millers is less expensive than the New Zealand imported product. This is because most imported wheat for milling in New Zealand is supplied through the Australian Wheat Board (AWB), a single selling desk operation, and not by the Australian growers. This contrasts with the situation applying to Australian millers who can deal directly with the Australian growers and purchase wheat at a lower price than that offered by the AWB. As a consequence, the applicant contends that Australian mills can currently export flour at more competitive prices than New Zealand mills for flour imported and milled from Australian wheat.

164 However, Staff have been advised by several parties that the current situation is an aberration, and is unlikely to be repeated again. Instead, it appears likely that local contract prices for wheat, which will be negotiated shortly, will reflect the lower world wheat prices. As a consequence, the volume of flour imports may drop.

165 The applicant, and some other parties (eg: Davis Trading), consider that bagged flour can be imported into most ports at prices similar to those applying in respect of Auckland. While Sherratt agrees that it can ship, and distribute, imported bagged flour into regions such as Christchurch and Dunedin at a similar cost to Auckland, the state of competition and pricing in those regions is such that it does not consider it to be viable to do so.

166 Apart from Australian imports, there is some bagged flour which is currently being transported from mills in the South Island to wholesalers and users in the North Island. For example, Canterbury Flour and South Canterbury Mills are supplying 20 kg bags from their plants at Ashburton and Temuka respectively to customers in the upper North Island. This is mainly for supply to hot bread shops and other small users. Bagged flour can be transported economically and without major practical difficulties on pallets aboard rail cars or trucks.

167 Staff are unaware of any bagged flour that is transported from North Island mills to end users in the South Island. Transport costs and the lower milling costs in the South Island make it uncompetitive for North Island mills to compete in the South Island industrial bagged flour market.

Conclusion on Constraint from Industrial Bagged Flour Imports

168 Having regard to the above factors, Staff consider that imports of industrial bagged flour from Australian mills, together with the supply of South Island bagged product, are likely to act as an effective constraint on the combined entity in the North Island industrial bagged flour market.

169 Having reviewed existing data, it is the view of Staff that regardless of the lack of any physical impediments to supplying imported flour to end users in the South Island, it is not feasible to do so on current price relativities. Nor is it considered feasible for North Island flour mills to compete on price terms with South Island bagged flour. Staff therefore consider that foreign bagged flour imports into the South Island, and the movement of bagged flour from the North to the South Islands, are unlikely to act as an effective constraint on the combined entity in the South Island industrial bagged flour market.

170 Staff consider that potential imports to the North Island industrial bagged flour market would be likely, of sufficient extent, timely and sustainable, and therefore would constrain the combined entity. However, Staff do not consider that potential imports to the South Island industrial bagged flour market will be likely, of sufficient extent, timely, or sustainable and thereby constrain the combined entity.

Constraint from Potential Competitors

171 The entry conditions to the industrial bagged flour markets by way of manufacture are substantially similar to those discussed in respect of the industrial bulk flour markets. Accordingly, the barriers to entry are considered by Staff to be high, forming a strong disincentive to such entry. Entry by way of a new flour milling facility is considered very unlikely, primarily due to the sunk costs, the combined entity’s size and reputation, and the excess capacity in the industry.

Constraint by Suppliers

172 Wheat used in the production of industrial bagged flour is readily available in New Zealand and from overseas. Staff do not believe that suppliers of wheat will constrain the combined entity. All flour millers pay similar prices for milling wheat.

Constraint by Acquirers

173 Acquirers of industrial bagged flour in the South Island would be able to exert little constraint on the combined entity, given the absence of substantial and consistent alternative sources for industrial bagged flour.

Conclusion on Industrial Bagged Flour Markets

174 **North Island:** Staff conclude that the proposed acquisition would not result, and would not be likely to result, in the combined entity acquiring or strengthening a dominant position in the market for the production and acquisition of industrial bagged flour in the North Island.

175 **South Island:** In view of the height of the barriers to entry, the conclusion that neither existing nor potential competition in the South Island industrial bagged flour market would act as a constraint on the combined entity, and that neither suppliers nor acquirers would act as such a constraint, Staff conclude that the acquisition would result, or would be likely to result, in the combined entity acquiring a dominant position in the market for the production and acquisition of industrial bagged flour in the South Island.

Market for Retail Bagged Flour

176 Retail bagged flour is sold to consumers by supermarkets and the route trade. All flour millers and at least one supermarket chain compete in the North and South Island markets for retail bagged flour.

Market Shares

177 Flour sales figures were obtained from all flour millers and from the Foodstuffs (Wellington) supermarket chain for the 1996 calendar year. According to those figures, the tonnages of flour supplied into the North and South Island retail bagged flour markets and the percentages which those tonnages represent of each market are shown in Table 7.

