

## COMMERCE COMMISSION Draft Determination

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

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

**NEW ZEALAND DAIRY BOARD  
KAIKOURA CO-OPERATIVE DAIRY COMPANY LIMITED  
KIWI CO-OPERATIVE DAIRIES COMPANY LIMITED  
MARLBOROUGH CHEESE CO-OPERATIVE LIMITED  
THE NEW ZEALAND CO-OPERATIVE DAIRY COMPANY LIMITED  
NORTHLAND CO-OPERATIVE DAIRY COMPANY LIMITED  
SOUTH ISLAND DAIRY CO-OPERATIVE LIMITED  
TASMAN MILK PRODUCTS LIMITED  
TATUA CO-OPERATIVE DAIRY COMPANY LIMITED  
WESTLAND CO-OPERATIVE DAIRY COMPANY LIMITED  
SOUTH ISLAND DAIRY CO-OPERATIVE LIMITED**

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

**Summary of Proposal:** The acquisition by an as yet unformed company ("NewCo"), of all of the shares in all or some of the above companies.

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

**Date of draft :** 27 August 1999

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## THE PROPOSED MERGER

### The Application

1 On 21 June 1999, the Commission registered an application for authorisation under section 67(1) of the Commerce Act 1986 (“the Act”) for an as yet unformed company (“NewCo”) to acquire all of the shares or assets in all or some of the following:

- New Zealand Dairy Board (“Dairy Board”);
- Kaikoura Co-operative Dairy Company Limited (“Kaikoura”);
- Kiwi Co-operative Dairies Company Limited (“Kiwi”);
- Marlborough Cheese Co-operative Limited (“Marlborough Cheese”);
- The New Zealand Co-operative Dairy Company Limited (“Dairy Group”);
- Northland Co-operative Dairy Company Limited (“Northland”);
- South Island Dairy Co-operative Limited (“SIDCO”);
- Tasman Milk Products Limited (“Tasman”);
- Tatua Co-operative Dairy Company Limited (“Tatua”); and
- Westland Co-operative Dairy Company Limited (“Westland”), (together the “Participants”).

2 In the notice, the Applicant gave an undertaking in terms of section 69A of the Act, as part of the authorisation sought, that NewCo will form and divest a separate company, which will own and operate substantial assets used in the processing of town milk. On 5 August 1999, the Applicant gave the Commission an undertaking to divest the 50 percent of the shares in New Zealand Dairy Foods Limited owned by Dairy Group.

3 The application has been made by Mr Graham Calvert, Independent Chairman of the Overview Committee of Dairy Industry Chairmen (a committee of representatives of the dairy co-operative companies and the Dairy Board).

4 The Commission notes that the Applicant is not seeking authorisation under section 58 of the Act, which deals with the Commission granting authorisation for restrictive trade practices. Therefore, the Commission will not be granting or declining authorisation for any dairy industry arrangements currently in place, or contemplated in the future. While relevant current and potential arrangements are likely to be considered in the Commission’s assessment of markets, dominance, and benefits and detriments, any authorisation granted for the proposed merger would not amount to authorisation for those arrangements, and any existing or possible arrangements thus considered would not be protected from future action under the Act.

5 As at the date of the notice, neither the Applicant nor the Participants had entered into any binding agreement relating to the proposed merger. The Applicant advises that any agreement which subsequently is entered into by the Participants will be subject to Commerce Commission authorisation.

## **The Proposed Merger Structure**

- 6 The Applicant advises that it intends to implement the proposed merger by a restructuring plan, authorised by certain proposed legislation, to enable the effective merger of participating dairy co-operatives, and the Dairy Board, a statutory body corporate. Under the proposed merger, the farmer shareholders of each dairy co-operative will vote on whether their dairy co-operative should participate in the new structure. The participating dairy co-operatives will then vote on whether the Dairy Board should be included in the new structure. The restructuring plan will specify the percentage of votes required to pass the resolution in each instance. Attached as Appendix A is a diagram showing the structure of the proposed merger.
- 7 The Applicant anticipates that the requisite number of shareholders of most dairy co-operatives will vote to participate in NewCo. It is also anticipated that the requisite number of dairy co-operatives will vote to include the Dairy Board in the structure. For those dairy co-operatives whose supplier shareholders do vote to join NewCo, their respective shareholders will be offered an equivalent shareholding in NewCo (based on current supply of milk solids) in exchange for their shareholding in their present dairy co-operative. A mechanism will be introduced to recognise the differing values of shares in each of the participating dairy co-operatives.
- 8 The proposal is made on the basis that shareholders of all existing dairy co-operatives will merge with NewCo. However, for those dairy co-operatives whose supplier shareholders choose not to merge, the restructuring plan will provide either for the resumption of their dairy co-operative's shareholding in the Dairy Board, or for the purchase of that shareholding by NewCo on the same basis. The price paid by the Dairy Board will be a fair and reasonable price as provided for in the Fifth Schedule to the Dairy Board Act 1961, or the purchase of that shareholding by NewCo on the same basis.
- 9 Either way, the intended result is a farmer-owned holding company that owns:
  - the participating dairy co-operatives (which are shareholders in the Dairy Board); and
  - the shares in the Dairy Board, including those previously owned by those dairy co-operatives not participating in the new structure.
- 10 The Commission has been advised, and it has been publicised, that at least two dairy co-operatives, namely Tatua and Marlborough Cheese, do not intend to merge with NewCo. For the purposes of this proposal, however, the determination will be based on the assumption that all potential participants will merge with NewCo. Should authorisation be granted, it will permit those dairy co-operatives which do not accept the offer to merge to do so at some later date, although no later than 1 September 2000 as envisaged by the Dairy Industry Restructuring Bill 1999.

### *Alternative proposed merger structure*

- 11 The Applicant advises that in the event that legislation does not provide for a restructuring plan, the participating dairy co-operatives would have to consider

proceeding by way of an amalgamation proposal under Part XIII of the Companies Act 1993.

- 12 The Applicant advises that if the participating dairy co-operatives were to amalgamate, they would merge either into an existing co-operative, or into a new company. The Dairy Board would become a subsidiary of NewCo.

## **THE PARTIES**

### **Dairy Board**

- 13 Under the Dairy Board Act 1961, the Dairy Board has statutory monopoly power over the acquisition and export of all dairy products from New Zealand.
- 14 The Dairy Board is currently responsible for virtually all manufactured dairy product exports sourced in New Zealand (about 99 percent). The balance is exported by permit holders who are licensed by the Dairy Board to export one or several products directly to one country of destination, or multiple destinations.
- 15 The Dairy Board purchases dairy products from dairy co-operatives and sells them either directly, or through its worldwide marketing network of subsidiary and associate companies, distributors and agents. More than 95 percent of manufactured dairy products produced in New Zealand are sold to the Dairy Board for export. As the exporting and overseas marketing arm of the industry, it links manufacturing and industry growth plans with export market requirements. The Dairy Board is the largest multi-national dairy marketing organisation in the world, exporting to over 100 countries through its distribution network.
- 16 The Dairy Board has 13 directors. The Minister of Food, Fibre, Biosecurity and Border Control appoints two directors, and the remaining 11 directors are elected by the dairy co-operatives. The Dairy Board Act prevents the election of more than five directors by a single co-operative or group of dairy co-operatives, to ensure that no single dairy co-operative gains control of the Dairy Board through its elected directors. Directors are also required to act in the best interests of the industry.
- 17 The Dairy Board issues non-transferable and non-tradeable shares to its supplier co-operatives in proportion to the quantity of milk solids supplied. As a consequence the exact shareholdings are adjusted each year.
- 18 Previously, the Dairy Board was subject to an exemption under Part II of the Commerce Act for certain behaviour which affected domestic markets. For instance, section 27 of the Dairy Board Act gave the Dairy Board the power to influence the price of certain classes of dairy produce, including butter and cheese, where that produce was sold on the domestic market. That provision was repealed on 3 July 1998, following the enactment of the Dairy Board Amendment Act 1998.
- 19 Aside from its marketing role, the Dairy Board carries out, or contributes funds to, various ancillary activities of relevance to the wider dairy industry. These activities include:



- artificial breeding, herd recording and testing, which is undertaken by Livestock Improvement Corporation Limited, a company wholly owned by the Dairy Board;
- research and development, which is carried out by the The New Zealand Dairy Research Institute, a charitable trust; and
- disease control.

## **THE MERGING DAIRY CO-OPERATIVES**

### **New Zealand Co-operative Dairy Company Limited (“Dairy Group”)**

- 20 Based in the Waikato, Dairy Group is the largest dairy co-operative in New Zealand with approximately 7,880 suppliers. In 1998, Dairy Group processed approximately 411 million kilograms of milk solids, or 46 percent of the national total. Dairy Group’s share of total milk has increased to 58 percent following the company’s acquisition of SIDCO (see para 23).
- 21 The principal activities of Dairy Group and its subsidiaries are: the collection and processing of its suppliers’ milk into dairy based products for domestic and export markets; domestic marketing and distribution of branded dairy based consumer product; dairy related support activities including rural retailing; the marketing and packaging of food ingredients; and the provision of energy to the processing factories.
- 22 Dairy Group’s dairy product manufacturing is carried out at 11 operating sites located in Waikato, South Auckland, Bay of Plenty and Christchurch. The company operates some of the largest butter, cheese and milk powder factories in the world.
- 23 Dairy Group has been involved in a number of acquisitions of other dairy co-operatives, the most recent being the Christchurch-based dairy co-operative, SIDCO. The merger between SIDCO and Dairy Group has provided Dairy Group with a supplier base in the South Island, although it has franchise arrangements with two town milk companies to produce town milk in the South Island under the Anchor brand.

### **Kiwi**

- 24 Kiwi is the second largest dairy co-operative in New Zealand, with 4,227 suppliers nationwide. The majority of these suppliers are located in Taranaki, Manawatu and Hawkes Bay. Kiwi’s 240 South Island suppliers are located around Christchurch and South Otago/Southland. In 1998, Kiwi processed approximately 241 million kilograms of milk solids, or 27 percent of the national total.
- 25 Kiwi owns and operates the world’s largest dairy manufacturing site, which is located in Hawera, together with a plant in Longburn in the North Island, and plants in Christchurch and Stirling in the South Island.
- 26 Kiwi’s principal activities include: the acquisition and processing of raw milk; the manufacture and processing of various dairy and powdered milk products; the processing and wholesale distribution of liquid milk, and other dairy-based consumer

products through its subsidiary, Mainland Products Limited<sup>1</sup>; and the manufacture and marketing of ice cream (Rush-Munro's of New Zealand Limited).

### **Northland**

- 27 Northland manufactures and processes various dairy products for the domestic market and for export at its two operating plants at Kauri and Maungaturoto. It has 1,700 suppliers and processed 87 million kilograms of milk solids in 1998.

### **Westland**

- 28 Westland, based in Hokitika, is involved in the production and supply of milk powder and butter. Westland exports milk powder and butter through the Dairy Board, and supplies butter on the domestic market. It has about 370 suppliers and processed 24 million kilograms of milk solids in 1998 at its only operating plant in Hokitika.

### **Tasman Milk**

- 29 Tasman Milk manufactures and processes various dairy products for export (butter, casein, caseinates) at its single manufacturing site at Takaka. It has 225 suppliers and processed about 12 million kilograms of milk solids in 1998.

### **Tatua**

- 30 Tatua manufactures and processes various high quality, low-volume, dairy products for the domestic and export markets at its single manufacturing site at Tatuanui (Waikato). These products include a variety of milk proteins, aerosol creams and UHT beverages. In 1998, the company processed about eight million kilograms of milk solids, and has 143 suppliers located within a 10 kilometre radius of its plant.

### **Marlborough Cheese**

- 31 Marlborough Cheese is a cheese producer with around a 15 percent market share of the New Zealand retail cheese market. The company has 81 suppliers and processed five million kilograms of milk solids in 1998 at its only operating site, in Tuamarina. Marlborough Cheese produces about 7,500 tonnes of cheese annually. It exports about 5,000 tonnes through the Dairy Board, most of which is sold to quota markets. Marlborough Cheese owns the trade marks for Koromiko.

### **Kaikoura**

- 32 Kaikoura manufactures and processes cheese for the domestic and export markets at Kaikoura. The company's total milk production in 1998 was three million kilograms of milk solids, from which 3,126 tonnes of cheese was produced. Kaikoura has 28 suppliers.

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<sup>1</sup> See paragraph 41 for further details on Mainland Products Limited.

## **THE AMALGAMATED COMPANY**

### **NewCo**

- 33 As noted above, NewCo is an as yet unformed company which will act as the vehicle to acquire all of the shares or all of the assets of the Dairy Board, and all or some of the other nine entities outlined in paragraph 1.
- 34 The Applicant advises that an interim constitution for NewCo will be adopted as part of the proposed merger. On 16 August 1999, the Applicant provided to the Commission a copy of the draft constitution of NewCo. NewCo will:
- have an interim board of nine to eleven directors;
  - be a co-operative in terms of the Co-operative Companies Act 1996; and
  - issue equity securities, called Q and A shares respectively, which do not have to be of nominal value.

## **OTHER PARTIES**

### **New Zealand Dairy Foods Limited (“Dairy Foods”)**

- 35 Dairy Foods is Dairy Group’s domestic marketing and sales company. Prior to 1 June 1999, Dairy Foods was a wholly owned subsidiary of Dairy Group. However, with effect from 1 June 1999, Dairy Foods became a public unlisted company with Dairy Group holding 50 percent of the shares of the company, and around 7,000 Dairy Group farmer shareholders holding the balance of shares. As noted above, Dairy Group will divest its 50 percent shareholding in Dairy Foods as part of the proposal.
- 36 Dairy Foods manufactures, markets and distributes chilled dairy products in the domestic and export markets. The company (through three subsidiaries), is organised into three separate business units (Beverages, Foods, and Export).
- New Zealand Milk Corporation Limited produces milk, cream, flavoured milk, juice drinks and some specialty products for consumption locally;
  - Country Foods New Zealand Limited (“Country Foods”) produces butter, cheese, yoghurts, desserts, dairy foods, cottage cheese and cream cheeses for supply to the local market; and
  - New Zealand Dairy Foods (Asia Pacific) Limited produces UHT milk and foods for export to the Asia/Pacific region.
- 37 Dairy Foods is prominent in a number of domestic food and beverage categories, as outlined in Table 1 below:

**TABLE 1**  
**Category Ranking**

	<b>Number 1</b>	<b>Number 2</b>
Yoghurt	Dairy Foods	Yoplait
Dairy Foods	Dairy Foods	Yoplait
Desserts	Dairy Foods	Yoplait
Custards	Dairy Foods	Mainland
Cultured Cheese	Mainland	Dairy Foods
Butter	Dairy Foods	Mainland
Block Cheese	Mainland	Dairy Foods
Specialty Cheese	Mainland	Dairy Foods
Milk & Cream	Dairy Foods/Mainland	Dairy Foods/Mainland
Flavoured Milk	Dairy Foods	Mainland

- 38 Dairy Foods' main production site is at Takanini in South Auckland, with distribution centres throughout the North Island, from which it supplies about 35 percent of the New Zealand fresh milk market. Dairy Foods receives about 550,000 litres of farm fresh milk every day - 410,000 litres is processed into fresh milk products, 85,000 litres into UHT products, and the remainder is used in food products.
- 39 Dairy Foods' beverage distribution is handled by a network of franchisees in the North Island, and by two licensees in the South Island (Nelson Milk Limited and Southern Fresh Milk Company Limited, Invercargill). The company's food distribution is handled by independent distributors throughout the North and South Islands except for key accounts, which are handled directly by Country Foods.
- 40 Dairy Foods' main trade marks are: Anchor, Primo, Fernleaf, Fresh n Fruity, Swiss Maid, Metchinikoff, De Winkel, Chesdale (licensed from the Dairy Board), NZ Fresh, Country Goodness, Ornelle, and Royal Tasman.

#### **Mainland Products Limited ("Mainland")**

- 41 Mainland is a private company which is owned 83 percent by Kiwi and 17 percent by Aorangi Laboratories Limited. The company's major business activities include: the acquisition of unprocessed milk for manufacture into fresh and UHT milk, cream, yoghurt and other cultured milk products and speciality cheeses; the packing, wholesaling and marketing of certain dairy products for the domestic market; the wholesaling of processed meats and smallgoods; and other small undertakings related to the chilled dairy foods industry. The major trade marks owned and used by Mainland include Mainland, Valumetric, Galaxy, Ferndale, Tararua, Ski and Meadowfresh.

#### **Town Milk Companies**

- 42 The dedicated town milk companies are Gisborne Milk, Northland Milk, Nelson Milk, Top Milk (Kaitaia), Taumarunui Milk, Independent Milk Processors (Clevedon), Marlborough Milk, and Fresha Valley (Northland). Some draw on as few as half a dozen suppliers. Southern Fresh Milk Company Limited and Nelson Milk Limited

have franchise agreements with Dairy Foods to produce liquid milk in the South Island under the Anchor brand. They also have their own brands. Marlborough Milk has a franchise for the Meadow Fresh trade mark for the Marlborough region.

## **Retailers**

- 43 Most retail milk and consumer dairy products in New Zealand are sold through supermarkets. The three supermarket chains in New Zealand are the Foodstuffs companies, Progressive Enterprises Limited and Woolworths (NZ) Limited. Supermarkets sell both the dairy co-operatives' proprietary brands, and their own brands ("housebrands"). For supermarkets, milk sales are the fourth highest turnover, and represent the biggest overall profit earner. The oil companies are also significant retailers of consumer dairy products and retail milk through their service station outlets.

## **Australian Dairy Industry**

- 44 The Australian dairy industry can be divided into two distinct sectors – the liquid milk sector and the manufacturing sector.
- 45 The liquid milk sector has three major competitors: Dairy Farmers Group (a farmer co-operative), National Foods Limited (an Australian-owned company) and Parmalat Foods Australia Pty Limited ("Parmalat", an Italian-based large scale international dairy company).
- 46 Both farmer-owned dairy co-operatives and private companies operate within the manufacturing sector. Dairy co-operatives dominate production, processing over 75 percent of all manufacturing milk supplies. The three largest companies – Murray Goulburn Co-operative Co Limited ("Murray Goulburn"), Bonlac Foods Limited ("Bonlac") and Dairy Farmers Group (all farmer dairy co-operatives) – account for around 45 percent of all milk intake, and around 50 percent of all milk used for manufacturing. Other major food processing companies include Nestle Australia Limited, Parmalat and Kraft Foods Limited.
- 47 Bonlac and Murray Goulburn are the two major exporters of dairy produce in Australia. Australia exports around 50 percent of its annual milk production, and more than 60 percent of its manufactured products. Australia ranks third in terms of world dairy trade, accounting for around 15 percent of world dairy exports.

## **COMMISSION PROCEDURES**

- 48 Section 67(3) of the Act requires the Commission to issue a decision within 60 working days, or such other longer period as the Commission and the Applicant shall agree. The Commission has sought, and the Applicant has agreed, to a time extension. The final determination on the application will be delivered on a date to be agreed between the Applicant and the Commission, and is likely to be in late October 1999.
- 49 If it is satisfied that the acquisition would not result, or would not be likely to result, in the acquisition or strengthening of a dominant position in a market, the

Commission must give a clearance to the acquisition under section 67(3)(a).

- 50 If it is not satisfied that the acquisition would not result, or would not be likely to result, in a dominant position in a market being acquired or strengthened, the Commission must nevertheless grant an authorisation for the acquisition if it is satisfied that the proposed merger would result, or would be likely to result, in such a benefit to the public that it should be permitted under section 67(3)(b).
- 51 If it is not satisfied as to the matters referred to in paragraphs 49 and 50 above, the Commission must decline to grant an authorisation under section 67(3)(c).
- 52 Submissions on the Draft Determination must be forwarded to the Commission by 17 September 1999 as late submissions will not be accepted. This includes all submissions by interested parties and experts.
- 53 Section 69B of the Act provides that the Commission may hold a conference prior to determining whether or not to give a clearance or grant an authorisation under section 67(3) of the Act. In respect of this proposal, the Commission intends to convene such a conference in Wellington to be held from 5-8 October 1999.
- 54 The Applicant sought confidentiality for certain information contained in the notice seeking authorisation, together with some parts of its further submissions, and a confidentiality order was made in respect of that information for a period of 20 working days from the Commission's determination of the notice. When that confidentiality order expires, the provisions of the Official Information Act 1982 will apply to that information.
- 55 The Commission's Draft Determination is based on the investigation conducted by staff, and their subsequent advice to the Commission.
- 56 The Commission has been informed by a Member participating in the consideration of this application, Ms Paula Rebstock, that her spouse Mr Ulf D. Schoefisch, is employed by Deutsche Bank. Deutsche Bank is providing investment banking services for some of the participants in the proposed merger which is the subject of the application. Ms Rebstock's spouse is not involved in any way in Deutsche Bank's activities in relation to this proposed merger. The Commission does not believe that this creates a conflict of interest as defined in section 14(2) of the Act such that Ms Rebstock is required to withdraw from participating in consideration of this application. If any party wishes to raise any objection to her participation, they must notify Mr Ken Heaton, Acting General Manager of the Commission, in writing within seven days of the release of this Draft Determination.

## **PROPOSED DIVESTMENT**

- 57 The Applicant has undertaken, as part of the authorisation sought, that Dairy Group's 50 percent shareholding in Dairy Foods will be divested. Dairy Foods will own and operate substantial assets used in the processing of town milk. Farmer suppliers already own 50 percent of the shares in Dairy Foods.

- 58 The Applicant advises that Dairy Group's 50 percent shareholding in Dairy Foods will be divested within 12 months of the implementation of the proposed merger. Dairy Foods is currently taking steps which ultimately will lead to the company being operated at arm's length from Dairy Group, as an independent entity. So far, some directors who are independent of Dairy Group have been appointed to the Dairy Foods board, and the company has acquired assets from Dairy Group, including several trade marks. These measures are designed to facilitate the sale. The Commission has been advised that the divestment will be effected by a sale of Dairy Group's shares in Dairy Foods to persons not interconnected or associated with NewCo.

### **Other Matters Affecting the Proposed Divestment**

- 59 The Applicant has advised the Commission that the assets to be divested to Dairy Foods will include all of Dairy Foods' brands, with the exception of the Anchor and Fernleaf trade marks. Attached as Appendix B is a list of the brands that will be owned by Dairy Foods. The brands used in overseas markets are identified separately. Attached as Appendix C is a list of brands that will be licensed by NewCo to Dairy Foods.
- 60 The Applicant has provided the Commission with the indicative terms of a proposed licence agreement. These terms will be subject to negotiation between NewCo and Dairy Foods. The main terms and conditions of the licence agreement, as they currently stand, are summarised below:
- the licence is to run for an indefinite period on a five year rolling term basis;
  - the licence is an exclusive licence for the specified brands to be used in New Zealand only, with NewCo retaining overseas rights. NewCo retains ownership of the Anchor and Fernleaf trade marks and the goodwill;
  - Dairy Foods is required to provide a range of undertakings with respect to its use of the trade marks, including matters relating to the quality of dairy products sold under the trade marks, the protection and the promotion of the trade marks and the goodwill, the reproduction of the trade marks, and the use of the trade marks within New Zealand and not outside New Zealand;
  - Dairy Foods is required to pay a royalty of two percent of the gross sales income for the dairy products sold under the trade marks. The royalty payment commences from the second five year term and is coupled with extensive reporting obligations; and
  - the licence may be terminated on the occasion of a number of events. In particular, the agreement may be terminated if there is a material breach by Dairy Foods, a change in control of Dairy Foods, or a breach of the proposed butter and milk supply agreements (see below), leading to termination of these contracts.

### *Supply Agreements*

61 The Applicant has advised that the proposed divestment will also include a long term supply agreement with NewCo for raw milk, and a separate supply agreement for butter, cheese and milk powder. The Commission has been provided with two draft supply agreements. The terms of the supply agreements are indicative only, and are subject to negotiation by the participants. A summary of the key elements of the two supply agreements follows:

- the supply contracts will remain in force for a term of five years. There are two further two year rights of renewal;
- Dairy Foods may elect to terminate the raw milk supply agreement after four years. The supply agreement for butter, cheese and milk powder may be terminated after three years. The Applicant submits that the termination clauses in the agreement will provide Dairy Foods with the option of developing its own supplier base. It believes that this would be readily achievable over a five year period;
- Dairy Foods must purchase a specified quantity in kilograms of raw milk, butter, cheese and milk powder for the term of the agreement, and it is not entitled to purchase in excess of this quantity during any season, except in certain specified circumstances; and
- Dairy Foods is required to provide NewCo with an annual forecast of Dairy Foods' quantity requirements for raw milk, butter, cheese and milk powder.

### *Other Commercial Agreements*

62 The franchise agreements between Nelson Milk and New Zealand Milk Corporation Limited ("NZMC"), the beverage arm of Dairy Foods, and between Southern Fresh Milk Company Limited and NZMC, will remain in force post-divestment.

63 Dairy Foods participates in two other significant commercial arrangements – for the supply of grated cheese and processed cheese. Dairy Foods currently sources its grated cheese from Dairy Group. Dairy Group in turn owns 50 percent of The Grated Cheese Company Limited. Post-divestment, Dairy Foods will continue to source grated cheese under contract, either with NewCo or The Grated Cheese Company directly.

64 Dairy Foods currently sources its processed cheese from Pastoral Foods NZ Limited ("Pastoral Foods"), as does Mainland. Pastoral Foods is owned by the Dairy Board. Dairy Foods also licenses the Chesdale trade mark from the Dairy Board. Post-divestment, Dairy Foods will continue to source its processed cheese from Pastoral Foods. The current licence of the Chesdale trade mark terminates upon a change of ownership of Dairy Foods. That agreement will, therefore, have to be renegotiated .



## **Relevance of These Matters under Section 69A of the Commerce Act**

65 Section 69A of the Act provides that the only undertakings the Commission can accept when considering an application for authorisation of an acquisition are undertakings to dispose of shares or assets. Section 69A(2) provides the Commission may not accept any other undertakings. The overall effect of these provisions is that the Commission may accept structural undertakings, but not behavioural undertakings. The Commission accepts that the undertaking to divest the 50 percent of the shares in Dairy Foods is an acceptable undertaking for the purpose of section 69A of the Act. The matters outlined in paragraphs 58-62 above do not form part of the Applicant's section 69A divestment undertaking. They are simply matters to which the Commission can give such weight as it considers appropriate in considering the proposal.

## **SECTION 26 STATEMENT**

66 In applying the relevant provisions of the Act, the Commission is required to have regard to the economic policies of the Government, transmitted to the Commission in accordance with section 26 of the Act. Specifically, section 26(1) provides that:

“In the exercise of its powers under ... this Act, the Commission shall have regard to the economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister.”

67 On 30 July 1999, the Minister for Enterprise and Commerce (“the Minister”) transmitted in writing to the Commission, pursuant to section 26 of the Act, a statement on the economic policy of the Government with respect to the dairy industry. A copy of the Minister's statement together with the covering letter is attached as Appendix D.

68 In the statement, the Minister states that:

“The Government's overall objective is to maximise the economic welfare of New Zealand. This overall objective is achieved by policies that facilitate the efficient use of resources across the economy. The growth of an internationally competitive export sector, of which the dairy industry is a significant part, is a key component of the Government's policies.”

69 Further, the section 26 statement provides that:

- “Changes to legislation are required to achieve the overall goals of the Government and the dairy industry”. The Government will provide arrangements for overseas markets where access is currently restricted, ensure competitive neutrality in the regulatory environment, and phase out the statutory powers providing for a single exporter for New Zealand dairy exports over time;
- the dairy industry must ensure that effective and efficient governance arrangements are in place, including adequate commercial, including appropriate capital market, disciplines; mobility of capital; adequate protection of shareholders' interests; and the separation of commercial and non-commercial interests; and

- in general, the Government sees full tradeability of shares (not linked to supply) in large commercial entities as conducive to effective corporate governance and efficient resource allocation.

- 70 The Minister also outlines the specific features of the legislation that are designed to enable the dairy industry to move to operate within an effective competitive and governance framework. These are detailed in the section describing the proposed legislative environment.
- 71 In the section 26 statement, the Minister comments that it is important that adequate provision is made in the initial constitution of the new entity for shareholders to “enter and exit at fair value in a timely manner” to ensure effective corporate governance. “Fair value” in the context of the proposed reforms is defined in the section 26 statement as the value that would be expected if:
- the shares were tradeable among supplying shareholders on a willing buyer and willing seller basis in an arm’s length transaction;
  - the earnings attributable to equity were fully unbundled and delinked from the milk price and distributed to shareholders as dividends, or are reflected in the exit value; and
  - the duty of directors is to maximise the earnings attributable to equity given the separation of a milk price which approximates that which would be paid in a competitive market.
- 72 The Commission notes, however, that the Dairy Industry Restructuring Bill 1999 (Restructuring Bill) does not make fair value entry or exit obligatory. This matter is discussed below. Accordingly, the Commission cannot assume that fair value exit and surrender provisions will necessarily be put in place following implementation of the proposed legislation.

### **Consideration to be Given to Statements of Government Economic Policies**

- 73 The implications of a section 26 statement have previously been considered by the Commission and the High Court.<sup>2</sup> The Commission has noted that:

“... having regard to the general policy discretion in the Act to promote competition sec 26 may be used to advise the Commission of Government policy or policies or to be more specific in relation thereto. It is not to influence or determine the decisions which the Commission must make. Thus, fully preserving the discretions given to the Commission in the Act, the Commission is required only ‘to have regard to’ such statements in reaching its decisions.”<sup>3</sup>

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<sup>2</sup> *Re New Zealand Kiwifruit Exporters Associations (Inc) – New Zealand Kiwifruit Coolstorers Association (Inc)* (1989) 2 NZBLC (Com).

<sup>3</sup> *Ibid.* 104,494.

74 The High Court (Wylie J) held that the issue of a section 26 statement:<sup>4</sup>

“... is the exercise of a statutory right specifically conferred on {the Minister} by the Legislature for the very purpose of influencing the outcome of applications under the Act. That is not to say that the Commission ... is bound to apply the policy so transmitted to it. The statutory injunction of section 26 is no greater than that the Commission ‘shall have regard to’ the Government’s policy.”

75 Further:

“As with any other evidence it is for the tribunal to assess the weight to be given to each item of evidence and in the case of a statement of this kind, which in our view is simply an evidentiary statement of Government policy - it is certainly not a direction – it remains for the tribunal to assess the weight to be given to it as an expression of official perception of, in this case, public benefit.”

...

“The tribunal may not ignore the statement. It must be given genuine attention and thought, and such weight as the tribunal considers appropriate. But having done that, the tribunal is entitled to conclude it is not of sufficient significance either alone or together with other matters to outweigh other contrary considerations which it must take into account in accordance with its statutory function: ... In the end, however weighty the statement may be as an expression of considered Government policy, it does not have any legislative effect to vary the nature of the duties which the tribunal must carry out.”<sup>5</sup>

76 In reaching its Draft Determination, the Commission has given careful consideration to, and has had regard to, the section 26 statement in relation to the dairy industry.

## OVERVIEW OF THE DAIRY INDUSTRY

### The New Zealand Dairy Industry

77 The dairy industry is an important element of the New Zealand economy. For the year ending 30 June 1999, dairy product exports accounted for around 23 percent of the country’s total export earnings.

78 Milk production in New Zealand is pasture-based, which results in marked seasonal variations in supply. Output reaches its maximum in spring and early summer, when grass growth is at its peak (ie in “flush”), and declines over the winter months when cows are “dried off”. Variations in weather conditions can also affect production levels, and often lead to fluctuations in milk supply from forecast levels.

79 The trend towards dairying, and away from sheep and beef farming, is continuing in New Zealand, although the rate of growth of the dairy farming industry has decelerated. Over the last five years, on average, milk output in New Zealand has been growing annually at 4.5 percent,<sup>6</sup> and processing facilities have expanded accordingly. Much of the recent growth has occurred in the South Island.

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<sup>4</sup> *New Zealand Co-operative Dairy Company Ltd & Anor v Commerce Commission* (1991) 3 NZBLC 99-219, 102,067.

<sup>5</sup> *Ibid.* 102,067-068.

<sup>6</sup> *Situation and Outlook for New Zealand Agriculture 1997* (Ministry of Agriculture).

- 80 Processed milk is a complex product containing a number of constituent components which, through the manufacturing process, are combined in varying proportions to produce a wide range of dairy products (including town milk). Because milk products rarely contain milk components in the same proportions as raw milk, processors are presented with challenges in terms of determining the aggregate product mix, and then allocating the production of each product type to a single plant, or a number of plants. This in turn has implications for the trading of milk components between dairy factories. For example, small specialised plants are likely to trade unwanted by-products, or to purchase components, while large multi-plant companies are likely to manage the process internally.
- 81 The major focus of the local dairy industry is on manufacturing products for overseas markets. Approximately 92 percent of the total milk produced in New Zealand is used in the production of dairy products for export. The remainder is used to produce town milk and some dairy products for domestic consumption.

### **The International Dairy Industry**

- 82 The Dairy Board is a major trader in the global dairy market, accounting for about 31 percent of internationally traded dairy produce. Its share of total world production is, however, substantially smaller at around 2.4 percent.
- 83 A major feature of international dairy markets is that they are characterised by substantial regulation and intervention. Virtually all domestic markets throughout the world are regulated and supported to some extent, including through centralised purchasing arrangements, subsidies, tariffs and quotas. As a result, most countries produce most of their dairy product requirements domestically. The proportion of dairy production traded internationally is relatively small (around eight percent of total world dairy production), and the output which is available to be traded internationally is subject to considerable market distortions.
- 84 In some markets, such as the European Union, the USA and Canada, a dairy products quota system operates (“quota markets”). These quotas limit the volume of dairy products which may be imported in a specified time period, the volume being less than that which is traded normally. As a consequence, the prices of dairy products on those countries’ domestic markets are raised, often well in excess of international prices. The Dairy Board, which controls the licences for export of New Zealand dairy products into these markets, is able to earn rents accruing from these quota licences on limited export volumes.
- 85 Another feature of the international dairy market is the diversity in terms of the products manufactured and the requirements of individual markets. The Dairy Board exports an array of products, ranging from commodity products, in which it is essentially a price taker, to other products which, by virtue of its size, allow it to influence prices by determining how much to sell, and to whom.

## **Structure of the New Zealand Dairy Industry**

- 86 The New Zealand dairy industry is characterised by a co-operative structure. Following Dairy Group's acquisition of SIDCO, which was completed recently, there are eight dairy co-operatives, each of which operates one or more dairy processing factories. All of these dairy co-operatives are owned exclusively by their milk supplying shareholders.
- 87 Based on kilograms of milk solids processed each year, there are now three large dairy co-operatives in the North Island (Northland, Dairy Group and Kiwi) and one small co-operative (Tatua). In the South Island, there are three large dairy co-operatives (Kiwi, Dairy Group (previously SIDCO) and Westland) and three smaller dairy co-operatives (Tasman, Marlborough and Kaikoura).
- 88 There are four major product groupings manufactured by dairy factories in New Zealand: milk powders such as skim-milk powder, wholemilk powder, and buttermilk powder; cream products, such as butter, and anhydrous milkfat; cheese; and protein products such as casein and caseinates. The large dairy co-operatives are involved in the production of the full range of dairy products, while the smaller dairy co-operatives concentrate on the production of a much more limited range of products.
- 89 Manufactured consumer dairy products are supplied on the domestic market by a combination of dairy co-operatives, private companies, joint venture companies and importers. The products include processed milk products, butter, block cheese, speciality cheese, spreads, processed cheese, yoghurts, dairy desserts and dips.
- 90 Milk sold for fresh consumption in New Zealand is described as town milk. Dairy co-operatives and town milk companies carry out the manufacture and sale of fresh milk and cream. This is achieved through the supply of proprietary brands and house brands to supermarkets, service stations and other retailers of fresh milk. Currently, Dairy Foods and Kiwi (through its subsidiary Mainland) have the major share of the town milk industry.
- 91 Historically, unprocessed milk for town milk supplies was sourced from dedicated suppliers as opposed to farmers supplying manufacturing milk (ie milk supplied to produce manufactured dairy products). However, following the deregulation of the town milk industry in 1993, and the subsequent rationalisation in the dairy industry during which many town milk companies were acquired by dairy co-operatives, the trend has been for dairy co-operatives to cease drawing milk from separate suppliers. Rather, processors now pay a premium for town milk which is supplied during the winter months. The winter premium reflects the additional input costs associated with producing out-of-season milk. For the remainder of the year, no distinction is made between raw milk supplied for town or manufacturing purposes.
- 92 Since deregulation of the town milk industry, the share of milk sold by supermarkets has increased markedly, while oil companies have also emerged as significant retailers of milk. At the same time, home deliveries have experienced a major decline, especially in the North Island.

## **Dairy Industry Rationalisation**

- 93 The dairy industry has experienced substantial rationalisation over the past decade, particularly through merger activity. The initial focus of this activity was in the North Island, where the bulk of the industry is located, but in recent years the South Island has also been characterised by a series of mergers. The outcome of this activity has been the emergence of two major market players - Dairy Group and Kiwi- which together account for about 85 percent of total dairy production in New Zealand.
- 94 At the same time, the dairy industry has been characterised by the concentration and consolidation of production of dairy factories on a limited number of sites. For example, Kiwi has consolidated much of its North Island activities on a single mega-site at Hawera, while Dairy Group has been in the process – not yet complete - of consolidating its dairy processing activities on four or five “super” sites in the central North Island.
- 95 There has been no evidence of greenfields entry into dairy processing. Indeed, entry into the dairy processing industry has, to a large extent, been precluded by industry regulation, and in particular by the requirement to export via the Dairy Board. The trend over a long period has been for dairy mergers and rationalisation.
- 96 The emergence of larger dairy processing plants, and the consolidation of plants on fewer sites, reflects in large part the presence of economies of scale and of scope in the processing of dairy products. Economies of scale in the processing of dairy products arise when the capital and input costs per unit of output decline as the capacity of the dairy factory is increased. Economies of scope arise from the production by dairy co-operatives of a mix of dairy products on a single site, also leading to a reduction in average production costs.
- 97 However, as processing plants increase in size they require larger volumes of raw milk to be consolidated on a central site. This has the effect of increasing transport costs as the milk is sourced from more distant suppliers, thereby creating a trade off between production scale economies and transport costs.

## **Entry and Exit Conditions for Suppliers to Co-operative Dairy Companies**

- 98 To join a dairy co-operative, it is necessary for a new entrant to make a nominal capital contribution. This in turn entitles the new member to receive a rebate from the surplus generated by the dairy co-operative based on the per kilogram amount of milk solids supplied, after adjustments for expenses have been made. The rebate includes a return on the capital contributed.
- 99 Regulation 42 of the Dairy Industry Regulations 1990, restricts switching of suppliers between dairy co-operatives to the months of June and July of each year in the North Island, and one month later in the South Island, unless the losing dairy co-operative agrees otherwise. The possibility of switching is limited by the available surplus capacity of the gaining dairy co-operative, and other factors.
- 100 Switching can impose certain costs on the supplier. Under the Co-operative Companies Act, a dairy co-operative may retain a switching suppliers’ share capital

for up to five years, or such other period determined by the company. A co-operative losing suppliers might wait the full five years, or other period specified in its constitution, before returning shareholders' capital in order to discourage switching. Also, the gaining dairy co-operative normally requires an immediate payment by incoming suppliers of their capital in full. Consequently, suppliers incur an opportunity cost while capital is tied up, as they receive no return for the 'dry' shares in the dairy co-operative they are leaving.

- 101 One potential barrier to switching could be the need to transfer ownership of the supplier's refrigerated storage vats, since the vats are usually owned by dairy co-operatives. However, in view of the regular purchase programmes undertaken by the dairy co-operatives and ability to maximise the use of vats, this is not seen as a barrier to switching.
- 102 There is limited evidence of suppliers switching between dairy co-operatives.
- 103 The Co-operative Companies Act provides that when suppliers leave a dairy co-operative, they are entitled to receive reimbursement for the amount of capital they have contributed to the co-operative, subject to any agreements between the dairy co-operative and the shareholder. However, those suppliers who exit the co-operative will never receive an amount greater than the nominal value of their shares.

### **The Payment System**

- 104 The dairy industry pay-out involves two tiers: the payment from the Dairy Board to the dairy co-operatives, and the payment from the dairy co-operatives to the suppliers. The pay-out for dairy products to suppliers is characterised by the bundling of the milk price, representing the return on the farmer assets, with the equity returns on the downstream processing and marketing investment by the dairy co-operative and the Dairy Board, into a single pay-out to suppliers.
- 105 On 1 June 1998, the Dairy Board introduced changes to the mechanism by which payments are made to dairy co-operatives. This followed a study commissioned jointly by the industry and the Dairy Board (the Industry Efficiency Improvement Study), and a review by the Business Development Project (BDP) between 1996 and 1998. The development of a Commercial Pricing Model (CPM) emerged from the work of the BDP. The new payment system, which was introduced at the beginning of the 1998/99 dairy season, and phased in gradually over the course of the season, replaced the existing payment system operating between the Dairy Board and the dairy co-operatives.
- 106 A brief description of the 'old' and 'new' payment schemes is provided below.