Table 7: Retail Bagged Flour Markets
for Year Ended 31 December 1996

Company	Tonnage of Retail Bagged Flour Sold and % of Total			
	North Island		South Island	
Goodman Fielder Defiance	[			
Combined Entity Allied Canterbury Flour S Canterbury Mills Harraways Milligans South Flour Foodstuffs (Well.)	CONFIDENTIAL			]
Total	**18,546**	100%	**7,761**	100%

Source: Applicant and collated information. Tonnages are estimates only

178 The combined entity would have a [ ] market share in the North Island retail bagged flour market and a [ ] market share in the South Island retail bagged flour market. In the North Island market, the only competitors to the combined entity would be Allied with a [ ] share and Foodstuffs (Wellington) with a [ ] share. In the South Island market, the combined entity's largest competitor would be Harraways with a [ ] share.

<u>Housebrands</u>

179 The above market share figures include the retail bagged flour sold by millers for use as housebrands by the supermarkets.

180 Supermarket chains contract with flour millers to produce retail bagged flour for labelling under one or more "controlled" labels or housebrands. In addition, as noted in Table 7, Foodstuffs (Wellington) purchases flour from millers (Allied at the moment) to bag its own housebrands. According to figures supplied by market research firm AC Nielsen (Nielsen), housebrand sales account for [ ] of retail bagged flour sales in the South Island by volume. In the North Island, housebrand volume shares are [ ] in the Auckland region and [ ] in the lower North Island.

181 Housebrand retail bagged flour contains no reference to the miller which supplies the flour. Examples of housebrands include Foodstuffs' "Pams" and "Budget" brands, Woolworth's "No Frills" brand, and Progressive's "Basics" brand.

182 According to information supplied by the flour millers, [ ] of Goodman Fielder's North and South Island retail bagged flour sales are housebrands. For Defiance, [ ] of such sales are housebrand sales. By comparison, the other millers that sell retail bagged flour tend to produce more housebrands than proprietary brands. For example, [ ] of Allied's retail bagged flour sales are housebrands.

183 In the context of the bread markets, the applicant argued that housebrand market shares should not be included in the combined entity's total market share for dominance analysis purposes (application at pp 21-23), because:

- housebrands compete with the millers' own brands;
- flour millers have no control over the pricing of housebrands; and
- housebrand contracts are typically for short terms of six months to one year.

184 Although the applicant's comments are noted, Staff believe that inclusion of the combined entity's housebrand business in the retail bagged flour market share figures is logical for the following reasons:

- the applicant agrees that there are efficiencies of scale to be achieved by the increased throughput which housebrand business brings to the millers' operations;
- although margins are lower, in addition to the contribution to overheads, housebrand account holders typically make a profit from these sales;
- only the larger millers such as Goodman Fielder and Defiance can produce the housebrand volumes required by supermarkets; and
- although shares of the housebrand business fluctuate, Goodman Fielder and Defiance have maintained a consistently high share of the housebrand business.

185 Therefore, Staff believe that consideration of the combined entity's share of the housebrand business in each retail bagged flour market is appropriate.

Conclusion on Market Shares

186 The combined entity's shares of the North and South Island retail bagged flour markets are [ ] and [ ] respectively, which are very high.

Constraint from Existing Competitors

187 In the North Island retail bagged flour market, the combined entity currently faces competition from Allied and Foodstuffs (Wellington). Allied has competed only to a limited extent to date. Allied bags retail flour at its Wellington mill. [ ] Allied has some capacity in
Wellington ([ ]) to devote to additional retail flour packing. Foodstuffs (Wellington) obtains its flour for packing from Allied's Wellington mill.

188 At its Auckland mill, Allied has excess capacity available but no packing machinery. Packing equipment is readily available in New Zealand, and can be purchased over a broad cost range - from a few thousand dollars to hundreds of thousands of dollars, depending on throughput and degree of automation. Were it to purchase packing machinery, Allied could enter the North Island market subject to achieving a commercially viable brand and access to retail shelf space. This may provide some constraint on the combined entity. [ ]

189 If Canterbury Flour purchased more sophisticated packing machinery it could also compete in the North Island retail bagged flour market, but not at levels that would be likely to constrain the combined entity. In addition to brand and shelf space considerations, Canterbury Flour would also have to overcome additional transport costs from the South Island.

190 In the South Island retail bagged flour market, Allied would have very little capacity available to produce retail bagged flour ([ ] tonnes) and would have to purchase packing machinery.

191 The other independent South Island flour millers currently compete in the retail bagged flour market on a localised, small-scale basis. They are not considered real threats to expand their participation significantly in the South Island retail bagged flour market. While the applicant claims that some of the millers have excess capacity, Staff believe that much is theoretical only. The millers are very small businesses without the capital or infrastructure to expand. They still pack flour by hand and/or with only rudimentary packing equipment and have no plans for expansion, being content with localised participation in the market. According to one miller, to expand production significantly, would take as much as five years.