#### *'Old System'*

- 107 Under the previous payment scheme, a series of 'standard cost models' were used by the Dairy Board to determine the prices paid by the Board to dairy co-operatives for each dairy product manufactured. Dairy co-operatives were essentially reimbursed for costs incurred, rather than in terms of the prices gained for the products sold.

108 The main features of the 'old' system were as follows:

- engineering and accounting models formed the basis for calculating the cost of producing a product from milk, after adjustments were made for changes in such costs as packaging, labour and equipment;
- to encourage production of the desired product mix, premiums and penalties were used to influence dairy co-operatives to produce certain products, and also to reward dairy co-operative companies for quality and service;
- the system provided for guaranteed purchases by the Dairy Board with the Dairy Board financing and managing inventory, and the dairy co-operatives were guaranteed payment every month on the basis of a schedule of prices developed 12 months in advance. As a result, dairy co-operatives were placed in essentially a risk-free commercial situation;
- the 'standard cost models' enabled a 'milk value' to be determined for each dairy product supplied to the Dairy Board for export. Milk value represented the residual amount after all marketing, production and industry good costs had been deducted. The 'milk value' in turn was broken down further into two components, fat and protein; and
- the pay-out was calculated by dividing the Dairy Board's export returns by the total kilograms of milk solids provided by all dairy co-operatives. The payment to each dairy co-operative was based on the amount of milk solids provided by that dairy co-operative to the Dairy Board. At the beginning of each season, the Dairy Board announced a provisional payment per kilogram of milk solids, which was adjusted as market returns were received.

109 The underlying philosophy of the 'old' payment system was that irrespective of the particular product manufactured by a dairy co-operative, all dairy co-operatives received the same gross return within a product category when calculated per kilogram of milk solids.

110 According to the Dairy Board, the 'old' payment system created a misalignment between production and marketing requirements. The 'old' system did not, in any significant degree, encourage producers to manufacture products which generated higher returns. The cost models also appear to have rewarded dairy co-operatives with large plants, and to have encouraged some dairy co-operatives to continue increasing the size of their plants. To that extent, the Dairy Board's cost model system probably contributed to further rationalisation of dairy manufacturing in New Zealand.

#### *'New' System*

111 From 1 June 1998, the CPM payment system was gradually phased in over the ensuing 12 month period. Under this model, payments to dairy co-operatives by the Dairy Board are based on market price signals received for dairy products.

112 For the purpose of determining payments under the 'new' system, the Dairy Board has grouped dairy products into four separate categories, which are based on the value added by manufacturers:



- standard commodity products, where payment is based on global commodity prices, but with provision for a small premium on those products to reflect higher manufacturing costs, quality and other factors;
- dairy products to which the Dairy Board adds value as the marketer. The dairy co-operative is paid the commodity price and the net added value is retained by the Dairy Board, but distributed to the dairy co-operative in the form of a rebate;
- dairy products to which both the Dairy Board and the dairy co-operatives add value. For these products, the manufacturer receives a premium over and above the base commodity price to reflect extra manufacturing costs and the contribution to net value added, with the Dairy Board retaining the balance of the premium; and
- new and specialty products for which the revenue earned is shared between the Dairy Board and the dairy co-operative which develops the product.

113 Under the CPM:

- the pay-out by the Dairy Board to dairy co-operatives is based on international commodity prices, and provides for a commodity margin after deductions have been made for milk and manufacturing costs. In the absence of any standard international commodity prices for dairy products, the Dairy Board has been obliged to calculate such prices using its own data;
- extra payments (above base commodity prices) are made to dairy co-operatives for products commanding market premiums (ie value-added products). There is scope for profit sharing between the Dairy Board and dairy co-operatives for the development of new and specialty products; and
- there is a separation of the supplier and shareholder revenue streams with market prices intended to provide the basis for determining the product mix decisions of dairy co-operatives.

114 Another important feature of the CPM has been the establishment of the CEO Forum, comprising the Chief Executive Officers of each of the dairy co-operatives. The primary function of the CEO Forum is to co-ordinate and manage all activities at the manufacturing-marketing level, including issues which require joint accountability (eg the product mix planning), issues which require joint consultation (eg price forecasting), and where necessary, the resolution of disputes between the affected participants.

*Product Allocation Process*

115 Prior to the commencement of each dairy season (and ideally by 31 March of each year), the Dairy Board advises dairy co-operatives of the required product mix and price/volumes it requires for different categories of product based on market forecasts. The dairy co-operatives then respond by indicating the products (and volumes) they wish to manufacture. The Dairy Board drives the correct mix and appropriate volume of products to be manufactured by dairy co-operatives, following negotiations between the Dairy Board and dairy co-operatives. However, the process can give rise to delays while disputes over product allocation between dairy co-operatives are resolved.

### *Payments to Suppliers*

- 116 Dairy co-operatives pay their suppliers based on the kilograms of milk solids in the milk supplied. This payment consists of the Dairy Board pay-out, and any margin which the dairy co-operative has been able to achieve above the Dairy Board's pay-out. Within any particular dairy co-operative, all suppliers receive the same pay-outs based on the kilograms of milk solids they supplied. The only exception is that those suppliers who supply out-of-season town milk are paid a premium. Suppliers whose collection costs are higher than the normal range of costs may incur a transport levy, although the imposition of transport levies is extremely rare.

## **LEGISLATIVE ENVIRONMENT**

### **Existing Legislative Environment**

- 117 The Dairy Board Act 1961 established the Dairy Board and specified its powers and functions. Section 14 of the Dairy Board Act gives the Dairy Board statutory monopoly power to control the acquisition and marketing of New Zealand's dairy export produce.
- 118 The Dairy Board Amendment Act 1996 amended the Dairy Board Act by creating a share structure for the Dairy Board. Specifically, this Act provided for the issue of shares to supplier-owned dairy co-operatives on the basis of the milk solids each dairy co-operative company produces annually. Under the Dairy Board Amendment Act, key decisions by the Dairy Board are subject to approval by 75 percent of the Dairy Board's shareholders.
- 119 To qualify for the issue of shares in the Dairy Board, shareholders are required to be a dairy co-operative registered under either the Co-operative Dairy Companies Act 1949, or the Co-operative Companies Act 1996.

### **Proposed Legislative Environment**

- 120 On 15 May 1998, the Government announced its intention to deregulate the producer boards. Producer boards were invited to develop plans as to how they would respond to a deregulated environment. A plan was prepared by the Dairy Board in conjunction with the New Zealand dairy industry, and submitted to the Government on 15 November 1998. The plan identified the need first to review the industry's export strategy and, second, to develop a strategy that encompassed both the New Zealand-based assets and international assets of the industry.
- 121 Subsequently, an industry working group was established to formulate a strategic plan for the dairy industry, and to identify the structure that would deliver the objectives of the strategic plan to current farmer shareholders in a deregulated environment. The group's final recommendation was that the industry should be structured around a single integrated manufacturing/ingredients marketing company with co-operative ownership, and a consumer marketing company with a corporate structure, initially owned by the co-operative, but with the potential to issue shares to suppliers or the public at an appropriate time.

- 122 On 15 July 1999, the Government introduced into Parliament the Restructuring Bill. Key features of the Bill are described below.
- 123 The Restructuring Bill provides for the removal, with effect from 1 September 2000, of the statutory powers providing for a single exporter for New Zealand dairy products, conditional upon:
- the amalgamation of two or more dairy co-operatives before 1 September 2000;
  - the amalgamated company being the beneficial owner of more than 75 percent of the shares in the Dairy Board; and
  - the amalgamation being authorised by the Commerce Commission.
- 124 The changes outlined above will be achieved by:
- the repeal of the Dairy Board Act;
  - the repeal without replacement of all existing Commerce Act exemptions in the Dairy Board Act; and
  - the conversion of the Dairy Board into a company under the Companies Act 1993.

#### **Relationship Between the Co-operative Companies Act and the Restructuring Bill**

- 125 Under Part III of the Co-operative Companies Act, a co-operative dairy company cannot refuse to issue shares to a person from whom it has accepted supply of milk. Clause 11 of the Restructuring Bill precludes NewCo from being registered as a co-operative dairy company under Part III of the Co-operative Companies Act. NewCo will remain subject to the other Parts of the Act.
- 126 Clause 9(1) of the Restructuring Bill provides that section 15 of the Co-operative Companies Act does not prevent the issuing of shares at a price that is a fair value for the shares and not a nominal value. (Section 15 of the Co-operative Companies Act provides that shares in a company registered under it may have a nominal value, notwithstanding section 38 of the Companies Act 1993.) This provision is specifically noted as not constituting a specific authorisation for the purposes of section 43 of the Commerce Act.
- 127 Clause 10 of the Restructuring Bill provides that the new co-operative company may include in its constitution a provision entitling shareholders who elect, or who are required to surrender shares in the new co-operative, to receive fair value of those shares on their surrender to the new co-operative. However, such a provision is not made mandatory.
- 128 Where shares in a dairy co-operative are surrendered at the option of a shareholder who has ceased to be a “transacting shareholder” in terms of section 4 of the Co-operative Companies Act, (for example where a shareholder has ceased to be a supplier to the company) for five years prior, or for such other period as may be determined by the board or specified in the constitution of the company, the shareholder may give notice requiring the company to accept the surrender of all or any shares in the company and the board, must, within 60 working days after

receiving the notice, resolve to accept the surrender, provided this will not have an impact on the company's solvency.

## **Other Provisions of the Restructuring Bill**

129 NewCo is granted:

- the right to export exclusively to certain tariff quota markets for specified dairy products for up to six and a half years (depending on when the quota year ends); and
- further rights to export to tariff quota markets for a transitional period during which the exclusive rights will be phased out.

130 NewCo will be owned by suppliers who will be able to trade shares in the company with other suppliers. The Bill allows for, but does not compel, the issue and surrender of shares in the new co-operative at “fair value”, rather than nominal value.

131 The Restructuring Bill provides for:

- the establishment by regulation of a new quota allocation company, the shares of which will be owned by supplying shareholders in existing dairy co-operatives. The new company will be responsible for managing the allocation of quotas;
- the introduction of a competitively neutral regulatory environment, including the removal of the current regulations which restrict milk suppliers switching from one processor to another during the dairy season; and
- the transfer to the new co-operative company of the Dairy Board shares currently held by non-participating co-operatives.

## **NewCo’s Proposed Constitution**

132 The Applicant has supplied the Commission with the current draft of NewCo’s proposed constitution. NewCo will issue A and Q shares. Current and intending supplying shareholders must hold A shares “in number more than 80 percent and less than 120 percent of the average number of kilograms of milk solids obtained from milk accepted by the company” from either the shareholder or the land from which the shareholder is currently supplying (this is still to be decided) over the preceding three complete financial years (the “supply link” - see clause 80).

133 If the number of A shares held by a shareholder exceeds the maximum, or is less than the minimum required under clause 80, the shareholder must comply with the supply link no later than 31 July of the financial year immediately following the financial year in which the shareholder did not comply with the supply link.

134 Subject to restrictions in the constitution, holders of A shares may transfer them to:

- another supplying shareholder; or
- an intending supplying shareholder who has been accepted by the company (clauses 48 and 49).

- 135 Clause 55 and Schedule A of the constitution set up a company-managed share sale facility. This facility enables persons wishing to buy or sell shares in the company to appoint the company as their agent for the purpose of facilitating such sales.
- 136 An exiting shareholder may transfer all shares in NewCo in this way. The company must provide this facility at least once a year, or more often if it considers this appropriate (clause 55). This does not limit any other lawful means of arranging transfers.
- 137 Former shareholders have the option to retain some or all of that shareholder's A shares for up to three complete financial years after that person has ceased to supply milk. A shares held by persons who have ceased to be supplying shareholders convert to Dry Shares from the date on which supply ceased (clause 43). Dividends are payable on Dry shares.
- 138 A shareholder has the right to request redemption of that shareholder's A shares from the company at the compulsory redemption value in (clause 25):
- if the shareholder has too many shares in terms of the supply link provided for in (clause 80); or
  - the board has determined that there is an illiquid market (where there have been less than 5 sales of A shares in the period 1 June to 31 August of the financial year in which notice of redemption has been given).
- 139 An exiting shareholder can only seek redemption of shares from NewCo, rather than selling through the managed share sale facility, if the shareholder has too many shares in terms of the supply link provided for in clause 80, and there is an illiquid market (as defined above). The current draft of the constitution notes (after clause 29) that "There is no right for a holder to redeem immediately on ceasing to be a supplying shareholder . A supplying shareholder who ceases to supply will generally only be able to require redemption of the majority of their shares three years after ceasing supply as the supply link is based on a three year supply average (see clause 80)".
- 140 Shares will be redeemed at the compulsory redemption value which is the lower of:
- "85 percent of the net tangible asset backing per A share as disclosed in NewCo's most recent published financial statements; and
  - 90 percent of the weighted average price of the last 20 sales made through NewCo's managed share sale facility...; and
  - 90 percent of the weighted average price of the last 1 million A shares sold through NewCo's managed share sale facility...".

### **Timing of the Proposed Changes under the Restructuring Bill**

- 141 It is envisaged that the Restructuring Bill will come into force in two stages. Some of the provisions, including those relating to the formation of the new company, the

quota allocation company and the amendments to the Dairy Board Act which will enable the Dairy Board to convert to a company, will come into force on the effective date of the proposed dairy co-operative amalgamation. The remaining provisions, including the removal of the single seller desk status of the Dairy Board, will come into effect on 1 September 2000, subject to the Commerce Commission granting authorisation for the proposed merger, and the amalgamation proceeding.

- 142 The Act expires on 1 September 2000 if the new co-operative amalgamation has not been authorised by the Commission, and has not become effective by that date.

Question 1:

The Commission seeks comment on any omissions, or any material inaccuracies in the preceding sections of the Draft Determination.

## THE RELEVANT MARKETS

### Introduction

- 143 The purpose of defining a market is to provide a framework within which the competition implications of a business acquisition can be analysed. The relevant markets are those in which competition may be affected by the acquisition being considered. Identification of the relevant markets enables the Commission to examine whether the acquisition will breach the threshold of anti-competitiveness set out in Section 47(1) of the Act by leading to the acquisition or strengthening of a dominant position.

- 144 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.”

- 145 Market definition principles have been set out by the High Court in *Telecom Corporation of NZ Ltd v Commerce Commission* (the AMPS A case):<sup>7</sup>

“First, and most generally, we seek to identify the area or areas of close competition of relevance for the application(s). In other words, we seek to identify the constraints upon the price and production policies of firms whose conduct is of relevance for the matters litigated. In this matter it is of especial importance to highlight the constraints upon Telecom’s price and production policies.

Secondly, competition may proceed both through substitution in demand and substitution in supply in response to changing prices or, more comprehensively, the changing price-product-service packages offered ... . The mental test that prompts a summary evaluation of the evidence is to ask how buyers and sellers would likely react to a notional small percentage increase in price of the products of interest, eg the standard telephone service, the cellular service (the ‘price elevation test’). ...

Thirdly, the market is a multi-dimensional concept – with dimensions of product, space, functional level, and time. Here we need to give special attention to the principles that should

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<sup>7</sup> (1991) 4 TCLR 473, 502; 3 NZBLC 102,340, 102,362.

govern the isolation of the dimensions of function and time.

If we ask what functional divisions are appropriate in any market definition exercise the answer, plainly enough, must be whatever will best expose the play of market forces, actual and potential, upon buyers and sellers.”

- 146 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 small yet significant and *non-transitory* increase in price (*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. These have been referred to by the Commission as “near entrants”.
- 147 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.<sup>8</sup> 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 percent) 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 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?
- 148 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.
- 149 In the proposal one of the markets involved is that for the acquisition and supply of unprocessed milk. In that market there is potential for market power to arise on the buyers’ side of the market, rather than on the suppliers’. Hence, the concern is not with the ability of a monopolist to raise the price to buyers, but with the ability of a monopsonist to lower the price it pays to suppliers. Consequently, the *ssnip* test needs to be adjusted to examine the effect of a five percent reduction in the price paid by a hypothetical monopsonist when testing for the product and geographic dimensions of the market.

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<sup>8</sup> Commerce Commission, *Business Acquisition Guidelines*, 1999, at pp. 14-15.



- 150 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 may indicate that the suppliers in other areas 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 provide a product which is an effective substitute and, therefore, that the geographical extent of the market is broader. 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.
- 151 In practice, the process of defining markets is unlikely to be as precise and 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 within which judgments on a case-by-case basis, using whatever information is available or can readily be generated, have to 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 provide useful information. This has been the approach used with regard to this proposal.
- 152 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 levels affected by this proposal have to be determined as part of the market assessment.
- 153 Previous Commission decisions have discussed at length the product, geographic and functional levels associated with markets in the dairy industry. Generally the Commission has defined the relevant domestic product markets as including the processing and supply of a range of manufactured dairy products, and the geographic market as being national. Those decisions did not consider it necessary to distinguish separate product markets within the generic dairy products grouping.
- 154 The Applicant submits that the relevant market is that for consumer dairy products. However, as certain of the products concerned, in particular cheese and butter, are manufactured in export plants which would become part of the proposed NewCo, this raises the possibility that should they fall in separate markets, significant competitive

effects might flow from the proposal. Therefore, it is proposed to canvas whether there are separate markets for cheese and butter.

155 On the basis of previous decisions, submissions from the Applicant and investigation of the proposal, the Commission has reached a preliminary conclusion that the potential areas of aggregation in the case of this application would be in the following markets:

- the acquisition/supply of unprocessed milk in the North Island;
- the acquisition/supply of unprocessed milk in the South Island;
- the secondary market for the wholesale acquisition/supply of unprocessed and near-milk in the North Island;
- the secondary market for the wholesale acquisition/supply of unprocessed and near-milk in the South Island;
- the processing and wholesale supply of town milk in the North Island;
- the processing and wholesale supply of town milk in the South Island;
- the manufacture and wholesale supply of cheese in New Zealand;
- the manufacture and wholesale supply of consumer spreads in New Zealand;
- the manufacture and wholesale supply of cultured dairy products in New Zealand;
- the manufacture and wholesale supply of dairy ingredients in New Zealand; and
- the acquisition/supply of manufactured dairy products in New Zealand for export.

### **The Markets for the Acquisition/Supply of Unprocessed Milk in the North and South Islands**

156 The proposal affects the market for the supply of unprocessed (or raw) milk by suppliers to dairy co-operatives, which is then processed into a large range of dairy products for sale on either the domestic or export markets. Of the total milk produced in New Zealand, around 92 percent is used in the production of dairy products for export, with the balance being used for town milk and other domestic dairy products.

#### *Product and Function Dimensions of the Market*

157 For the dairy co-operatives, there are no close substitutes to raw milk as an input to their dairy processing activities, while from the suppliers' perspective, dairy co-operatives are the only customers realistically capable of absorbing the huge quantities of unprocessed milk produced on a continuing basis by New Zealand's dairy farmers. This appears to be accepted by the Applicant. Hence, the relevant product and function market is that between suppliers and co-operative buyers for the supply and acquisition of unprocessed milk. This primary market considered here must be distinguished from the secondary market for unprocessed milk and near-milk discussed below.

#### *Geographic Extent of the Market*

158 In order to define the geographic extent of the market it is necessary to determine, in respect of each dairy co-operative, which other dairy co-operative (if any) would be a substitute acquirer of unprocessed milk from its suppliers if it were hypothetically to introduce a significant drop in pay-out. Previous Commission decisions on mergers

between dairy co-operatives have analysed in some detail the potential for suppliers to switch between dairy co-operatives, should pay-out levels to them be reduced. It is the ability or inability of suppliers to switch which determines whether the geographic market is restricted to each dairy co-operative's catchment area, or covers a broader region. Key aspects that affect a farmer's ability or need to switch are the following:

- the cost and practicality of transporting milk;
- equality of pay-outs within dairy co-operatives;
- the potential for dairy co-operatives to retain the capital contributions of their farmer shareholders;
- the presence of potential substitute acquirers; and
- the willingness of substitute acquirers to accept additional milk supplies.