192 Supermarkets could provide some degree of constraint on the combined entity in both the North and South Island markets. At least one chain, Foodstuffs (Wellington), bags a sizeable portion of its housebrand retail bagged flour. Foodstuffs (Wellington) provided Nielsen figures showing that controlled labels have a [ ] market share in the lower North Island and stated that its self-bagged flour comprises about [ ] of that market share. The [ ] tonnes of flour it uses for bagging is acquired from Allied under a [ ] contract. All three members of the Foodstuffs group (Auckland, Wellington and South Island) have their own housebrand retail flour. Foodstuffs (Auckland) and Foodstuffs (South Island) each have bagging potential. However, if Foodstuffs were to increase its production, it would require access to a sufficient supply of flour, which might be difficult to source in full from outside the combined entity.

<u>Conclusion on Constraint from Existing Competitors</u>

193 Existing competitors in the North Island retail bagged flour market are likely to act as a constraint on the combined entity.

194 In the South Island retail bagged flour market, capacity limitations of the current flour millers, their lack of sizeable packing machinery, and their lack of interest in expanding, make it unlikely that they would be a sufficient constraint on the combined entity so as to allay dominance concerns. The combined entity’s nearest competitor in the South Island market, Harraways, has only a [ ] market share, hand-packs its flour, and would have difficulty expanding its production, even though it has the theoretical capacity to do so. There is no indication that the combined entity would be constrained by the threat of a competitive response from any of the existing market participants. Finally, the prospect of supermarkets packing retail flour is dependent to the same extent upon their access to flour produced by the combined entity. Apart from Foodstuffs (Wellington), supermarkets have generally expressed a preference to buy pre-bagged housebrand flour.

<u>Constraint from Retail Bagged Flour Imports</u>

195 There is currently no retail bagged flour imported from overseas mills into either the North or South Islands. However, Staff have been advised that one supermarket chain (Woolworths in the North Island) imported retail bagged flour into the country some years ago.

196 Imports into the North Island are likely to be feasible for reasons similar to those discussed in *Constraint from Industrial Bagged Flour Imports*. It may be possible, for example, for a supermarket either to import industrial bagged flour and retail pack itself (or by contracting a packing firm) or to import retail bagged flour directly. Staff understand that one miller is exploring the possibility of importing retail bags from Australia.

197 Staff are unaware of any retail bags of flour being moved from the South Island to the North Island. However, as noted previously, industrial bagged flour is already moved from the South to the North Islands, and it appears possible for those parties to supply retail bagged flour.

198 Imports of retail bagged flour into the South Island (either from overseas or North Island mills) are not likely to be feasible for reasons similar to those discussed in *Constraint from Industrial Bagged Flour Imports*.

Conclusion on Constraint from Retail Bagged Flour Imports

199 Staff conclude that the combined entity would be likely to be constrained by the potential threat of imports (foreign or from the South Island) of retail bagged flour in the North Island market.

200 It is not likely that imports of retail bagged flour could be landed into the South Island (foreign imports or from the North Island) at prices sufficiently competitive to those of the South Island mills. Accordingly, Staff conclude that retail bagged flour imports into the South Island are unlikely to provide any effective constraint on the combined entity in that market.

Constraint from Potential Competitors

201 Any new entry to the retail bagged flour markets by way of a new flour milling facility is considered unlikely due to the large sunk costs, the combined entity's size and reputation, and the excess capacity in the industry. Such entry would most likely occur in conjunction with entry into one or other of the industrial flour markets.

202 However, the capital expenditures required to enter the packing level of the markets are not prohibitive. According to the applicant, packing equipment can be purchased for between $5,000 to $300,000, depending on the degree of automation and capacity of the equipment. Alternatively, independent packing companies could be contracted to bag flour or supermarkets could purchase bulk or bagged flour to bag on their own account. However, sourcing an adequate supply of flour to produce enough retail bagged flour to provide a sufficient constraint on the combined entity could well prove an issue.

203 Other barriers to entry would include the branding, reputation and marketing power of the combined entity and the difficulty of obtaining shelf space in the supermarkets (except for supermarkets themselves). In short, the barriers to entry are considered by Staff to be high, forming a strong disincentive to entry to the retail bagged flour markets.

Conclusion on Constraint from Potential Competitors

204 Staff do not currently consider that new entry to the North Island retail bagged flour market would be sustainable or of sufficient extent to constrain the combined entity in that market. Staff do not consider that new entry to the South Island retail bagged flour market would be likely, timely, sustainable or of sufficient extent to constrain the combined entity in that market.

Constraint by Suppliers

205 Access to a supply of flour for retail packing in the South Island retail bagged flour market is possible, but such suppliers would not be likely to constrain the combined entity in that market.

Constraint by Acquirers

206 Supermarkets, by promoting housebrands over proprietary brands, and through their control of shelf space, could exert some control over the post-acquisition behaviour of the combined entity.

Conclusion on Retail Bagged Flour Markets

207 **North Island:** At the present time, and based on the costing and business feasibility information available, Staff conclude that the proposed acquisition would result, or would be likely to result, in the combined entity acquiring a dominant position in the market for the production and sale of retail bagged flour in the North Island.

208 **South Island:** Staff conclude that neither existing nor potential competition in the South Island retail bagged flour market would act as a constraint on the combined entity in that market and that neither suppliers nor acquirers would act as a sufficient constraint. Accordingly, Staff conclude that the proposed acquisition would result, or would be likely to result, in the combined entity acquiring a dominant position in the market for the production and sale of retail bagged flour in the South Island.

Markets for Premium Pastry Flour

209 Separate North and South Island markets have been identified for the production and acquisition of premium pastry flour. Certain North and South Island pastry manufacturers are dependent upon this flour for their products. An estimated [ ] tonnes of premium pastry flour is produced each year to meet their requirements.

Market Shares

210 At present, Champion supplies [ ] of premium pastry flour. [ ] Accordingly, the combined entity would have a [ ] market share in each market.

Constraint from Existing Competitors

211 [ ] A large scale manufacturing facility with modern milling equipment is required to produce the quantity and quality of such flour demanded by its users. [ ]

Constraint from Imports

212 Staff have been advised by [ ]

213 Additional costing data provided by [ ].

214 On the basis of the information that has been made available, Staff consider that premium pastry flour imports do not represent a viable alternative based on current prices, and therefore are unlikely to provide a sufficient constraint on the combined entity in either the North or South Island markets.

Constraint from Potential Competitors

215 New entry by way of a flour milling facility is considered unlikely to occur because of the large sunk costs in establishing a sufficiently sized facility to produce premium pastry flour. The relatively small size of the markets would not make such entry sustainable. An entrant would also need to find outlets for the much larger quantities of ordinary flour produced.

216 Staff do not consider that new entry to the premium pastry flour markets would be likely, of sufficient extent, timely or sustainable so as to constrain the combined entity.

Constraint by Suppliers and Acquirers

217 There appear to be no constraints which suppliers (wheat growers) could impose on the combined entity. Acquirers, [ ], would likewise be unable to constrain the combined entity.

Conclusion on Premium Pastry Flour Markets

218 Staff conclude that neither existing nor potential competitors, nor imports, nor suppliers, nor acquirers would constrain the combined entity in either market. Accordingly, Staff conclude that the proposed acquisition would result, or would be likely to result, in the combined entity either acquiring or strengthening a dominant position in the market for the production and acquisition of premium pastry flour in the North Island and in the market for the production and acquisition of premium pastry flour in the South Island.

Bran and Pollard Markets

219 These by-products of flour milling are used as ingredients in stock-feed.

Market Shares

220 Bran and pollard sales by volume and market share figures for 1996 are shown in Table 8.

Table 8: Bran and Pollard Markets for Year Ended 31 December 1996

Company	Tonnage of Bran & Pollard and % of Total			
	North Island		South Island	
Goodman Fielder Defiance	[			
Combined Entity Allied Canterbury Flour S Canterbury Mills Other Millers	CONFIDENTIAL			]
Total	**45,277**	100%	**28,546**	100%

Source: Applicant and collated information. Tonnages are estimates only
* Estimate

221 The combined entity would have a market share of [ ] of the North Island bran and pollard market and an [ ] market share of the South Island bran and pollard market. The next largest supplier to the combined entity in each market, Allied, would have [ ] and [ ] market shares respectively.

Constraint by Acquirers

222 Faced with an attempt by the combined entity to exercise market power in either or both the North or South Island markets, acquirers of bran and pollard (primarily stock-feed manufacturers) could adjust their mix of ingredients to reduce the amount of bran and pollard required. Moreover, bran and pollard are merely by-products of the milling process and must be disposed of in some fashion. Should the stock-feed manufacturers refuse to purchase bran and pollard because of increased prices or some other exercise of market power by the combined entity, there does not appear to be another productive use for those by-products.

Conclusion on Bran and Pollard Markets

223 Despite the combined entity's relatively high market shares of [ ] and [ ], respectively, in the North and South Island bran and pollard markets, Staff conclude that the proposed acquisition would not result, and would not be likely to result, in the combined entity acquiring or strengthening a dominant position in either the market for the production and acquisition of bran and pollard in the North Island or the market for the production and acquisition of bran and pollard in the South Island.

Bread Markets

224 The following three bread markets have been identified as being relevant for the purposes of dominance assessment:

- the market for the production and sale of packaged bread in the upper North Island;
- the market for the production and sale of packaged bread in the lower North Island; and
- the market for the production and sale of packaged bread in the South Island.

225 Both Goodman Fielder and Defiance are major bakers of bread products. In general terms, the proposed acquisition would aggregate the largest and the third largest bakers of bread in New Zealand.