- 159 Commission inquiries on this and previous cases have found that there are no significant technical obstacles to transporting unprocessed milk from farm to factory over substantial distances within either the North or South Islands. However, transport costs tend to increase with the distance travelled, and as transport costs are a significant proportion of the processing costs, this tends to restrict the distances over which it is economic to transport milk. Hence, while there are instances of milk being transported for distances of up to 250 kilometres on a regular basis, particularly where a dairy co-operative has a geographically long, thin catchment area, most factory sites are located in the middle of relatively dense concentrations of dairy farms, with most milk being transported distances in the order of 100 kilometres or less. The outer limit figure of 250 kilometres used by the Commission in previous decisions as a rough means of delineating geographic market boundaries of dairy co-operatives is thus a relatively extreme figure in terms of current collection areas.
- 160 However, that figure is intended to provide only a rough guide for analysis purposes. Being relatively large, using that figure as the radius from main processing sites of potential catchment circles tends to lead to considerable overlaps between the "catchment circles" of adjacent dairy co-operatives. This in turn tends to suggest that suppliers located within the overlap areas could potentially switch to the adjacent dairy co-operative, thereby providing a constraint on their own dairy co-operative from reducing its pay-out. This constraining effect is enhanced by the practice of dairy co-operatives maintaining equal pay-outs to all of their shareholders. Competition between dairy co-operatives in the overlap areas would then protect all of the shareholders, including those too far from the boundary to be able to switch.
- 161 In practice, however, a farmer can switch to another dairy co-operative – assuming one is available - only when that dairy co-operative is prepared to accept the extra supply. The decision to accept switching suppliers is influenced by numerous factors, including the current and likely future capacity of the plant, the desired product mix of the receiving operation, collection costs, and the strategy of the receiving dairy co-operative. In addition, the suppliers' ability to switch may be influenced by the capital retention policy of the present dairy co-operative, the perceived sustainability of the pay-out differential, and statutory restrictions on the timing of such switches. Further analysis of the implications of these various factors on the actual level of competition in the relevant markets is covered in the competition (dominance) analysis below.

### *Previous Decisions*

162 On the basis of the 250 kilometre rule of thumb, recent Commission decisions on dairy mergers, while reflecting the nature of the dairy co-operatives involved, have tended to define the geographic extent of the markets for the acquisition/supply of unprocessed milk as being the greater part of either the North Island, or of the South Island. For example, in respect of the *Kiwi/Tui* decision (15 August 1996, M2305) relating to the North Island, the geographic extent of the market was defined as “the greater extent of the North Island”. That decision reflected the presence of two substantial dairy co-operatives covering most of the North Island, one in the centre and one in the south-west<sup>9</sup>.

163 In Decision 341 relating to the proposed acquisition of the South Island’s SIDCO by Kiwi, the Commission concluded in paras 68-70 that:

“... the geographic market is not larger than the South Island. In terms of the present application, it might be smaller than the entire South Island because of doubts that Tasman and Marlborough could actually compete with Kiwi and SIDCO, given their relative geographic isolation. However, should dominance concerns arise with the market broadly defined as South Island-wide, those concerns would be accentuated with any narrowing of the geographic market definition.”

### *Equal Pay-outs*

164 As noted above, the analysis used by the Commission in the past which established relatively broad geographic markets relied upon the fact that dairy co-operatives have traditionally maintained equal pay-outs to all suppliers. As a consequence, all suppliers in a dairy co-operative, including those which are too far from the boundary to be able to switch, gain protection against falling pay-outs from competition taking place in border areas. As the dairy co-operative is unable to use price discrimination only in the contested area to maintain its supplier base, it must maintain a competitive pay-out to all dairy co-operative members. Dairy co-operatives whose boundaries significantly overlap must therefore fall within the same geographic market.

165 During the recent *Kiwi/SIDCO* application, the Commission took the view that as pay-out equality derives from a rule contained within the constitutions of individual dairy co-operatives, the practice could not be assumed to continue indefinitely into the future. This does not suggest it would be easy for a dairy co-operative to move away from the historical practice of equal pay-outs, nor that there would be no farmer resistance to the change. However, there have been instances in recent years where inequality of pay-outs, or something close to it, has arisen. For example, in the first few years following the acquisition of Tui by Kiwi, Tui shareholders received a lower pay-out than their Kiwi counterparts. Similarly, as part of the acquisition of SIDCO by Dairy Group, Dairy Group shareholders were issued shares in Dairy Foods. While Dairy Group still maintains equivalent milk pay-outs to its shareholders, this is an example of a method of distributing wealth to shareholder groups by means other than a purely averaged milk pay-out. It could be argued that these are unusual cases,

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<sup>9</sup> It was considered that if the pay-out from one dairy company – say, Kiwi – were to fall 5 percent below that of its neighbour – Dairy Group – for the foreseeable future, suppliers on the border would switch to Dairy Group (in the assumed absence of a transport levy), and vice versa.

brought about where a dairy co-operative with a higher pay-out has acquired another with a lower pay-out, and where the gap could not be narrowed immediately.

- 166 However, the Commission notes that significant changes are occurring, or could occur, in the industry. Should the industry be deregulated, either as a result of the proposal or, if that should fail, by government action, the potential for competitive entry could require a reassessment of the traditional pay-out practice. Dairy co-operatives might be forced to raise the pay-outs for some suppliers in order to compete with “cherry picking” entrants.<sup>10</sup>
- 167 The potential exists for changes to occur in the future which would result in the need for a fundamental reassessment of the geographic dimensions of the market for unprocessed milk. Given the nature of this proposal, involving the potential merger of all of New Zealand’s dairy co-operatives, there is little advantage to be gained from an attempt to accurately define the geographic boundaries under current practice and possible future scenarios. NewCo would control virtually 100 percent of the market, regardless of definition.

#### *Conclusion on Extent of Geographic Market*

- 168 The Commission, for the purposes of this proposal, proposes to define the following geographic markets for unprocessed milk:
- the market for the acquisition/supply of unprocessed milk in the North Island; and
  - the market for the acquisition/supply of unprocessed milk in the South Island.
- 169 It is also noted that in the South Island the market would be likely to be less than South Island wide if a detailed analysis were undertaken, as documented in *Kiwi/SIDCO*.
- 170 More detailed analysis of the extent and nature of actual competition between dairy co-operatives within these markets is contained in the competition and dominance analysis for the market below.

#### **The Secondary Markets for the Wholesale Acquisition/Supply of Unprocessed and Near-Milk in the North and South Islands**

- 171 Dairy co-operatives trade unprocessed milk, or products close to unprocessed milk such as milk concentrate and cream. This trade occurs both between dairy co-operatives, and between dairy co-operatives and non-dairy companies. The trade occurs in response to a number of commercial factors, including:
- the need to sell surplus milk when the seasonal peak flow exceeds processing capacity;

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<sup>10</sup> “Cherry picking” refers to a market entry strategy where the highest value products or customers are targeted. In the case of the dairy industry, an entrant would be likely to enter in the lowest cost raw milk collection area, passing some of the cost saving to the farmer in a milk payout level that was higher than the averaged co-operative payout.

- the acquisition of unprocessed milk to be used as an input by companies not wishing to deal directly with suppliers;
- trade with companies better placed to supply certain products (eg winter milk from Northland); and
- trade involving the acquisition of components rather than whole milk (such as cream or whey), or the disposal of components not required for own production.

### *Product and Functional Extent of the Market*

172 This is a market defined primarily by its functional level, being a wholesale market which operates between dairy co-operatives. It is to be distinguished from the primary market discussed above, between suppliers and dairy co-operatives. Farmers require regular, generally daily milk collections throughout the season, and hence effectively enter season-long contracts with their dairy co-operatives. In exchange, the dairy co-operative requires an equivalent commitment from the supplier, meaning that the farmer is generally unable to switch within a season, nor to take advantage of opportunistic spot trading. In contrast, the secondary market involves trading opportunities which arise on an irregular basis, or at particular times of the season. It also involves trade in products other than unprocessed milk.

173 Trade in this market occurs for a number of reasons. For example, it may improve the efficiency of dairy co-operatives by better utilising capacity or allowing specialisation, or it may provide fresh dairy inputs for non-dairy companies. Town milk companies also dispose of excess milk in this market. Examples of trade between dairy co-operatives include the following:

- Westland has arrangements to sell peak milk to neighbouring dairy co-operatives where the flow exceeds its processing capacity;
- Northland transfers a considerable volume of milk concentrates to other dairy co-operatives, and also sells winter milk to other town milk companies, particularly Dairy Foods;
- Tatua sells surplus cream to Dairy Group; and
- town milk companies sell surplus milk to dairy co-operatives.

174 Non-dairy companies needing a supply of dairy input could operate through the primary market by entering into milk supply contracts between themselves and suppliers. This has been done in the past by Cadbury. However, such vertical integration can cause problems because of the seasonal nature of milk supply, the sometimes unpredictable nature of manufacturing demand, and the lack of the specialist skills needed to manage this unprocessed input – in particular, assessing and maintaining milk quality. Consequently, non-dairy companies have rarely entered the primary market. Cadbury recently withdrew from that market, preferring instead to source its milk requirements from dairy co-operatives.

175 Examples of non-dairy companies buying fresh milk and cream supplies through the secondary market include the following:

- ice cream and chocolate manufacturers such as Tip Top and Cadbury;
- specialty cheese makers such as Puhoi cheese; and

- general food manufacturers such as Watties and Quality Bakers.

The first two categories are relatively heavy users of dairy inputs.

- 176 The disposal of peak milk supplies is an important issue for the several, relatively small, independent, town milk companies. These companies experience a relatively constant demand for their products – mainly town milk and cream - throughout the year, but a variable supply of milk from their suppliers. If a company ensures that it has sufficient supply to meet its demand all year around, it will need to be able to sell surplus supplies during the peak time of the year.<sup>11</sup>
- 177 Arrangements for dealing with this problem vary between companies. For example, the suppliers of Nelson Milk – the town milk co-operative – are members both of that co-operative and of Tasman Milk Products – the local manufacturing co-operative. The former sends any surplus milk to the latter where it is processed. Southern Fresh has traditionally disposed of excess milk to the Stirling cheese plant (now, Kiwi South Island), and has in the past also sold milk to Edendale. For Southern Fresh there are also opportunities occasionally to sell surplus milk to other non-dairy companies that need small amounts of fresh input, such as Tip Top (South Island) and Cadbury.
- 178 Tasman Milk suggested that arranging suitable commercial terms of trade was not particularly difficult, assuming that companies were willing to do business. The NZIER, in a separate submission on behalf of the Applicant,<sup>12</sup> supports this view, stating that:

“The payment arrangements for the milk that is transferred among co-operatives, or for surplus milk from the town milk sector, are fairly standard. Essentially, it is the prevailing milk pay-out price adjusted to reflect the component value associated with the product being manufactured and adjusted for transportation . . . In future, the commodity milk price (CMP) will be the reference price.”

- 179 While the flows in this market are small relative to those in the primary market, this market is important from a competition perspective in maintaining the viability of smaller competitors such as independent town milk companies, and in providing essential fresh dairy inputs for manufacturing companies such as chocolate and ice cream manufacturers.

### *Geographic Extent of the Market*

- 180 For trade in unprocessed milk, and in fresh products closely related to unprocessed milk such as cream, the Commission’s investigations suggest that trade is usually between dairy co-operatives and companies within geographic proximity to each other. For example, Southern Fresh has dealt with companies in the Canterbury, Otago and Southland areas. Westland’s overflow arrangements are with South Island dairy co-operatives. Northland commonly trades with dairy co-operatives and companies in the northern half of the North Island, such as Dairy Group and Tatua.

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<sup>11</sup> Alternatively, if the company were to ensure that its supply met demand during the peak period of the season, it would need to buy in milk to augment its supplies during the rest of the year.

<sup>12</sup> *Surplus Milk, An Examination of the Issues*, submission to the Commission, August 1999.

- 181 Given the concentrated nature, and value, of some products, it is technically possible, and on occasion commercially viable, for trade to take place over greater distances, and even across Cook Strait. For example, Marlborough Cheese has purchased milk from Kiwi (North Island). However, such inter-island trade appears to be rarely practised because of the delays, risk and expense, and is certainly not done on a regular basis. Hence, for the purposes of analysing this proposal the Commission intends to use North Island and South Island markets.

### *Conclusion on Secondary Markets*

- 182 The Commission has identified the following secondary markets for unprocessed and near-milk:
- the market for the wholesale acquisition/supply of unprocessed and near-milk in the North Island; and
  - the market for the wholesale acquisition/supply of unprocessed and near-milk in the South Island.

### **The Markets for the Processing and Wholesale Supply of Town Milk in the North and South Islands**

- 183 Pasteurised fresh milk sold in New Zealand is referred to as “town milk”. Town milk supply now generally includes the supply of a variety of types of milk, flavoured fresh milks and cream. Milk types include the traditional full cream and homogenised varieties, together with the more recently introduced products such as reduced fat and calcium enriched types. Town milk is produced and distributed by a number of dedicated town milk companies, most of which are co-operatives, as well as by the domestic operations of the largest dairy co-operatives, namely Dairy Group, Kiwi and Northland. These deliver direct to retail outlets, as well as providing home delivery through franchised operators.
- 184 In the past, unprocessed milk for town milk processing was supplied by farmers dedicated to town milk supply, and receiving premiums for the more expensive milk produced during the winter months. These farmers supplied specialist town milk companies. However, with deregulation in 1993, the major dairy co-operatives took over and rationalised the town milk suppliers, and integrated their operations within their wider manufacturing activities. Unprocessed milk for town milk is now taken from the seasonal milk flow, with winter contracts paying a significant premium being offered to sufficient suppliers to provide fresh milk over the winter period. The contracts typically cover a period of about three months in the North Island, and four months in the South Island, although some industry participants have indicated that the winter season is becoming shorter, down to only 10 weeks, even in the South Island.

### *Functional and Product Dimensions of the Market*

- 185 The relevant product market is that for town milk. Studies both here and overseas indicate that the price elasticity of demand for town milk is very low, generally less



than  $-0.2$ ,<sup>13</sup> suggesting strongly that there are no close substitutes for it. Anecdotal evidence also suggests that price increases in recent times have had little or no appreciable effect on demand.

- 186 The functional dimension of the market is that between town milk processors and retailers for the wholesale supply of town milk.

### *Geographic Extent of the Market*

- 187 The Commission, on a number of previous occasions, has defined the geographic extent of the market for the processing and wholesale supply of town milk as being island-wide, with separate North and South Island markets<sup>14</sup>.
- 188 The Commission's investigations on the proposal have found that on the demand side of the town milk market, there is a trend towards the national distribution and marketing of brands, such as Anchor (Dairy Foods) and Tararua (Mainland). Large retail customers of the town milk companies, in particular supermarkets and oil companies, prefer to deal with a small number of suppliers for administrative simplicity, and hence are encouraging a trend towards national supply contracts.
- 189 On the other hand, the supply side is still divided into North and South Island spheres of operation. In the North Island, Mainland supplies from Auckland to Wellington from its Palmerston North base, while Dairy Foods supplies as far south as Wellington from Takanini in South Auckland. In the South Island, Mainland supplies the majority of the South Island from its base in Christchurch. Dairy Foods currently has a more limited presence in the South Island, with Anchor franchises operated by Nelson Milk and Southern Fresh. With its recent acquisition of SIDCO, Dairy Foods is expected to expand its operations from a new Christchurch base. [

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- 190 Town milk supplies are not currently transported across Cook Strait, because of the cost and the time implications of the crossing. The journey from Auckland to Christchurch would take about three days of the ten day shelf life of fresh milk, which would render the product unattractive to supermarkets. It has been suggested that this could change in the future should extra shelf life (ESL) technologies be adopted in New Zealand, although this seems unlikely within the next few years. Dairy Group stated that such technology was relatively expensive and the returns to justify such an investment were unproven.
- 191 While the two main dairy co-operatives in the town milk market operate, or are moving to operate, throughout both Islands from their large plants, the smaller town milk companies tend to operate in more regionally defined areas, some in very localised regional markets. The prime reason cited by industry participants for the

<sup>13</sup> See: R. J. Brodie, R. G. Moffitt and J. D. Gough, "The Demand for Milk: An Econometric Analysis of the New Zealand Market", *Research Report No. 147*, Agricultural Economics Research Unit, Lincoln University, January 1984.

<sup>14</sup> The most recent town milk decision was decision 324, *Mainland/SIDF*, 12 May 1998. This decision defined a South Island wide town milk market.

limited reach of smaller companies is the cost and difficulty of establishing a large distribution operation. Companies need a critical mass to compete effectively in major markets and across significant distances, with the ability to provide seven day a week supply to major customers being essential to gain a significant market share. At the same time, the cost of transporting milk into their relatively remote and small markets appears to give them a certain degree of natural protection, perhaps aided by local support for local companies and brands.

192 These considerations suggest that the strength of competition is not uniform across each island. There may be pockets in which local producers may have some degree of market strength, and this appears to be the case with Anchor in the Auckland region. Nonetheless, it is questionable whether any of those local producers could impose a *ssnip*.

193 For the purposes of analysing this proposal, the Commission concludes that the relevant geographic markets for the processing and wholesale supply of town milk are the North Island and the South Island.

#### *Conclusion on Town Milk Markets*

194 The Commission has identified the following town milk markets:

- the market for the processing and wholesale supply of town milk in the North Island; and
- the market for the processing and wholesale supply of town milk in the South Island.

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

#### *Product Market*

195 There is a lack of clear evidence as to whether there are substitutable products for cheese. Nonetheless, supermarkets regard cheese as a separate and distinctive product, and have expressed concern to the Commission about the impact of the proposed merger on cheese prices.

196 The Commission has adopted the preliminary view that there is a separate product market for cheese.

#### *Functional and Geographic Dimensions of the Market*

197 In terms of the geographic extent of the market, all dairy products (with the exception of town milk), including cheese, are marketed and distributed on a national basis from centralised production facilities. The relevant functional dimension is that for the manufacture and wholesale supply of cheese.

#### *Conclusion on Cheese Market*

198 The Commission concludes that the relevant market is that for the manufacture and wholesale supply of cheese in New Zealand.

## **The Market for the Manufacture and Wholesale Supply of Consumer Spreads in New Zealand**

- 199 As noted in the introduction to this section, butter will be analysed separately, as it is an important product for dairy co-operatives in the domestic market, and, in the event that the proposed merger were to proceed, its production would be restricted to NewCo. This market is concerned with butter sold in consumer packs, rather than bulk butter sold for industrial use. The latter is considered under the market for ingredients. As part of its consideration of butter, the Commission has given consideration to whether butter is part of a wider consumer spreads market.

### *Product Market*

- 200 A variety of butter types are manufactured and sold on the domestic market, including salted, unsalted and semi-soft. Butter is commonly used as a spread, but is also used for baking, cooking and garnishing. However, it appears to have an important substitute in the form of margarine, as suggested by the following observations.. Firstly, econometric evidence from the United States indicates that there is a relatively high cross-price elasticity of demand between butter and margarine, indicating that the two are close substitutes in that country.<sup>15</sup>
- 201 Secondly, evidence from retailers in New Zealand suggests the same relationship. Supermarkets consulted suggested that margarine and blends are reasonably close substitutes for butter. The experience of all of the supermarket chains approached by the Commission – Foodstuffs, Progressive and Woolworths – was that an increase in the retail price for one would lead to an increase in the demand for the other. Moreover, the demand for butter in New Zealand is in a long-term decline, apparently caused by consumers changing to non-dairy substitutes, principally margarine. Dairy Foods, a major domestic marketer of butter, submitted market research data showing that in the last 12 months the overall volume of butter sold in the New Zealand market<sup>16</sup> had declined by approximately [ ] percent. Dairy Foods also monitors butter's share of a wider spreads market, consisting primarily of butter, margarine and blends of the two.
- 202 The Commission therefore concludes that the information available to date indicates that butter is part of a wider market for consumer spreads.

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<sup>15</sup> See: D. Salvatore, *Managerial Economics in a Global Economy* (2<sup>nd</sup> edition), New York: McGraw-Hill, p. 100.

<sup>16</sup> The market research data is sourced from 'key accounts' - primarily supermarkets.

### *Function and Geographic Dimensions of the Market*

- 203 As these products are manufactured and distributed nationally, the Commission concludes that the market for the manufacture and wholesale supply of consumer spreads in New Zealand is the relevant market.

### *Conclusion on Consumer Spreads Market*

- 204 The Commission has reached the preliminary conclusion that the relevant market is that for the manufacture and distribution of consumer spreads in New Zealand.