226 The data used to prepare market share estimates in the three bread markets has been provided by the applicant and compared against information available from Nielsen and other industry participants.

Market Shares

227 Set out in Table 9 are estimates of the market shares of industry participants for packaged bread.

Table 9: Estimated Packaged Bread Sales
Year to 29 December 1996

Bakery	**Upper North Island**		**Lower North Island**		**South Island**	
	Sales $(m)	Share	Sales $(m)	Share	Sales $(m)	Share
Goodman Fielder	[					
GF Housebrand						
GF Franchisees						
Defiance						
Def Housebrand			CONFIDENTIAL			
Combined Entity						
Allied						
Allied Housebrand						
Rivermill						
Yarrows						
In-store Housebrand						]
Total	**204.3**	100%	**95.9**	100%	**87.8**	100%

Source: Applicant and collated information. Sales are estimates only.

228 The following points should be noted about the estimates in Table 9:

- the market shares for the combined entity include the shares for the three independent Goodman Fielder franchise bakeries (see paragraph 233);
- housebrand and in-store supermarket bakery sales have been calculated from information provided by the applicant; and
- the combined entity's share in the South Island market has increased since 29 December 1996 from [ ] to [ ], after Goodman Fielder secured the contract to bake housebrand

bread for Foodstuffs (South Island). Allied's share in that market has decreased correspondingly [ ] to [ ] after it lost that contract. The revised current shares for the South Island market are set out in Table 10.

Table 10: Estimated Packaged Bread Sales in the South Island Market
Year to 29 December 1996
Adjusted for Allied's Loss of Foodstuffs' Housebrand Contract

Bakery	**South Island**	
	Sales $(m)	Share
Goodman Fielder	[	
GF Housebrand		
GF Franchisees		
Defiance		
Def Housebrand		
Ex-Allied Housebrand		
Combined Entity		
Allied		
Allied Housebrand		
Rivermill		
Yarrows		
In-store Housebrand		]
Total	**87.8**	**100%**

Source: Applicant and collated information.
Sales are estimates only.

229 For Table 10, Staff believe that the sales and share numbers shown are reflective of the market situation as at April 1997, adjusted for the housebrand contract change.

230 Allied is taking market action after losing the contract and is seeking to gain market share through significant discounting. The move has resulted in Goodman Fielder not achieving the full sales previously achieved by Allied under the contract. Staff are not satisfied that Allied will be able to sustain this level of discounting for any extended period of time. Staff acknowledge that the Foodstuffs' (South Island) housebrand contract may change again over time.

231 As shown in Table 9, the combined entity would have had a combined market share of [ ] in the upper North Island, [ ] in the lower North Island and [ ] in the South Island in the year to 29 December 1996. In that year, Allied had market shares of [ ] in the upper North Island, [ ] in the lower North Island and [ ] in the South Island, although its share in the South Island market has since reduced substantially to [ ] through its loss of the Foodstuffs' (South Island) housebrand contract.

232 Rivermill (upper North Island), and Yarrows (lower North Island), each provide competition in one of the North Island markets. Rivermill sells bread in the upper North Island market (with a [ ] share), but not elsewhere, while Yarrows supplies the lower North Island market only (with a [ ] share). No independent plant bakeries operate in the South Island market.

233 The three Goodman Fielder franchisees, Walter Findlay, Northern Bakeries and Breadcraft Wairarapa each are independently owned, but have a tie with Goodman Fielder entitling them to bake that company's breads, though they also bake some bread which is sold under

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competing brands. However, several other industry participants suggested that the three franchisees are regarded as Goodman Fielder bakeries. In Table 9, the shares of the three franchise bakers are included within the market shares shown for the combined entity.

234 Several of the larger supermarkets have started producing packaged bread in their in-store bakeries. Currently, their combined market shares are small at [ ] in the three markets.

Constraint from Existing Competitors

235 The three franchise bakers supply bread in localised areas - Northern bakeries in Northland, Walter Findlay on the East Coast and Breadcraft Wairarapa in the Wairarapa. Each is a relatively small bakery run as a family business without the capacity to supply much beyond its current area. Given their limited capacities and their existing franchise arrangements with Goodman Fielder, Staff do not believe that these bakeries would constrain the combined entity.

236 The applicant argues that Rivermill and Yarrows are expanding plant bakers operating in their specific regions. Rivermill is also vertically integrated with its own mill in the South Island.

237 Staff understand that Rivermill has attempted, but has been unable, to supply supermarkets, apparently as it was not competitive on price (including discounts offered), with other bakers. Therefore, it has concentrated on supplying the route trade.

238 The applicant argues that if supermarkets concluded that the products provided by the national plant bakers were priced uncompetitively, then the supermarkets would encourage either Rivermill or Yarrows to expand against guarantees of shelf space and housebrand contracts. It is stated that Rivermill, with its South Island-based mill, would have an additional incentive to expand its operations into the South Island market. That has not occurred, according to the applicant, only because of the extremely competitive market in the South Island.

239 Yarrows supplies bread from Taranaki to Paraparaumu, but has not been prepared to contest sales in Wellington. It appears to be concentrating on expanding its frozen dough business.

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240 In the view of Staff, neither Rivermill, nor Yarrows, appears able to act as a constraint on the combined entity, beyond the limited regions where each currently sells packaged bread.

241 Allied is both a flour miller and a plant baker. It now has its highest packaged bread market share in the upper North Island market with [ ]. Although it currently has no unused capacity in that market, it is [ ] the capacity of its Auckland bakery. Clearly, Allied will be an active participant in the upper North Island market.

242 In the lower North Island, Allied has a [ ] market share. The applicant identified Allied's Wellington bakery as having a [ ] loaves per week (or [ ]) surplus capacity. Allied, in its submission, accepts that figure. Allied would appear to have sufficient capacity to raise its output in that market significantly.

243 In the South Island, Allied now has a [ ] market share after losing the Foodstuffs housebrand contract, which amounted to a [ ] market share. The applicant identified Allied's Christchurch bakery as having a [ ] loaves per week (or [ ]) surplus capacity and Dunedin bakery as having a [ ] loaves per week (or [ ]) surplus capacity. Allied, in its submission, does not dispute those figures. Allied has been discounting on price to regain lost market share (successfully to date), and would appear to have sufficient capacity to raise its output in that market significantly.

244 Staff believe that Allied would remain a competitive constraint on the combined entity in the upper North Island and lower North Island markets, but are not convinced that it would have sufficient market presence to constrain the combined entity in the South Island market. However, Allied would have the production potential to recover the market share which it lost recently to Goodman Fielder in the South Island market.

245 The remaining contributors are in-store supermarket bakeries. Staff are aware that the [ ].

246 The application states that "out of 338 major supermarket stores, 242 have in-store bakeries". It is apparent that a significant proportion of the latter number do, or could, bake packaged bread to compete with the product from the plant bakers.

247 According to the applicant, the cost of putting in a full in-store bakery capable of baking packaged bread is [ ]. Where there is already an existing in-store bakery, then the cost of upgrading that facility to bake packaged bread is said to be approximately [ ].

248 The applicant suggests that the overall trend is for supermarkets to manufacture their own housebrand bread. The applicant notes that Big Fresh bakes in-store all of its own housebrand bread, Countdown is now doing likewise in a number of stores and Foodtown is planning to bake packaged bread in any new or refurbished store.

Conclusion on Constraint from Existing Competitors

249 Given the market shares of the combined entity, the potential of existing competitors (especially Allied) to increase output, together with the growing presence of housebrands and packaged bread produced by in-store supermarket bakeries, existing competitors are likely to constrain the combined entity in the two North Island markets. Therefore, Staff do not intend to discuss these two markets further.

250 In the South Island market, Allied is the only competing plant baker and Staff consider it unlikely that Rivermill and Yarrows would establish South Island bakeries. However, in-store bakeries would provide some constraint.

251 The applicant suggests that the packaged bread market in the South Island is extremely competitive, and that the supermarkets have far greater countervailing power than in the

North Island markets. That proposition will be considered below under possible constraint by acquirers of products produced by the combined entity.

Constraint from Potential Competitors

252 The applicant suggests that potential new entry could come from several sources:

- Either Rivermill, or Yarrows, expanding from being a regional to a national supplier - possibly invited or supported by one or more supermarket groups;
- Bunge from Australia, which currently competes in the Australian bread markets and is bidding to acquire Defiance's Australian assets;
- Supermarkets (eg: Big Fresh); and
- Supermarket group bakeries (wholesale arm), which are already distributing throughout New Zealand to their various supermarkets and would have no difficulty adding bread to their distribution system. Woolworths Australia has already taken that step in the Australian bread markets.

253 Entry conditions, including the nature and height of any entry barriers, must be determined before the threat of new entry, which might constrain the conduct of the combined entity, can be properly evaluated.

Entry Conditions

254 The following entry conditions to the packaged bread markets were identified:

- There is over-capacity in the industry;
- Whereas entry to one of the packaged bread markets could be achieved for relatively modest amounts, to enter all three packaged bread markets on a national basis with the ability to constrain the combined entity, Allied suggested that capital expenditure of about $[ ] million would be required. [ ];
- Technology is freely available;
- Availability of flour supplies is uncertain;
- Branding is considered important by industry participants. Goodman Fielder has a range of brands, including "Nature's Fresh", Defiance has been building the "Countryfare" brand and Allied, the "Tip Top" brand;
- Obtaining space in supermarkets for new bread brands is difficult. After housebrands and plant bakery brands are stocked, there is little space left for new brands;
- Advertising and promotion costs would be substantial for a new entrant to the packaged bread markets. Major advertising and promotional campaigns are required to gain volume sales;
- Goodman Fielder and Defiance have built reputations for quality products which would be a difficult barrier for a new entrant to the packaged bread markets to overcome; and
- There would be sunk costs involved in establishing a new plant bakery operation of sufficient scale to be able to restrain the combined entity.