## **The Manufacture and Wholesale Supply of Cultured Dairy Products in New Zealand**

### *Product Market Characteristics*

- 205 Aside from town milk, cheese and butter, which are considered to fall into distinct markets and hence are analysed separately above, there is a range of other dairy products sold on the domestic market, including yoghurts, desserts, dairy foods, cottage cheese and cream cheese. Because it is difficult to distinguish the boundaries of consumer products of this type, at least without recourse to extensive econometric analysis, and because the proposed merger raises dominance concerns in all of them, they are treated as falling within the one market for the purposes of analysis here. Small amounts of dairy products such as milk powder and UHT milk are also sold domestically.

### *Functional and Geographic Extent of the Market*

- 206 The major suppliers of cultured dairy products are the domestic operations of the major dairy co-operatives, in particular Dairy Group (Dairy Foods) and Kiwi (Mainland). These subsidiaries manufacture cultured dairy products in plants separate from the core commodity export plants.<sup>17</sup> The functional level is that between manufacturers and wholesale purchasers. The Commission's investigation confirms that distribution of these products is from centralised plants on a national basis. The geographic market is therefore nationwide in extent.

### *Conclusion on Cultured Dairy Foods Market*

- 207 The Commission concludes that, on the basis of the information available to date, the relevant market is that for the manufacture and wholesale supply of cultured dairy products in New Zealand.

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<sup>17</sup> In addition to dairy products, both Dairy Foods and Mainland produce a number of non-dairy product lines, such as fruit juice and meats. Although these operations are significant in some of those non-dairy markets – for example, Mainland is a significant player in meats through its Kiwi and Huttons brands – the proposal will not result in any aggregation of market share, nor will the business be dependent on NewCo for essential inputs. For this reason, the analysis will focus on the dairy products parts of those businesses. The same applies to Kiwi's small ice cream operation (Rush-Munro's).

## **The Manufacture and Wholesale Supply of Dairy Ingredients in New Zealand**

- 208 Dairy ingredients cover a wide range of products which, to make the analysis tractable, are considered as a group.

### *Product Market Characteristics*

- 209 The dairy co-operatives supply a large number of dairy products as intermediate inputs to both dairy and non-dairy manufacturing companies. The term “dairy ingredients” encompasses hundreds of products. The Commission agrees with the Applicant that for convenience, these can be grouped into the following four major categories: proteins, oils and fats, flavourings, and stock feed.
- 210 Proteins are mainly casein, whey, and cheese products. Casein is used in nutritional products, pizzas and other products as a protein source in place of meat. Bulk cheese is used in a variety of different products such as sauces, pizzas, and is mixed with bread dough. Dairy sourced oils and fats are sold to manufacturers, typically for use in bakery products and ice cream. New Zealand law requires that ice cream must contain a minimum of 10 percent dairy fat. Flavourings include those for milkshake syrups, chocolate dips, ice cream toppings and other products. Specialised cheese and butter flavourings are also produced. Stock feeds largely consist of milk replacement products, formulated from dry blended milk for calves and lambs. The product is mainly sourced from downgraded milk powder.

### *Functional and Geographic Markets*

- 211 The functional level of the market is that for the manufacture and wholesale supply of dairy ingredients. These are sourced from dairy co-operatives throughout New Zealand, and from overseas in some cases, and hence the geographic market is considered to be nationwide in extent.

### *Conclusion on Dairy Ingredients Market*

- 212 The Commission concludes that, on the basis of the information currently available, the relevant market is that for the manufacture and wholesale supply of dairy ingredients in New Zealand.

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

- 213 In the current regulatory environment, this market concerns the supply to and acquisition of dairy products, manufactured by the dairy co-operatives, by the Dairy Board.

### *Product and Geographic Extent of the Market*

- 214 By statute, the Dairy Board is the sole exporter of dairy products from New Zealand, although provision exists for the Dairy Board to issue licences to others who may then independently export specified products to specified markets. A substantial number of such licences are current, but the volume of product covered is very small as a proportion of total exports. As an alternative, dairy co-operatives may sell their manufactured dairy products on the domestic market, but the domestic market is very

limited in size in relation to production. The vast bulk of manufactured dairy products produced in New Zealand are acquired by the Dairy Board for sale overseas. As these products are acquired in a market in New Zealand, behaviour by the dairy co-operatives and the Dairy Board in respect of these products, and therefore the impact of the proposed merger, fall within the ambit of the Act.

- 215 As the Dairy Board acquires manufactured dairy products from all dairy co-operatives in New Zealand, the extent of this market can be considered to be New Zealand-wide.

#### *Functional Level of the Market*

- 216 It could be argued that the proposed merger will internalise the current market between the Dairy Board and dairy co-operatives, and that therefore this market will no longer exist. However, in *Queensland Wire*,<sup>18</sup> the High Court of Australia stated as follows:

... a market can exist if there be the potential for close competition even though none in fact exists ... Indeed, for the purposes of the Act, a market may exist for particular existing goods at a particular level if there exists a demand for (and the potential for competition between traders in) such goods at that level, notwithstanding that there is no supplier of, nor trade in, those goods at a given time.

- 217 While the vertical integration resulting from the proposed merger will remove the need for external market transactions between the current dairy co-operatives and the Dairy Board, vertical integration does not in itself remove markets from competition analysis. Otherwise, firms could avoid some of the prohibitions of the Act by simply engaging in vertical integration. Furthermore, the market will still exist for companies other than NewCo. For these companies the acquiring party might be an agent or multinational marketer likely to be located overseas.

#### *Conclusion on Export Market*

- 218 The Commission concludes that the relevant market is that for the acquisition/supply of manufactured dairy products in New Zealand for export.

#### **Conclusion on Market Definition**

- 219 On the basis of the analysis above, and on information currently available, the Commission has reached the conclusion that the relevant markets for the purpose of analysing the competition issues arising from the proposed merger are the following:

- the acquisition/supply of unprocessed milk in the North Island;
- the acquisition/supply of unprocessed milk in the South Island;
- the secondary market for the wholesale acquisition/supply of unprocessed and near-milk in the North Island;
- the secondary market for the wholesale acquisition/supply of unprocessed and near-milk in the South Island;
- the processing and wholesale supply of town milk in the North Island;

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<sup>18</sup> *Queensland Wire Industries Pty Ltd v Broken Hill Pty Coy Ltd & Anor* (1989) ATPR 40-925.

- the processing and wholesale supply of town milk in the South Island;
- the manufacture and wholesale supply of cheese in New Zealand;
- the manufacture and wholesale supply of consumer spreads in New Zealand;
- the manufacture and wholesale supply of cultured dairy products in New Zealand;
- the manufacture and wholesale supply of dairy ingredients in New Zealand; and
- the acquisition/supply of manufactured dairy products in New Zealand for export.

Question 2:

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

Question 3:

The Commission seeks comment on whether any additional markets require consideration.

## ANALYSIS OF DOMINANCE IN THE RELEVANT MARKETS

### Overview

- 220 Section 67(3) of the Act, when read in conjunction with s 47(1) of the Act, requires the Commission to give clearance for a proposed acquisition if it is satisfied that the proposed acquisition would not result, and would not be likely to result, in a person acquiring or strengthening a dominant position in a market. If the Commission is not so satisfied, clearance must be declined.
- 221 Section 3(9) of the Act states that a person is in a “dominant position” in a market if:
- “... a person as a supplier or an acquirer of goods or services either alone or together with an interconnected or associated person is in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market ...”
- 222 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.
- 223 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 list of factors, and any other relevant matters which may be found in a particular case. With co-operatively owned and operated companies, such as dairy co-operatives, consideration is also given to the degree of constraint imposed by the co-operative ownership structure.
- 224 In the Commission’s view, as expressed in its *Business Acquisition Guidelines 1999* (p.17), a dominant position in a market is generally unlikely to be created or strengthened where, after a proposed acquisition, either of the following situations exist:

- the merged entity (including any interconnected or associated persons) has less than in the order of a 40 percent share of the relevant market; or
- the merged entity (including any interconnected or associated persons) has less than in the order of a 60 percent share of the relevant market and faces competition from at least one other market participant having no less than in the order of a 15 percent market share.

225 In *Port Nelson Ltd v Commerce Commission* (1996) 3 NZLR 554, the Court of Appeal approved the following dominance standard, adopted by McGechan J in the High Court:

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

226 In the cases of the markets for unprocessed milk, secondary milk and town milk, the relevant markets are considered to be North and South Island based. However, many of the features of competition in these markets are generic. To avoid duplication, a single dominance analysis is undertaken, with the relevant differences between North and South Island markets outlined where appropriate.

227 As a dairy industry deregulation package is to accompany the formation of NewCo, it is necessary to consider both competition as it currently exists and as it could exist in a deregulated environment. In general, throughout the following analysis, the analysis of existing competition is undertaken from a historical or status quo perspective. In these sections reference is made to features of the market which are constrained by the current regulatory environment. Consideration of competition in the expected deregulated environment will be considered under the potential for competitive entry.

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

### **The Markets for the Acquisition/Supply of Unprocessed Milk in the North and South Islands**

229 In considering whether the proposed merger might lead to the acquisition or strengthening of a dominant position in a market, the following issues are relevant:

- constraint by existing competition;
- constraint by potential competition;
- constraint by co-operative ownership structure; and
- constraint by potential substitutes.

#### *Existing Competition*

230 The New Zealand dairy industry is currently made up of eight dairy co-operatives, predominantly supplying dairy products for export via the Dairy Board. This structure has arisen out of a long period of rationalisation and amalgamation of dairy co-operatives which started just after the turn of the century. Of the eight dairy co-



operatives remaining, the three largest – Dairy Group, Kiwi and Northland - account for approximately 94 percent of the acquisition of unprocessed milk.

- 231 Market shares for the dairy co-operatives in the North and South Island markets are as follows:

**TABLE 2**

**Market Shares in the Unprocessed Milk Markets<sup>19</sup>**

**North Island**

Proportion of total, on annual basis

Dairy Group	55.0%
Kiwi	32.3%
Northland	11.6%
Tatua	1.1%

**South Island**

Proportion of total, on annual basis

Dairy Group	63.2%
Westland	14.6%
Kiwi	10.1%
Tasman	7.3%
Marlborough	3.0%
Kaikoura	1.8%

- 232 Traditionally, competition between dairy co-operatives has involved suppliers on the borders of company catchment areas switching to neighbouring dairy co-operatives when farm gate payouts became uncompetitive. However, farmer switching has become extremely rare in recent years. For example, in the North Island in the last five years the three main dairy co-operatives have experienced virtually no switching at all. In that period no suppliers have switched between Kiwi and Dairy Group, and only one has switched from Northland to Dairy Group, as a result of a farm sale to an existing Dairy Group supplier. To put this in perspective, these dairy co-operatives have a combined membership of about 12,500, or roughly 85 percent of all dairy farmers.

- 233 The lack of recent switching activity is likely to reflect a number of factors:

- industry regulation;
- geographic separation of catchments;
- the cost of transporting milk;
- acceptance of supply;
- financing of capital contributions;
- payout uncertainty;
- equalised payouts; and
- farm vat ownership.

<sup>19</sup> Based on Dairy Board figures for milksolids produced by company for the 1997/98 season. Actual production levels vary from year to year as a result of climatic and other factors.

- 234 Although farm vat ownership may retard switching in some cases, this is a relatively minor matter which is not considered further.
- 235 In addition to supplier switching, an evaluation of the extent of existing competition has to include the following two factors:
- benchmarking between dairy co-operatives; and
  - the threat of takeover.
- 236 These factors which relate to the extent and nature of current competition in the dairy industry are discussed in turn.

#### Industry Regulation

- 237 Industry regulation, in particular the requirement to export via the Dairy Board, has foreclosed the potential for international companies to enter and compete for suppliers. This issue is discussed further under consideration of the potential for competitive entry.
- 238 Co-operative regulation, particularly the ability to retain capital contributions contained within the Co-operative Companies Act, may have created a significant barrier to switching. This is considered further under financing of capital contributions.

#### Geographic Separation of Catchments

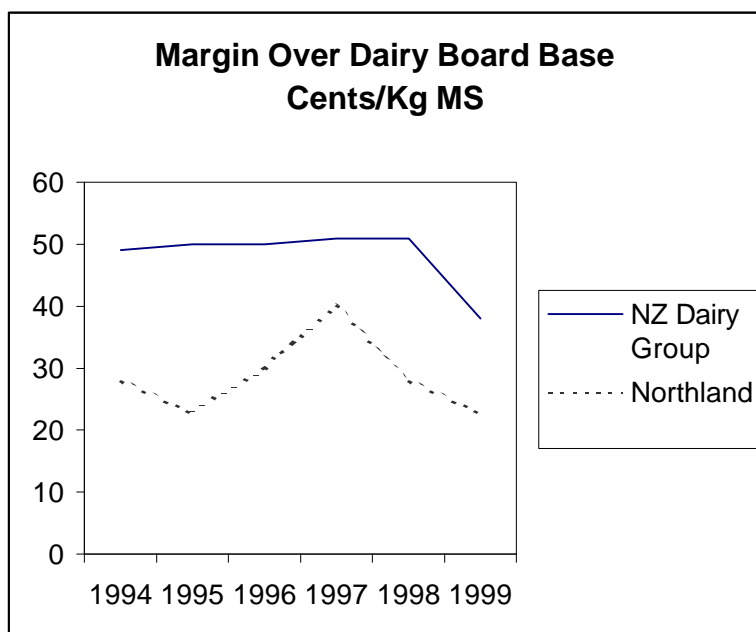
- 239 The Applicant submits that, following the merger and acquisition activity of recent years, many dairy co-operatives are now in relatively well defined geographic catchments which have little overlap with their nearest neighbours. Examples cited include Westland and Tasman in the South Island, and Kiwi and Dairy Group in the North.
- 240 The NZIER submits on behalf of the Applicant<sup>20</sup> that relatively few switching opportunities exist for suppliers in the current environment. The industry provided the NZIER with an estimate that perhaps 650 suppliers, or 4.5 percent of the total, were located in areas where they might be able to switch, providing that they wished to do so, and that the receiving dairy co-operative chose to accept them. The NZIER notes that the industry had difficulty providing this estimate, suggesting that competition for suppliers in marginal areas, even where possible, is not something commonly considered by dairy co-operatives.
- 241 However, the basis for this estimate is not clear-cut, and obviously judgement is required. It might also be argued that while switching may not occur often, it could occur, and this potential can result in competition existing as a state of tension between rival dairy co-operatives.

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<sup>20</sup> NZIER report in support of application, sections 3.1.1 and 3.1.2.

- 242 The Commission has found, both in this proposal and in previous applications, that there is a wide divergence of opinion within the industry on the economics of competing for suppliers, and the nature of competition between dairy co-operatives. Kiwi has generally argued that milk can economically be transported very long distances, and hence that overlaps in the enlarged potential catchment areas, which exceed the sizes of current collection areas, are large. Westland has also tended to support the Kiwi view. Other dairy co-operatives, such as Northland, Dairy Group and SIDCO, have considered that current collection areas tend to match closely with natural catchments established by the economics of the business.
- 243 In some cases the difference between views may reflect whether the bulk transport of milk, or of milk components between plants, is viewed as being different from the options available to suppliers to switch dairy co-operatives. Views also appear to differ on the treatment of the long run costs of plant expansion. A dairy co-operative which focuses on current spare capacity is more likely to accept additional supplies which more quickly use up existing spare capacity, bringing forward the time when new plant must be built.
- 244 The NZIER further submits on behalf of the Applicant that there are currently three significant local overlap areas between dairy co-operatives where switching is possible:
- in the South Island, the area of overlap between Kiwi South Island and Dairy Group South Island (formerly SIDCO);
  - in the North Island, the area of overlap between Kiwi and Dairy Group; and
  - in the North Island, the area of overlap between Dairy Group and Northland.
- 245 These overlaps encompass those areas where there is the potential for significant competition between dairy co-operatives, and which together account for around 95 percent of unprocessed milk supply within the market. However, the areas of overlap in the South Island are in two quite distinct pockets of about 400 kilometres apart. In addition, it could be argued that there are other potential areas of overlap between Marlborough and Tasman, and between Tātua and Dairy Group. In the Commission's view, these overlaps indicate the areas where there is at least the potential for competition on a significant scale.
- 246 In evaluating the extent of this potential competition, there are a number of factors which would suggest that the potential for border competition is more limited than might appear from a simple 'distance to competing factory' analysis. For example, in the North Island, the areas on the border between Kiwi/Dairy Group have relatively little dairy farming, and form something of a natural barrier in terms of milk tanker transport. On the Dairy Group/Northland border in the Rodney area, north of Auckland, there would appear to be considerable overlap. Historically, however, Northland has not been in a position to compete with Dairy Group on payout, as shown in Figure 1. Even if Dairy Group had lowered its payout by five percent, its suppliers would have been unlikely to have switched to Northland because of its still lower payout, thereby satisfying the *ssnip* test for separate markets. For its part, Dairy Group has shown no inclination to take Northland's suppliers in the last five years.

**FIGURE 1**



- 247 In the South Island, Kiwi South Island's operations are small compared to those of Dairy Group South Island. Information supplied by Kiwi during the investigation into the *Kiwi/SIDCO* authorisation suggested that Kiwi could not have taken a material number of switching suppliers in that region without a major capacity expansion, similar to the size of a 'greenfields' entry.

**Question 4:**

The Commission seeks comment on the degree of overlap that currently exists between competing dairy co-operatives.

**Question 5:**

The Commission seeks comment on the degree of switching, to existing or new dairy co-operatives or companies, that might occur if the industry was deregulated.

**Question 6:**

The Commission seeks comment on the degree of overlap that would be needed to affect a dairy co-operative's performance, should significant switching occur.

**The Cost of Transporting Milk**

- 248 The cost of unprocessed milk collection is a significant component of the total processing cost of a dairy co-operative. While this cost element as a proportion of total costs varies between companies, it falls typically within the range of 10 to 20 percent.

- 249 Transport costs increase with distance, although because a significant component is loading and unloading, they tend to rise less than proportionately.
- 250 There is also a trade-off between the greater costs of drawing larger quantities of milk from further afield to a plant, and the economies of scale in processing the greater quantities of milk through a larger plant. The trend in the industry is to concentrate processing on a small number of very large sites, but only Kiwi has been prepared to transport milk long distances to do so.

Question 7:

The Commission seeks comment on the impact of transport costs on the potential for suppliers to switch dairy co-operatives, both currently and in a future deregulated market.

Acceptance of Supply

- 251 Although dairy co-operatives with better payouts will be attractive to suppliers of lower payout dairy co-operatives, the willingness of the former to accept switching suppliers may be low if it results in the consequent dilution of its payout. Even in the case where the (potentially) receiving co-operative would like more milk, the ability to trade bulk milk through the secondary milk market may lower incentives to take additional suppliers.
- 252 An example of the importance of supplier acceptance in influencing switching is Tatua. In theory, Tatua, which is located in the heart of Dairy Group's Waikato collection area, could provide choice to Dairy Group suppliers. However, Tatua has a policy of not accepting new suppliers, and has a strategy of focusing its efforts on certain niche markets as a means of maximising returns to its shareholders, in which it has been very successful. It might be argued that this strategy could change, bringing it into competition for Dairy Group suppliers. But Tatua is unlikely to compete directly with Dairy Group in the production of bulk commodity products, a business where it has no competitive advantage. Hence, there is little prospect that Tatua will provide any significant competition to Dairy Group for unprocessed milk supply in the foreseeable future.
- 253 In a deregulated environment, new entrants could employ strategies similar to Tatua's, providing more competition for unprocessed milk. This issue is considered under the analysis of competitive entry prospects in the unprocessed milk market.
- 254 During the investigation of the Kiwi/SIDCO application earlier this year, the Commission received submissions from suppliers wishing to switch from Kiwi to Dairy Group, although none subsequently did so. From the information received by the Commission the reason appears to be that Dairy Group was unwilling to accept new suppliers from Kiwi's area without levies being imposed to cover the transport costs involved<sup>21</sup>.

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<sup>21</sup> A further deterrent was the apparent reluctance by Kiwi to indicate to its shareholders whether it would be likely to withhold their capital contributions should they leave.

255 Ultimately, suppliers cannot switch between dairy co-operatives unless the company to which they wish to move is prepared to accept them. In deciding whether to accept new suppliers, a dairy company will take into account matters such as the following:

- current and planned future plant capacity;
- the transport costs of the new milk;
- the expected profitability of the product mix likely to be produced;
- the costs and benefits of additional suppliers as compared to purchasing unprocessed milk or other component in bulk inputs; and
- the likelihood of strategic behaviour, with dairy co-operatives deterred from poaching suppliers from neighbouring companies if retaliation is thought likely.