255 The barriers to entry to the packaged bread market in the South Island are cumulatively high, forming a fairly strong disincentive to entry or expansion. The primary barriers are the current over-capacity in a mature market, Goodman Fielder's strong reputation, high

brand advertising costs and the limited shelf space available in the supermarkets. Also, the slow progress made by Defiance in achieving market share would not instil confidence in potential entrants that they are likely to achieve satisfactory returns on their investments.

256 Staff have not identified any potential plant bakery entrant. Any such entrant would need to establish a secure source of flour, a potential difficulty given the market power of the combined entity and the impracticality of imports. Staff have received no information that Bunge might be contemplating entry in this country.

257 It is likely that the number of in-store supermarket bakeries will continue to grow, with many being of sufficient size to produce packaged bread. Subject to the supermarkets being able to source flour at acceptable prices and terms, they are likely to provide some competition for the combined entity.

258 Staff have been given no indication from the three major supermarket chains that they are contemplating manufacturing or supplying packaged bread through supermarket group bakeries (wholesale arm) to their various supermarkets.

Conclusion on Constraint from Potential Competitors

259 No new competitors have been shown to be likely to enter the South Island packaged bread market. However, the capacity of Allied and the in-store supermarket bakeries to expand, together with the countervailing power of the supermarkets, might constrain the combined entity. The countervailing power of the supermarkets in the South Island market will be considered in the next section.

Constraint by Suppliers and Acquirers

260 Suppliers of flour and other inputs are not believed to be likely to impose any significant constraint on the combined entity in the South Island packaged bread market.

261 The applicant notes that housebrands controlled by the supermarkets nationally comprise a [ ] share of bread sales. Those sales are concentrated in the South Island market with a [ ] share. It is argued that the extent of housebrand bread sales in the South Island market has provided the supermarkets with a degree of countervailing power and has been the major driver of price competition in bread sales in that market. There is a much greater level of price-driven competition in that market, supported by vigorous promotions by both the supermarkets and the plant bakers. However, if only Allied remains as a substantial competitor in the South Island market, given its limited ability to expand sales, that housebrand-driven competition may be lessened after the proposed acquisition has been implemented.

262 The supermarkets with their purchasing power, ability to allocate shelf space, and use of housebrands and promotions, have been able to play one plant bread supplier off against another. The supermarkets currently have a degree of countervailing power. All the

supermarket chains indicate that their countervailing power is likely to be reduced if the proposed acquisition goes ahead.

Conclusion on Constraint by Suppliers and Acquirers

263 Suppliers are not believed to be likely to constrain the combined entity in the South Island packaged bread market. In the North Island markets, constraint by acquirers has not been considered as it is believed that the combined entity would be constrained by existing competitors.

264 As acquirers of packaged bread in the South Island market, supermarkets currently have a considerable degree of countervailing power, primarily derived from there being three competing plant bakers. Post-acquisition, the combined entity would have a [ ] market share, Allied would be the only significant competitor, with no independent plant bakers, and no likely new entrants. Staff conclude that the supermarkets would not retain sufficient countervailing power to constrain the combined entity in the South Island market.

Conclusion on Packaged Bread Markets

265 **Upper North Island:** Staff conclude that the proposed acquisition would not result, and would not be likely to result, in the combined entity acquiring or strengthening a dominant position in the market for the production and sale of packaged bread in the upper North Island.

266 **Lower North Island:** Staff conclude that the proposed acquisition would not result, and would not be likely to result, in the combined entity acquiring or strengthening a dominant position in the market for the production and sale of packaged bread in the lower North Island.

267 **South Island:** In all the circumstances, and for the reasons noted in respect of the analysis of this market, Staff conclude that the proposed acquisition would result, or would be likely to result, in the combined entity acquiring a dominant position in the market for the production and sale of packaged bread in the South Island.

VERTICAL INTEGRATION

268 The Commission has assessed the impact of vertical integration on competition in a number of its previous decisions, including *Dunlop/Goodyear* (Decision 204, 1987), *Eachairn/Fluid Control* (Decision 214, 1987), and *Carter Holt Harvey/Elders NZFP* (Decision 249B, 1990).

269 When examining the likely effects arising from vertical integration in relation to these acquisitions, the Commission has previously adopted the conclusions of the US Department of Justice Guidelines, 1984.