**Question 8:**

The Commission seeks comment on the factors that might affect a dairy company's ability or willingness to accept new supply.

**Question 9:**

The Commission seeks comment on how the factors referred to in Question 8 might change following industry deregulation.

### Financing of Capital Contributions

- 256 The ability of suppliers to switch between dairy co-operatives may be hindered if switching suppliers are unable to retrieve their capital contribution from their present dairy co-operative in order to pay into the new dairy co-operative. This problem arises if the current dairy co-operative elects to withhold the suppliers' capital<sup>22</sup>. For individual or small groups of switching suppliers, this provision is unlikely to be exercised. However, this clause could be invoked should large numbers choose to switch. In that case, a significant barrier to switching would then be raised, in the form of the need for a supplier to finance more than \$100,000 of capital for the period over which the original capital is being withheld, which can be for up to five years<sup>23</sup>.
- 257 Additionally, current regulations restrict suppliers from switching between dairy co-operatives within a season without the written consent of the releasing dairy co-operative. In the North Island, the season is defined as commencing on 1 August each year, and ending on 31 May. Elsewhere in New Zealand, the season is defined to commence on 1 September, and end on 30 June. While this restriction is not a major impediment in itself, by concentrating applications to switch into a short time period, it may serve to increase the risk of the losing co-operative exercising its right to withhold suppliers' capital. It also increases the uncertainty a supplier faces when switching, as discussed below.

<sup>22</sup> Dairy co-operatives establish the terms and conditions relating to capital contributions, and withdrawals, in their individual constitutions. The provisions of the Co-operative Companies Act, sections 18, 20 and 22 in particular, establish the ability to retain capital, should the dairy co-operatives solvency be at risk. The maximum time period is at the discretion of the Board. In the case of Kiwi, the company constitution limits the retention period to a maximum of five years.

<sup>23</sup> For an average farm producing approximately 60,000 kilograms of milksolids in the Dairy Group supply area, \$120,000 will be required in capital contribution at the current \$2 per kilo share standard. However, as farm size and dairy co-operative share standards vary, actual capital contributions will also vary widely.

- 258 The issue of the potential for capital to be retained by dairy co-operatives relates to the lack of assured liquidity of suppliers' investment in their dairy co-operative. The introduction of fair value entry and exit from dairy co-operatives could remove this barrier. However, as noted above, there is no compulsion to introduce fair value entry and exit contained in the proposal. Likewise, there can be no assurance that NewCo will implement the proposal to introduce some form of share tradeability.
- 259 As outlined above, the Commission's understanding of NewCo's draft constitution is that shares will be tradeable within a shareholding range. If the market for NewCo's shares is very illiquid, under certain circumstances NewCo may redeem shares. This would be similar to the current system, with the maximum capital retention period currently suggested in the draft as three years. However, the final form of the company constitution will be subject to shareholder approval.
- 260 Fair value entry and exit terms that facilitate switching or exit from the industry would also require extraction of suppliers' fair value share of the Dairy Board.
- 261 The Commission is also of the view that any share trading system limited to members of a dairy co-operative would raise concerns in terms of how effective such a market would be, and hence how accurately fair value would be reflected in share prices.

Question 10:

The Commission seeks comment on how the fair value of dairy co-operative shares is likely to be established, and how this relates to current nominal value shareholding.

Question 11:

The Commission seeks comment on how the fair value of Dairy Board shares is likely to be established.

Question 12:

The Commission seeks comment on the suggested share trading mechanism and redemption system currently being contemplated for NewCo, and the impact of the proposed system on the potential for fair value to be realised on entry and exit.

Payout Uncertainty

- 262 In the current environment, a further issue affecting switching is the uncertainty faced by suppliers in the switching decision. In switching, the supplier bears the risk that two or three years later the former dairy co-operative might be paying as much or more than the new one. This implies both that suppliers are unlikely to switch because of one bad year alone, and that they are likely to require a greater difference in payout than analysis that assumes certainty of future payments would imply.
- 263 This problem results from the fact that switching suppliers cannot be sure that they will be able to switch back easily, should they need to. As already noted, fair value entry and exit would remove this barrier.



- 264 As applications to supply a new dairy co-operative must be lodged well before season commencement, and final payout levels are not announced until late July, a supplier is likely to have to apply to change dairy co-operatives before knowing what the final payout for the current year has been. This will increase the incentive to delay switching for another year, as there seems to be considerable uncertainty over payout levels until the final announcement is made.<sup>24</sup>

### Equalised Payouts

- 265 In the current environment, averaging of milk payout and transport costs removes the ability of dairy co-operatives to target selectively the most attractive suppliers from each other.

#### Question 13:

The Commission seeks comment on the likely impact of deregulation on the ability of companies to target the most attractive suppliers and supply areas.

### Conclusion on Potential for Switching

- 266 The Commission considers there is potential for suppliers in border areas to switch between dairy co-operatives, even though limited switching has occurred in recent years. If further structural changes or deregulation occurred in the industry, switching would be considerably more likely than in the current regulatory environment.

#### Question 14:

The Commission seeks comment on any additional factors it should be aware of when considering the current potential for switching between dairy co-operatives.

#### Question 15:

The Commission seeks comment on any additional factors that could impact on the potential for switching between dairy co-operatives following deregulation of the industry.

### Benchmarking

- 267 Currently suppliers use comparison of dairy co-operative payout levels as a benchmark of relative dairy co-operative performance. It has been argued by the Applicant that benchmarking of payouts across dairy co-operatives is currently the most important form of competition.
- 268 Benchmarking is about information. However imperfect a signal it might be, it gives suppliers some measure of relative performance. However, benchmarking does not give suppliers the ability to substitute between dairy co-operatives, either in the market for unprocessed milk, or in an investment market for dairy co-operative shares. Suppliers may be able to use the information to put pressure on their dairy co-operative's management to improve its performance.

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<sup>24</sup> For example, Mr Bill Guest (Chairman, Northland Federated Farmers), was quoted in the *Northern Advocate* on 3 August 1999, as saying "The final payout was 13 cents up on what he (the Northland Dairy Company Chairman) was telling farmers at a round of meetings last week... That is just ridiculous."

**Question 16:**

The Commission seeks comment on the impact of benchmarking between co-operatives on the management and efficiency of dairy co-operatives, and on the extent and nature of competition between.

**Threat of Takeover**

- 269 Currently, dairy co-operatives can face some threat of takeover. However, the strength of this threat is mitigated by a number of factors.
- 270 Dairy co-operatives do not have tradeable shares. There is no mechanism to purchase a controlling shareholding, as might happen to a company listed on the stock exchange. There is no transparent market signal from share price movements available either to potential takeover parties, or to management.
- 271 Takeover of dairy co-operatives generally involves merger by agreement. Management may be able to block a merger that would benefit shareholders in the long term. However, this ability to block a merger is limited by the ability of the other party to the potential merger to go directly to shareholders.
- 272 The relative performance of dairy co-operatives appears to be largely driven by the economics of their geographic collection areas, and the business strategy adopted. In the current system the industry strategy is influenced by the Dairy Board, which is owned by the dairy co-operatives. It is currently unlikely, therefore, that a large New Zealand dairy co-operative would acquire a smaller one for the purposes of fundamentally transforming its approach to business. Traditionally, the transformation which takes place following mergers is asset rationalisation through plant closures. The current regulatory structure in the industry constrains the potential for fundamental change.

**Question 17:**

The Commission seeks comment on the extent to which the threat of takeover currently imposes management discipline on dairy co-operatives.

**Conclusion on Existing Competition**

- 273 The Commission considers that there are a number of factors which serve to act as a constraint on the market power of dairy co-operatives, namely the potential for suppliers to switch, benchmarking and the threat of takeover, which would be lost if the proposed merger were to proceed.

*Impact of the Proposed Merger on Competition*

- 274 Following the proposed merger, NewCo would have virtually 100 percent of the current market for the purchase of unprocessed milk in New Zealand. However, the proposed deregulation of the export industry would increase the potential for competitive entry.

### *Constraint by Potential Competition*

- 275 When assessing previous applications involving the dairy industry under the current regulatory environment, the Commission reached the view that the prospect of new entry was unlikely to provide significant constraint on the merged entity. For instance, in *Kiwi/Moa-Nui* (Decision 267) the Commission noted that *de novo* entry into dairy manufacturing had been “extremely rare”, and that the industry had rather been characterised by amalgamations and rationalisation.
- 276 Some of the factors which have made entry unlikely include the following:
- the underlying industry economics, involving economies of scale and scope, suggest that a substantial capital investment would be required;
  - the circular problem of securing sufficient milk supply to make a scale operation viable prior to building such facilities, while the construction of such facilities would be highly risky without a guaranteed supply;
  - the associated problems of getting suppliers to switch, as previously discussed (effect of capital retention, timing restrictions, etc. on switching);
  - the potential for incumbent response (localised payouts, short term disbursements to shareholders, transport levies to outlying shareholders) to make competitive acquisition of milk supply difficult;
  - single desk selling removing the marketing and distribution advantages of overseas investors;
  - the co-operative structure of the industry bundling returns and increasing the price of milk above its commodity value; and
  - for domestic entry, the cost of establishing brands and a marketing and distribution network combined with a very small economy unable to support multiple large companies.
- 277 For these reasons, the Commission has generally not been satisfied in past decisions that the threat of new entry would have been likely to impose sufficient constraint on those merged dairy co-operatives.

### Effect of the Proposed Merger on Entry

- 278 The proposal before the Commission is unique in that the proposed merger is set against the backdrop of industry deregulation, deregulation which in itself is dependent upon authorisation by the Commission of the proposal. Should deregulation occur, it has the potential to substantially alter the competitive landscape. In essence the proposed merger has two major effects on competition:
- removal of most of the existing competition in the industry; and
  - facilitation of new entry, primarily by removal of the single desk export arrangements.

### Removal of Single Desk Exporting

- 279 Removal of the single desk may allow global firms with established brands, global distribution networks and the financial resource to undertake long term and major

investments to enter. There are reasons why this is more likely under deregulation than in the past:

- in the absence of the single desk they would be able to exploit sources of value independent of quota markets, for example brands and product technology;
- new strategies would become available. For example if a global consumer products company were to purchase Dairy Foods it might supply both the domestic and export markets; and
- should fair value entry and exit conditions be introduced, as claimed by the Applicant, supplier switching would be facilitated, increasing ease of competitive entry.

280 As New Zealand is perceived as having a competitive advantage in the production of milk, a strategic decision might be made by a new entrant to establish a supply base in New Zealand.

281 Such companies could exercise the option of adopting a 'cherry picking' strategy, choosing to produce the highest value products from production facilities based in the lowest cost areas.

282 The Commission notes that:

- an entrant may have to compete with a bundled milk payout, where returns from downstream value added activities are bundled with the commodity milk price;
- NewCo will receive all quota returns for at least six years;
- 'cherry picking' strategies can be countered by localised payout differentials;
- the Resource Management Act will make entry slow and transparent, allowing time for defensive strategies to be communicated and implemented; and
- there is no assurance that fair value entry and exit will be implemented.

Question 18:

The Commission seeks comment on the extent to which the continuation of bundled milk pay-outs might impair competitive entry into the New Zealand dairy industry.

Question 19:

The Commission seeks comment on the extent to which ownership of quota rents remaining within NewCo for at least six years might impair competitive entry into the New Zealand dairy industry.

Question 20:

The Commission seeks comment on the extent to which failure to implement fair value entry and exit from NewCo might impair competitive entry into the New Zealand dairy industry.

Question 21:

The Commission seeks comment on the type of fair value entry and exit conditions that would need to be implemented to facilitate contestability in the markets for the acquisition/supply of unprocessed milk.

- 283 Discussions with New Zealand and Australian dairy companies suggest that entry could come in the following broad categories:
- commodity products;
  - consumer products; and
  - niche products.
- 284 Commodity products include products such as milk powders, butter, and cheese. The output of the New Zealand dairy industry has largely been in this category, but is changing to include more consumer products. For commodity operations, scale and good cost and process control are critical success factors.
- 285 Consumer products involve packaged/branded dairy goods, yoghurts, desserts, milk based drinks and non-dairy products that fit with the marketing and distribution strategy of the company. With the continuing improvement of long shelf life technologies, the export of liquid milk products to Asia and other international destinations is possible. Access to consumer markets, brands and product technology are critical success factors.
- 286 Niche products can be produced by small operations focussed on niche opportunities such as specialty cheeses. Such operators already exist in New Zealand. Examples would include Puhoi cheese, and Southern Fresh which exports ice cream (currently under licence from the Dairy Board).
- 287 The nature and probability of entry into each of these areas varies significantly, although it is acknowledged that in practice some companies will have a mixture of these categories within their operation.

#### Assessing Likelihood of Entry

- 288 The Commission assesses the likelihood of entry against the ‘*lets*’ test: whether entry is *likely*, of sufficient *extent*, *timely* and *sustainable*<sup>25</sup>.
- 289 Whether entry is likely depends on whether a company would be likely to earn a satisfactory return. It is not sufficient to state that a company such as, for example, Nestle could undertake scale entry. It must be likely to make a profit in doing so. This is related to the sustainability condition, which tests whether there is a lasting incentive for entry.
- 290 To be of ‘sufficient extent’ implies that the entry must be at a level and spread of operation that is likely to cause market participants to react in a significant manner, across a significant part of their operations.
- 291 To alleviate dominance concerns the Commission generally considers that entry on sufficient scale must be likely to occur within a period of two years, in which case it would be considered timely.

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<sup>25</sup> Commerce Commission, *Business Acquisition Guidelines* 1999, pp 19-20

### Likelihood of Entry

- 292 New Zealand dairy co-operatives have generally argued that major companies would enter on strategic grounds to access low cost milk supplies. Kiwi stated that Nestle has a major operation down to the farm gate in Australia. Nestle and similar companies are significant in the Australian market, but the Commission understands that these operations are aimed at domestic consumer markets, which are much larger in Australia, rather than commodity export markets.
- 293 Australian dairy companies, both co-operative and proprietary, considered commodity entry unlikely. The key reasons were:
- insufficient financial return in the commodity business;
  - it would be very difficult to compete with NewCo, unless NewCo became very inefficient; and
  - commodity products can be easily purchased at low cost on world markets.
- 294 The lack of financial return problem cited by the Australian companies would be exacerbated by a continuation of bundled milk payouts from NewCo. While the proposal before the Commission suggests that the milk price will be unbundled, no such condition has been agreed by the farmer shareholders of the existing dairy co-operatives. Even if the proposed merger were to be accepted by farmers, there will always be a number of judgement based factors involved in setting a commodity milk price. This will leave scope for manipulation of the milk price to increase barriers to entry.
- 295 Against the ‘lets’ test the Commission considers it highly unlikely that entry by a large scale commodity company would occur in the near future. It is possible that if NewCo were very inefficient such entry might eventuate in the long run, but not within a timeframe acceptable to the Commission.
- 296 Development of significant competition from a consumer operation would be possible, especially if Dairy Foods is sold to a company with access to the product technology, marketing and distribution needed. At this stage however, the Commission cannot assume this is likely to occur. Dairy Foods has not been sold, and the likely purchaser will not be evident until after the completion of this authorisation process.
- 297 Entry of new niche companies, and expansion of existing niche companies is highly likely. However, in the Commission’s view, the likely scale of this type of entry will provide little constraint on a company the size of NewCo. The Commission also notes that niche companies, by definition, often seek to avoid direct competition with large companies.

## Conclusion on Constraint by Potential Competition

- 298 The Commission is not satisfied that the threat of new entry is likely to impose sufficient constraint on NewCo to avoid dominance concerns.

### Question 22:

The Commission seeks comment on the likelihood, timing, nature and scale of potential entry under the proposed regulatory environment.

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

- 299 The Applicant submits that NewCo's co-operative ownership structure will be a significant source of constraint on market power. This claimed constraint works through two mechanisms:
- by ensuring all shareholders are suppliers and that shareholding is in proportion to quantity supplied, any profits are returned to the suppliers. This removes the incentive to lower prices to suppliers; and
  - as the suppliers that own the dairy co-operative are dependent on it for their livelihoods, they are highly motivated and active shareholders. This is argued to constrain management from actions that are not aligned with shareholder interests.
- 300 Dairy co-operatives differ from most firms, as generally any constraint offered by suppliers is external to the firm. In a dairy co-operative, however, such constraint from suppliers is internal. If a dairy co-operative attempts to exercise market power by decreasing its payout or increasing its costs, the supplier shareholders are potentially able to constrain these actions. Therefore, the issue is the degree of constraint offered by the co-operative structure.
- 301 In its consideration of several previous applications, the Commission has examined the extent to which co-operative ownership provides a constraint on the market power of a co-operative. These include the *NZ Dairy/Waikato Valley* (Decision 264, 7 June 1991), *Kiwi/Moa-Nui* (Decision 267, 9 April 1992) and *Ravensdown/SouthFert* (Decision 279, 21 June 1996) decisions<sup>26</sup>. The High Court in *The New Zealand Co-operative Dairy Company Limited & Anor v Commerce Commission* (1991) 3 NZBLC 102,059 considered that:

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

<sup>26</sup> Refer also to *Ravensdown v Commerce Commission* (AP168/96), 9 Decemeber 1996, High Court Wellington.

### Incentives to Lower Prices

- 302 In a company, owned either by public or private shareholders, the long run objective is to maximise profit, or returns to shareholders. The benefits of these gains, if any, are eventually delivered to shareholders either through dividends, or through capital gains in the value of the firm itself. In the case of a dairy co-operative with no other lines of business, its most important cost item is the cost of unprocessed milk. Minimising this cost is an area which, other things being equal, could deliver substantial gains to shareholder returns.
- 303 In a traditional dairy co-operative however, those gains would either increase owners' equity, by definition owned by the shareholders, or be paid out in the current period as dividends to the shareholders. In a co-operative, where share values are nominal and shares are not tradeable, increases in equity will not be immediately reflected in share value changes. The value is either distributed by bonus share issues, which increase the share value held per kilo of milksolids supplied, or milk supply payments in following years. While there may be issues associated with the timing of payouts, the shareholders, in this case the suppliers, ultimately receive the value. Given this relationship, the fact that 100 percent of suppliers are shareholders, and that ownership is in proportion to the value supplied, there seems to be little or no value to be gained by the co-operative from lowering payouts for the purpose of transferring value from suppliers to shareholders.
- 304 NewCo may differ from this analysis, depending on the final structure of the company's constitution. The Applicant is currently proposing to delink shareholding from supply, at least to some extent<sup>27</sup>. While the shares would still be held by suppliers, this would then raise distribution issues within the dairy co-operative. Suppliers with larger shareholdings relative to the supply standard would have an incentive to support higher dividends and a lower milk price. The outcome would depend on the balance of power within the dairy co-operative and the final details of the share scheme. The proposed shareholding alters the incentive to change price, reducing the relative neutrality that was previously present.

### Constraint on Management

- 305 Inefficient investment decisions and excessive cost structures are commonly encountered where firms are subject to insufficient competitive pressures, or owners are unable to monitor closely the performance and activities of the business. As with any large firm with a separation of ownership from management, dairy co-operatives are likely to suffer from these problems.
- 306 In *Kiwi/Tui* the level of influence of dairy co-operative members on the directors and activities of the company was discussed in detail. The discussion indicated that suppliers are relatively active shareholders. It has been argued by the Applicant that shareholders, because of their very high level of interest in the business of the co-operative, are likely to be more effective than shareholders of a publicly traded

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<sup>27</sup> The initial proposal was for a shareholding range to be available to suppliers, where suppliers could hold up to a maximum of 120 percent of the supply standard, or down to a minimum of 80 percent. However, the final form of the company constitution will be subject to shareholder approval.



company. However, shareholders of publicly traded companies are able to easily sell their shareholding if dissatisfied. Furthermore, publicly traded companies often have significant shareholdings held by companies rather than individuals. Often these companies are specialists in the industry being considered, or are businesses specialising in investment analysis. Publicly traded companies are further scrutinised by market/share analysts, and share price movement can be used as a constant measure of company performance.