270 The Commission has stated that vertical acquisitions are subject to the same tests as horizontal acquisitions, but "...it accepts that, in general, such acquisitions are less likely to result in the acquisition or strengthening of a dominant position in a market than those which lead to horizontal integration."[10]

271 The Commission also states that "... unless a situation of dominance exists at one of the levels affected by a vertical acquisition, such acquisitions are in normal circumstances unlikely to lead to the acquisition of a dominant position in a market". However, "...(w)here a situation of dominance exists at one of the levels affected by the acquisition, the Commission will examine the acquisition to determine whether that dominant position is likely to be strengthened or extended to other markets".

272 Areeda and Turner[11] argue that vertical mergers are only likely to raise competition concerns where both markets are highly concentrated, and have substantial entry barriers.

Vertical Integration Assessment

273 As noted previously, Goodman Fielder has an integrated operation beginning with wheat purchasing, through flour milling, to the baking of bread and the production of a range of other bakery products. Defiance is involved in wheat purchasing, flour milling, and the baking of bread and other bakery products, albeit on a lesser scale than Goodman Fielder.

274 Accordingly, the effect of implementing the proposed acquisition would be to strengthen the level of existing vertical integration between the wheat, flour milling, bread baking and other bakery product markets identified earlier in this report.

275 A feature of the New Zealand flour milling and bread baking industries is that much of the total flour produced is sold into the "tied" bakery sector. Thus, Goodman Fielder, Defiance, Allied and Canterbury Flour each supply the total requirements of their own baking companies, with this business generally being unavailable to be competed for by other flour milling companies.

276 As noted in *Goodman Fielder/Wattie* (Decision 201A, 1987), the requirement to source flour within a vertically integrated company is consistent with the practice in other countries, including Australia and the United Kingdom. One of the major reasons for the practice, both in New Zealand and overseas, is that vertical integration provides security and consistency of supply for mills and bakeries, maximises the utilisation of production capacity, and lowers transaction costs.

277 Following implementation of the proposed acquisition, the level of vertical integration among the wheat markets, the industrial bulk, industrial bagged, retail bagged and premium pastry flour markets, and the packaged bread markets would be extensive. Further, all of these markets would be characterised by a high level of concentration. Indeed, Staff conclude that following implementation of the proposed acquisition, the combined entity

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10 Business Acquisition Guidelines, p.23.

11 Antiitrust Law, Volume IV: An Analysis of Antitrust Principles and Their Application Areeda P and Turner F, P 269

would be, or would be likely to be, dominant in five markets in the South Island (industrial bulk flour, industrial bagged flour, retail bagged flour, premium pastry flour, and packaged bread), and in two in the North Island (retail bagged flour and premium pastry flour).

278 Given the factors outlined above, Staff consider that the vertical integration arising from the proposed acquisition is likely to strengthen the dominance of the combined entity in the markets in which dominance arises, or is likely to arise, from the proposed acquisition. Indeed, it is the view of Staff that the only method by which new entrants would be able to compete effectively post acquisition is through two-level entry (ie: flour milling and bread baking). Staff do not consider that entry on such a scale would be likely, timely or sustainable. Staff acknowledge that a new bakery operation, without an integrated milling operation (eg: Yarrows), is possible, providing such an entrant could be satisfied of an independent, secure, source of supply of flour.

279 In the remaining flour and bread markets, it is the view of Staff that vertical integration is unlikely to result in the combined entity acquiring, or being likely to acquire, dominance. The reasons are as follows:

North Island Flour Markets

- the presence of two other vertically integrated market participants (Allied and Canterbury Flour);
- the actual or potential threat of industrial and retail bagged flour imports; and
- the proposed acquisition will not increase the proportion of the market occupied by tied sales.

North Island Bread Markets

- the presence of one large vertically integrated company (Allied); and two regional bread bakeries; and
- the countervailing power of supermarkets.

Conclusion on Vertical Integration

280 Staff conclude that the existence of vertical integration strengthens the conclusions of dominance reached in this report.

CONCLUSION

281 Staff conclude that the proposal would result, or would be likely to result, in the combined entity acquiring a dominant position in five markets and either acquiring or strengthening a dominant position in two markets.

RECOMMENDATION

282 Having had regard to the factors set out in section 3(9) of the Act, Staff conclude that the proposed acquisition would result, or would be likely to result, in the combined entity:

(a) acquiring a dominant position in the following five markets:

- the market for the production and acquisition of industrial bulk flour in the South Island;
- the market for the production and acquisition of industrial bagged flour in the South Island;
- the market for the production and sale of retail bagged flour in the North Island;
- the market for the production and sale of retail bagged flour in the South Island; and
- the market for the production and sale of packaged bread in the South Island; and

(b) either acquiring or strengthening a dominant position in the following two markets:

- the market for the production and acquisition of premium pastry flour in the North Island; and
- the market for the production and acquisition of premium pastry flour in the South Island.

283 It is recommended that, in terms of section 66(3)(b) of the Act, the Commission decline to give a clearance for the proposed acquisition.

Andrew Brice
Chief Investigator
14/4/1997