- 307 It is argued by the Applicant that NewCo would ensure a high level of transparency of management performance by means of internal benchmarking. In terms of information, it is difficult to see that NewCo would provide a high level of transparency in practice. As with all companies key performance data will be commercially sensitive. Managers in any company have significant incentives not to reveal information on true management performance, and in this respect NewCo is unlikely to be an exception.
- 308 Shareholders of NewCo will have practically no ability to exit the co-operative other than by exiting the industry itself. The Applicant submits that existing suppliers dissatisfied with company performance could break away and establish their own operations.
- 309 The Commission considers that such exit is possible on a small scale. It is unlikely that large scale breakaway would occur, especially given the likelihood of capital contributions being retained if a significant supplier group wish to exit.
- 310 It was also noted in *Kiwi/Tui* and subsequent decisions that the constraint provided by the co-operative structure is moderated by the limited influence small numbers of suppliers are able to exercise as the dairy co-operative increases in size.
- 311 The Commission has acknowledged in previous decisions that the co-operative ownership structure could impose some degree of constraint on the market power of the proposed merged entity to make decisions which could adversely affect its suppliers. However, the degree of discipline imposed by the market on publicly traded companies is not present in dairy co-operatives.

#### Conclusion on Constraint by Co-operative Ownership

- 312 The Commission concludes that there are significant elements of difference between co-operative and corporate structures, and that NewCo might face some degree of internal constraint from its co-operative ownership, though this may be less than that of traditional dairy co-operatives due to the proposed modified shareholding rules. However, the Commission is not satisfied that it would impose a sufficient degree of constraint on NewCo to avoid dominance concerns.

**Question 23:**

The Commission seeks comment on the degree of constraint imposed on NewCo by the co-operative structure of the industry.

**Question 24:**

The Commission seeks comment on the impact of the proposed changes to NewCo's co-operative structure, when compared to traditional dairy co-operatives, on the degree of constraint imposed on NewCo.

*Constraint by Potential Substitute Uses of Dairy Farm Land*

- 313 Suppliers ultimately have the option of converting to other land uses, such as sheep, beef or deer farming, should payouts fall below acceptable levels. In the past, the industry has seen trends both out of dairying into other forms of agriculture and, over more recent periods, into dairying. Discussions with dairy industry participants during the Kiwi/SIDCO investigation confirmed that there is also the potential for some variation in quantities supplied by individual suppliers in response to changes in payout.
- 314 In terms of entry and exit decisions at the farm level, it has been argued that the capital costs of conversion to dairying are substantial. Likewise the capital contribution to the dairy co-operative may be difficult to remove, should numerous suppliers wish to exit, effectively making this investment sunk for an extended period. This would suggest that prices would need to fall substantially below those that encouraged entry to promote substantial exit activity. Hence, while the Commission accepts the validity of the industry exit argument, given price changes of sufficient magnitude over a long enough time span, the scale of price changes and time span involved are considered likely to fall outside the boundaries commonly used by the Commission to assess the size of markets and gauge market power.
- 315 There is also, in some cases, the ability to switch to town milk supply. While it is true that this may be possible in some cases, it is noted that only some eight percent of milk production goes to the domestic market, of which a subset is town milk, and that the town milk market is fully supplied. Furthermore, most town milk is sourced from within companies that would be merged under this proposal, leaving virtually no alternatives. For this reason, relative to the volumes produced for export, it is not believed that this option is a substantial constraint on a large dairy co-operative.

**Question 25:**

The Commission seeks comment on the degree of constraint imposed on NewCo by the potential for substitute uses of dairy farm land.

Conclusion on Constraint by Potential Substitute Uses of Dairy Farm Land

- 316 The Commission is not satisfied that NewCo would face sufficient constraint from potential substitute land uses to avoid dominance concerns.

### **Conclusion on Dominance in the Markets for the Acquisition/Supply of Unprocessed Milk in the North and South Islands**

- 317 The Commission concludes that the potential and actual constraint of competitive entry and the co-operative ownership structure of NewCo, while providing some constraint, are not sufficient to satisfy the Commission that NewCo would not, or would not be likely to, acquire or strengthen a dominant position in the markets for the acquisition/supply of unprocessed milk in the North and South Islands.

### **The Secondary Markets for the Wholesale Acquisition/Supply of Unprocessed and Near-Milk in the North and South Islands**

- 318 This market exists due to:
- the seasonality of milk supply;
  - efficiency improvements that can be gained from improved capacity utilisation; and
  - the need to provide fresh dairy inputs to companies not involved in unprocessed milk acquisition from suppliers.
- 319 The market includes unprocessed milk, and other products close to unprocessed milk such as milk concentrate and cream.

#### *Existing Competition*

- 320 Town milk companies need to sell excess milk, as market demand is flat while milk supply is seasonal (even for dedicated town milk suppliers). This has been particularly important for small independent town milk processors. The large town milk operations of Dairy Group and Kiwi internalise this transfer within the main manufacturing co-operatives. In these dairy co-operatives, winter milk supply for the domestic market is acquired by contracting with a sufficient number of suppliers for the winter period. For the rest of the year the domestic market supplies come from the manufacturing bulk milk supply.
- 321 Some smaller town milk companies have an equity relationship with the local manufacturing co-operative to ensure access to manufacturing capacity. Nelson Milk suppliers are members of Tasman Milk, the local manufacturing co-operative. Marlborough Milk has a shareholding in Marlborough Cheese. Top Milk utilises Northland through a similar arrangement, though Northland stated that it was only a very small amount of milk involved, and even then they were not keen to take on additional peak milk supplies. Others rely on market transactions; for example Southern Fresh has utilised a number of outlets, including neighbouring dairy co-operatives and manufacturers such as Cadbury, when possible.
- 322 Peak overflow trade occurs if one dairy co-operative has insufficient capacity and another in reasonable proximity has spare capacity. This has occurred in the South Island in the past. Opportunities for this form of trade are quite specific to the circumstances of the dairy co-operatives involved.

- 323 Fresh inputs are also important to independent food processing companies. Chocolate and ice cream manufacturers are good examples. Ice cream manufacturers need bulk cream. As cream is a by-product of milk, this is an example of a fresh product that is unlikely to be supplied in isolation from a wider dairy operation. Discussion with ice cream manufacturers suggested that the purchase of such fresh inputs could at times be on an 'as and when available' basis, depending on supply availability and the demand profile of the manufacturer.
- 324 Often the volumes traded are quite small. Even for larger companies, getting attention from dairy co-operatives could be difficult. Tip Top stated that it has difficulty getting service from large dairy co-operatives. [
- ]
- 325 The Commission notes that this market is very small relative to the size of the New Zealand dairy industry. In general, the markets appear to be thin, with transactions taking place in response to particular needs and commercial opportunities. Prices are therefore likely to be variable, and dependent on the nature of the relationship between trading participants.

#### *Impact of the Proposed Merger on Competition*

- 326 The proposed merger would mean almost all manufacturing capacity currently available to receive excess milk would reside in NewCo. The proposal would internalise co-operative to co-operative capacity driven trading. Indeed, the proposal would be likely to open more opportunities for plant to plant transfer, due to better information and production co-ordination.
- 327 For small town milk companies, the implications of the proposed merger are not clear. The likely status of the equity relationships that currently exist for companies such as Nelson Milk and Marlborough Milk under NewCo will not be certain until the details of the proposal are finalised.

#### Question 26:

The Commission seeks comment on the likely status of existing equity relationships of town milk companies and their suppliers should the proposed merger proceed.

#### Question 27:

The Commission seeks comment on the likely impact of the proposed merger on future entry into the town milk markets.

- 328 For companies currently trading small amounts of fresh product with dairy co-operatives, there is the issue of whether continuation of the business will be worthwhile. NewCo should be prepared to trade if the 'price is right', and not all volume is committed. However, the price might be considerably higher from a monopolist with little interest in the business in question.

#### Question 28:

The Commission seeks comment on the likely impact of the proposed merger on trade in fresh dairy inputs.

*Constraint by Potential Competition*

- 329 Companies are unlikely to enter this market directly. Therefore the applicable entry conditions are those outlined in the analysis of entry into the acquisition and processing of unprocessed milk. As discussed, the Commission is of the view that the likelihood of scale entry into that market within a reasonable timeframe is low.

*Constraint by Potential Substitute Uses of Excess Milk*

- 330 For a town milk operation of sufficient size, there is the option of processing excess seasonal milk supplies. This was an option chosen by the former SIDF dairy co-operative in the South Island, which installed a small drier in Christchurch to make milk powder. Processing into other long life products such as UHT milk may also be an option for such a processor. Dairy Foods stated that the drier option was still an option for a company of its size.
- 331 While building a facility such as a small drier is an option for a large operation, this appears to be the exception rather the rule, and is unlikely to be attractive for a small competitor. Most town milk companies have an arrangement involving sale of milk to dairy co-operatives. This would suggest that standalone processing capacity has not been the favoured option of most companies to this point in time.

Question 29:

The Commission seeks comment on the viability of existing or potential town milk operations to find alternate methods of disposing of flush milk supplies following the proposed merger.

*Conclusion on Dominance*

- 332 Should the proposed merger proceed, virtually all manufacturing processing capacity will be within NewCo. Likewise, supplies of most fresh dairy inputs, such as bulk cream for ice cream manufacture, will need to be sourced from NewCo. The Commission therefore concludes that it cannot be satisfied that NewCo would not, or would not be likely to, acquire or strengthen a dominant position in the secondary market for the wholesale acquisition/supply of unprocessed and near-milk in the North and South Islands.

**The Markets for the Processing and Wholesale Supply of Town Milk in the North and South Islands**

*Existing Competition*

- 333 The New Zealand town milk market was deregulated in 1993, and since that time there has been significant consolidation in the industry. Plants have been purchased and closed on a regular basis. This trend is continuing, with major companies continuing to rationalise their town milk production facilities. Dairy Foods has stated

that it intends to close its Tauranga plant within 12 months, while [ ]

- 334 Present suppliers to the town milk market consist of the three major dairy co-operatives, dedicated town milk companies and some boutique/niche processors. Of the dairy co-operatives, Dairy Group (Dairy Foods), Kiwi (Mainland) and Northland are active in this market. The dedicated town milk companies are Top Milk (Kaitaia), Gisborne Milk, Nelson Milk, Taumaranui Milk, Marlborough Milk and Southern Fresh Milk.
- 335 Estimated market shares for the current North and South Island markets are shown below. Dairy Foods South Island market share is currently sourced from Southern Fresh.

**TABLE 3**

**Estimated Shares of Town Milk Sales**

<i>North Island</i>	
Dairy Foods (Dairy Group)	[ ]%
Mainland (Kiwi)	[ ]%
Northland	[ ]%
Gisborne	[ ]%
Top Milk	[ ]%
	100%
<i>South Island</i>	
Mainland (Kiwi)	[ ]%
Southern Fresh	[ ]%
Nelson Milk	[ ]%
Dairy Foods (Dairy Group)	[ ]%
Marlborough Milk	[ ]%
	100%
<i>National</i>	
Dairy Foods (Dairy Group)	[ ]%
Mainland (Kiwi)	[ ]%
Northland	[ ]%
Southern Fresh	[ ]%
Nelson Milk	[ ]%
Gisborne Milk	[ ]%
Marlborough Milk	[ ]%
Top Milk	[ ]%
	100%

- 336 As discussed in the market definition section, the two main dairy co-operatives are Dairy Group and Kiwi. On a national basis, they supply an estimated [ ] percent of the market, with milk sourced from their own plants. They also franchise their brands (Anchor and Meadowfresh) to dedicated town milk companies. For example Nelson Milk and Southern Fresh provide Anchor branded milk in the South Island. Including Northland, the share of national town milk volumes sold by dairy co-operatives applying to enter NewCo is estimated to be [ ] percent. If volumes supplied under franchise and other fresh products are included (cream and flavoured milk), Dairy Group and Kiwi's combined share increases to [ ] percent of the market.
- 337 This aggregation of market share under the two main dairy co-operatives has occurred over the last 3-4 years. In 1996, Dairy Group and Kiwi only accounted for approximately [ ] percent of the market. Aggregation has occurred as the result of acquisitions by Kiwi (Mainland), both directly by Kiwi and by dairy co-operatives that were then in turn acquired by Kiwi.
- 338 The Applicant submits that scale economies in town milk processing are not particularly significant, and hence not a major barrier to entry. The Applicant notes the existence of a couple of very small suppliers as evidence of this – Fresha Valley in Northland, and a small independent supplier in South Auckland.
- 339 The Commission agrees that while there are some production scale economies, these are not a significant barrier to entry. The major economic issue is the need for a distribution network and the critical mass required to make entry economic. To be able to gain significant market share requires the ability to supply major retail chains seven days a week, sometimes several times a day. For supermarkets, it can be necessary to 'merchandise', that is deliver to, organise and maintain stock in the shop chiller. While some supermarkets do have regional arrangements, there is a strong preference for companies that can supply most if not all stores – island wide or nationwide if possible.
- 340 The importance of distribution seems to be one of the prime reasons that Mainland and Dairy Foods have such a strong position, while small companies generally remain in geographic or product niches. Small companies are likely to remain vulnerable because of the lack of the critical mass needed to supply large customers.
- 341 On a national basis, Dairy Foods and Mainland are relatively equal in size, with [ ] percent and [ ] percent of national processing volumes. However, they have differing regional strengths. Dairy Foods is relatively strong in the North Island with [ ] percent of this market, against Mainland's [ ] percent. It is particularly strong in the Northern half of the North Island, with approx. [ ] percent share of this region. In the South Island Mainland is predominant with [ ] percent of the market. Dairy Foods' representation in the South Island is mainly via franchise arrangements with Southern Fresh and Nelson Milk. Dairy Foods is generally expected to establish a presence in Christchurch following the Dairy Group/SIDCO merger.
- 342 The other regional companies, Northland, Gisborne Milk, Taumaranui Milk, Nelson Milk, Marlborough Milk, and Southern Fresh, while important in some areas, have

limited scope to compete directly with Dairy Foods and Mainland. In the North Island, the next largest company, Northland, only has about [ ] percent of the market. In the South Island, Nelson Milk and Southern Fresh have about [ ] percent each of the South Island market, but consider their ability to compete directly with the major companies is restricted by geographic isolation and distribution problems. The South Island's small and widely dispersed population is an issue for these companies. Conversely, both Nelson Milk and Southern Fresh suggested that without their geographic isolation they would not have survived competition with Mainland.

- 343 Competition in town milk markets has been very aggressive. It has been common practice to purchase competitors and close their factories. Nelson Milk and Marlborough Milk both stated that competitors had approached them with a view to purchasing their operations.
- 344 Failing purchase of the operation, a number of tactics have been employed to remove small companies. Local/customer based pricing has been used in areas in which regional milk companies were operating. Both Nelson Milk and Southern Fresh had their home distribution networks (of independent vendors) taken over by Mainland, removing substantial volume from their businesses literally overnight. Anchor is allegedly using volume discounting to inhibit the growth of the independent processor that recently started operations in South Auckland (cited in the application as an example of successful new entry).

#### *Impact of the Proposed Merger on Competition*

- 345 Following the proposed merger, the main source of competition in the North Island market will be Dairy Foods. In the South Island, the ability of Dairy Foods to establish itself and expand in the Christchurch region will be the key to maintaining significant competition in that market.
- 346 However, Dairy Foods will be dependent on NewCo for supply of its key input, unprocessed milk, via the proposed supply contracts. As such, the Commission is of the view that it cannot be satisfied that a competitor operating on the proposed basis can be considered to act as a constraint on NewCo. In the Commission's view, an independent supply base would be needed to establish a truly credible competitor.
- 347 Of the remaining operations, most are currently independent except Northland. Northland stated that at this stage no decision had been made as to whether Northland's town milk operation would be merged with or separated from NewCo. Assuming Northland's operation was merged, there would be a small aggregation of share in the North Island market, with Mainland's share rising from [ ] percent to [ ] percent.
- 348 In the South Island market, the main effect would be to foreclose the immediate possibility of a substantial competitor being established in the Christchurch region, since the potential milk supply base would be part of NewCo.
- 349 The immediate impact on the independent companies would appear to be mainly from the terms and conditions on which NewCo might choose to deal with flush milk. Given the incentives that exist to continue to rationalise the town milk industry, it is



questionable whether it would be in the best interests of Newco's shareholders to accept such milk at current prices.

- 350 Many of the independents also depend on Dairy Group and Kiwi for brands. However, this is the case with or without the proposed merger, and the trend to date would appear to be for the large companies to franchise when it suits, but eventually move to supply the market themselves. Assuming existing licensing arrangements remain in place, the Commission considers it unlikely that the proposed merger will alter this trend.

#### *Constraint by Potential Competition*

- 351 The Applicant submits that there are low barriers to entry. The Commission accepts that production (plant costs) barriers are low. However marketing and distribution issues are substantial. Australian companies consulted in the process of investigating the proposed merger were generally of the view that no more than two major companies would be profitable in such a small market. This would appear to be consistent with the trend for consolidation since deregulation, and the very large share of the market held by the two major town milk companies. The Commission considers it unlikely that a major competitor would enter just to provide town milk.
- 352 Christchurch is a significant market by New Zealand standards, and one where Dairy Foods is weak. Furthermore, with the trend to national distribution deals, it seems likely that Dairy Foods would be looking to expand its operation in this area in the longer term. This would be much easier for Dairy Foods than a new entrant, as it now has substantial milk supply in the Christchurch region as a result of Dairy Group acquiring SIDCO. There is little doubt that for an operation of Dairy Foods' size establishing plant is not a major barrier, nor is establishing a distribution network.
- 353 In Decision 324, *Mainland/SIDF*, dated May 1998, the Commission found that Mainland would not be likely to acquire a position of dominance in the South Island town milk market. The acquisition resulted in the combined entity gaining approximately [ ] percent of the South Island market. Dominance was not found on the grounds that the threat of competitive entry would provide significant constraint, combined with the countervailing power of retailers.
- 354 In the *Mainland/SIDF* decision the Commission concluded that Nelson Milk and Southern Fresh may not be able to provide sufficient constraint on the enlarged entity. However, it was expected that Dairy Foods would have the potential to enter the market within a period of [ ] months. [

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#### Constraint by Potential Competition in the North Island - Conclusion

- 355 Given the rapid aggregation of the town milk market, the Commission accepts the view that scale entry by a third competitor into the domestic town milk market is unlikely.

- 356 The Commission is therefore not satisfied that NewCo would be sufficiently constrained by the threat of entry in the North Island to avoid dominance concerns.

Constraint by Potential Competition in the South Island - Conclusion

- 357 The Commission is not clear how easily Dairy Foods might be able to expand into Christchurch following the proposed merger. The issue will be access to milk supplies in the Canterbury region. With no certainty of the identity of the buyer of Dairy Foods, and the terms and conditions of supply, the Commission is not satisfied that the threat of entry to the South Island is likely to provide sufficient constraint on NewCo.
- 358 Given the small size of the South Island market, the Commission considers scale 'greenfields' entry is unlikely. The Commission also notes that established South Island companies have not been able to establish a significant presence in the Christchurch market.

Question 30:

The Commission seeks comment on the potential for new entry on a significant scale to either or both of the North and South Island town milk markets.

*Constraint by Potential Substitutes for Fresh Milk*

- 359 The Applicant submits that UHT milk is a potential substitute for fresh milk, and one that has gained a substantial share of the Australian market.
- 360 Australian companies contacted by the Commission stated that the large scale success of UHT in Australia had been driven by price. A major Australian co-operative (Murray Goulburn) was trying to establish the market. In the process it had been selling UHT milk below cost. This had driven the share gains achieved. The Australian companies spoken to by the Commission were sceptical that UHT would maintain its market position at profitable prices.
- 361 UHT milk is milk with a longer shelf life as a result of heat treatment. The main differences between UHT and fresh milk are that UHT milk is less costly to store and transport as it doesn't require refrigeration, but more expensive to manufacture. While establishing a town milk operation might cost in the order of \$[ ] million, Southern Fresh stated that for it to expand into UHT would cost in the order of \$[ ] million. Significant volumes would be required to justify such investment.
- 362 Although New Zealand processors (such as Dairy Foods) produce UHT milk, it is not a significant product in the New Zealand market. This would suggest that the benefits (reduced transport and storage costs) do not outweigh the costs (increased production costs, cost of overcoming consumer resistance). Even if it were to become established, it does not seem likely to change the nature of competition in the market – access to supermarkets will still be relatively restricted in practice.

**Question 31:**

The Commission seeks comment on the extent to which the development of UHT and other extended shelf life milk technologies have the potential to change the nature of competition within the town milk markets.

*Other Constraints – Countervailing Power of Retailers*

- 363 The Applicant has submitted that supermarkets and oil companies have considerable countervailing power. Previous Commission decisions, and investigation of this proposed merger, would suggest that considerable countervailing power does exist. Discussion with supermarkets in particular indicates they were able to reduce the scale of a price rise (for housebrand milk) at the end of 1998.
- 364 Housebrands appear to increase the level of countervailing power, as noted above, and are a significant subset of supermarket milk sales, accounting for approximately 37 percent of supermarket sales. Supermarkets can, and to some extent currently do, sponsor new entrants to maintain the level of competition in the town milk market. While this can occur by making shelf space available for competing branded milk, the existence of housebrands may further lower barriers to entry by removing the need for an entrant to establish its own brand.
- 365 While major retailers do appear to have countervailing power, to exercise such power does require at least one credible alternative source of supply. Under the proposed merger, the main source of this countervailing power in the North Island will be Dairy Foods. The other significant competitor, Northland, is included in the proposed merger. The Commission is not satisfied that Dairy Foods, with its dependence on NewCo for unprocessed milk supplies, can be relied upon to provide retailers with a credible alternate source of supply.
- 366 In the South Island, Nelson Milk and Southern Fresh will remain independent and will provide some measure of genuine choice for retailers such as supermarkets. However, the degree of constraint will be limited by the cost of transportation from relatively remote locations.
- 367 Major retailers have the ability, at least in theory, to vertically integrate back to the farm. However, this would be a substantial departure from the core business of a retailer. [
- ]
- 368 While supermarkets currently have considerable countervailing power, especially in the housebrand market, they only account for about 40 percent of total town milk sales. About another 20 percent goes to the route trade, which is 80 percent oil companies. The remaining 40 percent goes to dairies, superettes, restaurants, business and homegate delivery<sup>28</sup>. These remaining channels to market have little or no countervailing power.

<sup>28</sup> The data referred to in this paragraph is based on Dairy Foods' current distribution profile.

- 369 In the North Island, the Commission concludes that it cannot be satisfied that the countervailing power of retailers will be able to restrain NewCo sufficiently to avoid dominance concerns.
- 370 In the South Island, while acknowledging that some constraint will be offered by the remaining town milk companies, the Commission is not satisfied that this constraint will be sufficient to avoid dominance concerns.

Question 32:

The Commission seeks comment on the extent to which the countervailing power of retailers will be able to constrain NewCo.

Question 33:

The Commission seeks comment on the extent to which major retail chains might be able to facilitate new entry into the town milk markets.

*Conclusion on Dominance – North Island*

- 371 NewCo's share of the North Island market would increase from [ ] to [ ] percent. The other significant competitor, Dairy Foods, would hold [ ] percent of the market. This would normally fall well within the Commission's safe harbours for mergers and acquisitions.
- 372 However, given the dependence of Dairy Foods on NewCo for its critical input – unprocessed milk – the Commission is not satisfied that Dairy Foods will be able to act as a constraint on NewCo. Competitive entry on a large scale into this market is unlikely, and given the lack of credible alternative sources of supply, the countervailing power of retailers will be limited.
- 373 The Commission therefore concludes that it cannot be satisfied that NewCo would not, or would not be likely to, acquire or strengthen a dominant position in the market for the processing and wholesale supply of town milk in the North Island.

*Conclusion on Dominance – South Island*

- 374 Mainland's share of the South Island market is approximately [ ] percent, with no competitor holding a share in excess of [ ] percent. This is well outside the Commission's safe harbours. The Commission is not satisfied that potential entry, or countervailing power of retailers can be relied upon to constrain NewCo.
- 375 The Commission therefore concludes that it cannot be satisfied that NewCo would not, or would not be likely to, acquire or strengthen a dominant position in the market for the processing and wholesale supply of town milk in the South Island.

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

### *Existing Competition*

- 376 There is a wide variety of cheese on the market, ranging from block cheese which is a commodity product, through to high value specialty cheeses. There are large price variations across these product segments. The high unit value of specialty products can sustain specialist niche processors, which currently exist in the domestic market (examples are Puhoi and Kapiti cheese).
- 377 For the purposes of analysis, the market is considered to consist of two main categories of cheese product; block cheese and specialty cheese. Bries, blues, camemberts and parmesan are examples of specialty cheeses. Cheddar and colby cheese sold in supermarkets are examples of mass produced/commodity types of cheese. For the commodity cheeses, there is a trend towards convenience or ready to use products, such as cheese slices and grated cheese.
- 378 The cheese market is heavily influenced by production specialisation. For this reason, companies commonly sell product to their retail competitors. For example, Mainland produces most blue vein cheese. As well as selling directly to retailers, Mainland also sells product to companies such as Anchor, Kapiti and Whitestone. Further processing is also often specialised in plants serving both the domestic and export market. For example, Pastoral Foods in Eltham is a 100 percent owned subsidiary of the Dairy Board, and is the largest supplier of processed cheese in New Zealand.
- 379 Most of the New Zealand market is taken up by commodity cheese products sourced from Dairy Foods, Mainland and Marlborough Cheese. These companies collectively account for about [ ] percent of the New Zealand market by volume (all segments). The cheese is manufactured in plants within the dairy co-operatives, with the bulk of production going to exports. The domestic market receives product from these plants.
- 380 Australian dairy co-operatives such as Bonlac have attempted to compete in the commodity area of the market. However, for commodity products the only advantage an importer would have is price, and imported product does not have a cost advantage. As a result, imports have been relatively unsuccessful.
- 381 For specialty cheeses, the market is significantly different. In this area being imported can be an advantage, and imports are competitive with significant market penetration. However, this is a relatively small portion of the overall market.

### *Impact of the Proposed Merger on Competition*

- 382 Following the proposed merger, the source of supply for [ ] percent of the New Zealand cheese market will be encompassed by NewCo. Dairy Foods will have about [ ] percent of the market, leaving NewCo with about [ ] percent. However, Dairy Foods will be dependent on NewCo for supplies of bulk cheese. As previously noted, the Commission is not satisfied that a competitor operating on the currently proposed supply contract basis can be considered to act as a constraint on NewCo.

### *Constraint by Potential Competition*

- 383 A new entrant producing bulk commodity cheese at a cost level that would be competitive, would arguably require entry to the market for the purposes of export as well as domestic supply. Consequently, the analysis is the same as applied to commodity entry in the raw/unprocessed milk market. The Commission is of the view that this type of entry is unlikely within a two year timespan.
- 384 For specialty cheese, competition exists from both niche manufacturers and imports. It is quite possible that further entry by niche manufacturers could occur following deregulation. However, as already noted, this is a relatively small part of the overall market.
- 385 Cheese is readily transportable, and can be stored for long periods. Most retail industry participants agreed that imports would be a viable source of supply if needed, but there would be significant transport and storage costs. Availability and cost of fresh storage is an issue. Foodstuffs, which imports margarine from Australia, had looked at the additional costs of importing butter and cheese. Foodstuffs suggested the additional costs of importing could be at least 5-10 percent of current product cost.

#### **Question 34:**

The Commission seeks comment on the potential for entry into the market for the production of bulk cheese.

#### **Question 35:**

The Commission seeks comment on the viability and practicality of importing bulk cheese into New Zealand.

### *Constraint by Potential Substitutes for Cheese*

- 386 The Applicant submits, and the Commission agrees, that there are few direct substitutes for essential dairy items such as cheese.

### *Conclusion on Dominance*

- 387 The Commission concludes that potential and actual constraints by competition following the proposed merger are not sufficient to satisfy the Commission that NewCo would not, or would not be likely to, acquire or strengthen a dominant position in the market for manufacture and wholesale supply of cheese in New Zealand.

## **The Market for the Manufacture and Wholesale Supply of Consumer Spreads in New Zealand**

### *Existing Competition*

- 388 Butter is a commodity product produced on large scale by the export businesses of the dairy co-operatives. The domestic business units market and distribute product sourced from the dairy co-operatives. Competition in butter in New Zealand currently

occurs between Mainland and Dairy Foods.

- 389 As noted in the market definition, information supplied to the Commission by the supermarket chains and Dairy Foods suggests that butter is in competition with margarine, especially in the long term. Margarine has a large share of the market – nearly [ ] percent - and this share is increasing.
- 390 Margarine is supplied by non-dairy companies, and is commonly imported from Australia. This suggests that the retail price of butter will be constrained by its price relative to margarine, which in turn will be constrained by Australian margarine supply prices.

#### *Impact of the Proposed Merger on Competition*

- 391 The proposed merger will remove the existing competition between dairy co-operatives to supply butter to the domestic market – all butter will be sourced from NewCo. However, competition from other products, principally margarine, will be unaffected.

#### *Constraint by Potential Competition*

- 392 Butter is readily transportable, and can be stored for long periods. Most retail industry participants considered that imports would be a viable source of supply if needed, but there would be significant transport and storage costs. Butter imports are not currently used as a source of supply by retailers. Availability and cost of fresh storage would be a significant issue in moving to imports as a source of supply.
- 393 Industry sources advise that margarine is more easily imported. While there is some domestic manufacturing of margarine, it is commonly sourced from Australia.

#### *Conclusion on Dominance*

- 394 The Commission concludes that the potential and actual constraints by competition from substitute products following the proposed merger are sufficient to satisfy the Commission that NewCo would not, or would not be likely to, acquire or strengthen a dominant position in the market for the manufacture and wholesale supply of consumer spreads in New Zealand.

### **The Market for the Manufacture and Wholesale Supply of Cultured Food Products**

#### *Existing Competition*

- 395 This market consists of a diverse number of products which, for the purposes of analysis, are aggregated into two general categories – processed milk and fresh dairy foods (“fresh foods”).
- 396 Processed milk covers a variety of products, primarily UHT, condensed and powdered milk, and processed cream. While these products are quite different, they all have relatively long shelf lives. As such, they are more transportable and storable than fresh products.

- 397 Fresh foods include yoghurts, dairy foods, dairy desserts, custards, cottage and cream cheese, sour cream and dips. Again, these are a diverse grouping of products. In common, however, they have a limited shelf life and generally require chilled storage.
- 398 There is a range of products in this market, and market shares vary substantially. However, in general, Mainland and Dairy Foods account for most of the market. The exceptions are processed milk where Nestle has approximately [ ] percent of the market, and the yoghurts/dairy foods/desserts segments of fresh foods where International Fine Foods (Yoplait brand) has about [ ] percent of the market. In the processed milk market, Bonlac, in partnership with Frucor, has recently introduced Bonlac's 'Wave' brand flavoured milk, a UHT milk product sourced from Australia.
- 399 Manufacture of these products uses a variety of inputs, some of which are fresh milk and cream. For small operations, the volume of fresh inputs is not large. For example, International Fine Foods is able to source fresh inputs from Gisborne Milk (mostly cream), a small town milk co-operative of 15 shareholder suppliers. Other inputs such as skim-milk powder can be sourced from a variety of sources, and International Fine Foods have used milk powder from Australia in the past.

#### *Impact of the Proposed Merger on Competition*

- 400 With the proposed divestment of Dairy Foods there will be no change in the manufacturing and wholesale levels of this market. However, Dairy Foods will be dependent on NewCo, a monopoly supplier of fresh milk inputs, for the quantities required to support its operation.

#### *Constraint by Potential Competition*

- 401 Companies wishing to enter this market will require access to raw inputs such as milk and cream. Their options are to source their own suppliers, purchase from NewCo or seek supply from one of the town milk companies.
- 402 The Commission questions whether a *de novo* competitor would enter this market on a significant scale. Australian companies spoken to by the Commission considered the New Zealand market too small to support another significant company. Entry would be via the purchase of an established company, with viable scale, brands and distribution. Access to the export market would also be important. Access to unprocessed milk supplies would be an issue for any major competitor.
- 403 The potential for imports is restricted by transport costs and the limited shelf life of some products. Some Australian companies have attempted to compete in this market in specific product areas. For example, Dairy Farmers have tried to export yoghurt to New Zealand, but were not successful. There may be more potential for imports in the future, as products such as extended shelf life yoghurts become more common, but it is not clear how readily these products will be accepted in comparison with locally sourced fresh product.
- 404 Small companies such as International Fine Foods would be able to source fresh ingredients from small town milk companies that continue to operate. However, apart from International Fine Foods itself, which was formed as a divestment from an



Auckland milk processor when acquired by Dairy Group in 1988, no other significant domestic competitors have entered the market.<sup>29</sup>

- 405 The Commission is therefore not satisfied that the threat of new entry is likely to impose sufficient constraint on NewCo to avoid dominance concerns.

*Constraint by Potential Substitutes*

- 406 There are generally no close non-dairy substitute products in this market.

*Conclusion on Dominance*

- 407 As a result of Dairy Foods' dependence on NewCo for milk supply, the Commission concludes that potential and actual constraints by competition following the proposed merger are not sufficient to satisfy the Commission that NewCo would not, or would not be likely to, acquire or strengthen a dominant position in the market for the manufacture and wholesale supply of cultured food products in New Zealand.

Question 36:

The Commission seeks comment on the ability of current or potential competition to constrain NewCo in the market for cultured foods in New Zealand.

**The Market for The Manufacture and Wholesale Supply of Dairy Ingredients in New Zealand**

*Existing Competition*

- 408 The ingredients market involves provision of intermediate inputs to both dairy and non-dairy manufacturing companies. These products can be grouped into proteins, oils and fats, flavourings and stock feed.
- 409 Some products in this category have been discussed in the secondary milk market, in particular milk and fresh cream which have been traditionally sourced from dairy co-operatives within the same island as the acquiring company. Products sold in bulk for industrial use, that are also sold in consumer markets, such as butter and cheese, are considered to fall within the ingredients market.
- 410 Currently, dairy co-operatives compete to supply dairy ingredients. Bulk ingredients such as casein could be sourced from a number of dairy co-operatives. Likewise, milk powder inputs for stockfeed companies can come from any of the dairy co-operatives producing powder, and prices can be quite competitive. Most ingredients are sourced from Dairy Group, Kiwi and Northland.
- 411 Some dairy co-operatives are heavily dependent on inputs from other dairy co-operatives. Tatua is the prime example at present. Should new entrants pursue a

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<sup>29</sup> *New Zealand Co-operative Dairy Company/Auckland Co-operative Milk Producers Limited*, Decision 216, 26 April 1988.

similar strategy, they would be equally dependent on being able to source bulk dairy ingredients.

- 412 Some dairy ingredients are very specialised (eg cheese flavourings for cheese flavoured snack food products). For these types of products, the customer is likely to be dependent on a single source of supply. In this case, the competition will occur when the supply relationship is being established rather than on an ongoing basis.

#### *Impact of the Proposed Merger on Competition*

- 413 Following the proposed merger, supplies of virtually all bulk dairy ingredients would come from NewCo. Dairy Foods, which will not have an independent supply base, will not produce ingredients products (eg butter, casein, whey, bulk cheese), and therefore will not be a source of supply to this market.

#### *Constraint by Potential Competition*

- 414 Companies are not likely to enter the dairy industry solely to provide ingredients. Most ingredients are by-products of manufacturing processing (cream, whey, casein) or products that result from the production of other dairy products (for example, butter production can produce skim-milk powder or casein).
- 415 Potential for competition in this market therefore stems from entry to the unprocessed milk and downstream processing markets. This analysis has been undertaken as part of the analysis of the market for unprocessed milk, where the Commission concluded that scale entry was unlikely.

#### *Constraint by Imports*

- 416 The Applicant submits that pricing in most of the ingredients markets is set by import/export prices. The Applicant argues that export prices set a floor on domestic prices, while the domestic ceiling is set by the landed cost of imports. How much value can potentially be delivered by domestic competition is then a function of how wide this band is.
- 417 The size of this gap should be set by transport costs<sup>30</sup>. For the closest external market, Australia, the Applicant submits that transport costs for containerised trans-Tasman shipment are in the order of \$50/tonne. It is submitted that this is similar to the domestic cost of transporting product (within an island). Presumably there may be additional costs if the customer is not at a sea port.
- 418 At an export port, such as Auckland, the margin between the domestic base and ceiling prices set by Australian prices is twice the transport cost, all other things being equal. The seller is indifferent to selling at the Australian domestic price less the cost of shipment, while the buyer will pay up to the Australian price plus the cost of shipment. This margin is then in the order of \$100/tonne.

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<sup>30</sup> Other transaction costs could also be an issue, if transacting offshore is significantly more expensive than transacting domestically. For the purposes of the analysis it is assumed transport costs are the only significantly different cost.

- 419 At current prices, bulk butter and wholemilk powder sell for approx. \$3000/tonne, so this margin is approx. three percent of product cost. For casein, selling around \$7500/tonne, it is only about 1.3 percent. For lower value products such as stockfeed milk powder, which is in the \$1500/tonne price range, the margin is approximately six to seven percent of product value.<sup>31</sup>
- 420 Tip Top stated that it has imported butter and milk powder for use in making ice cream when those products were cheaper overseas. In some cases, this involved re-importing New Zealand product. This resulted from the distortions in the international market place, and the fact that New Zealand sourced ingredients were priced against a bundled milk price, inflated by factors such as quota returns to the New Zealand industry.
- 421 Tatua requires casein as an input to its production processes. Currently this is locally sourced from neighbouring dairy co-operatives through an arrangement with the New Zealand Dairy Board. However, Tatua has stated that casein could be imported from Australia if required.
- 422 Stock food companies currently rely on downgraded powder from local co-operatives. Industry sources advised that while some products could be imported from Australia, the price was significantly above that currently available from local co-operatives. Furthermore, Australia could not provide equivalent inputs to all the products currently sourced locally.
- 423 The Commission concludes that imports are a viable option for some but not all ingredients.

**Question 37:**

The Commission seeks comment on the viability and practicality of importing dairy ingredients into New Zealand.

*Constraint by Potential Substitutes*

- 424 The Applicant submits that most ingredients have suitable non-dairy substitutes available.
- 425 As an example of the substitutability of products, sources in the ice cream industry stated that ice cream can be made with a variety of inputs. Fresh milk and cream are ideal, however butter and milk powder can be used. Palm oil can also be used to make ice cream, although a company producing and marketing dairy based ice cream would not use palm oil. Furthermore, while butter and milk powder can be used to some extent, the industry view is that the best results come from fresh inputs of milk and cream.
- 426 The Commission considers it is likely that for a range of manufactured or baked food products, similar circumstances will prevail. In some cases comparable non-dairy

<sup>31</sup> The product values stated are indicative only, and vary both between transactions and over time as international markets fluctuate.

substitutes will be available, in which case dairy inputs presumably are chosen as the cheapest option. In other cases, the use of substitutes will materially alter the taste, quality or marketability of the final product.

**Question 38:**

The Commission seeks comment on the suitability and availability of non-dairy substitute products that might compete in the New Zealand dairy ingredients market.

*Conclusion on Dominance*

427 The ingredients market includes a wide range of dairy products that are inputs to a large range of manufactured goods. In some cases, non-dairy substitutes are available. In others, imports are an economic alternative. However, the Commission is also aware that non-dairy substitutes cannot cover all applications. Also, imports are not a viable option in all cases.

428 Therefore, on the basis of the information available, the Commission concludes that it cannot be satisfied that NewCo would not, or would not be likely to, acquire or strengthen a dominant position in the market for the manufacture and wholesale supply of dairy ingredients in New Zealand.

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

*Existing Competition*

429 The Dairy Board purchases dairy products from dairy co-operatives and sells them either directly or through its world-wide marketing network of subsidiary and associate companies, distributors and agents. A small amount of dairy produce is exported directly by dairy co-operatives or companies under permits issued by the board. These arrangements usually involve niche or specialised products, exported to markets or customers too small to be effectively handled by the Dairy Board.

430 The Dairy Board is constituted under, and governed by, the Dairy Board Act. This Act, in effect, gives the Dairy Board statutory monopoly power over the export of dairy produce from New Zealand. Accordingly, the Dairy Board is dominant in the market for the acquisition of manufactured dairy products in New Zealand for export.

431 While the Dairy Board is commonly referred to as having a statutory monopoly, the Dairy Board is in competition with numerous companies in various markets throughout the world. The Dairy Board Act creates a monopsonist purchaser for New Zealand dairy products, not a monopoly seller in world markets. As such the Dairy Board does not compete for supply from its dairy co-operatives which are its shareholders and owners. It does however, in consultation with its shareholders, make decisions that allocate production to its suppliers. As well as production planning issues, the Dairy Board is responsible for the product payment system between itself and the supplying dairy co-operatives.

- 432 On the supply side of the market, the dairy co-operatives compete for the rights to supply preferred products, both in terms of product mix and quantities. This competition seems to be intensifying as the product payment system has moved to a more market based approach compared with the historical cost reimbursement approach. As noted previously, the co-operatives are judged primarily on relative payouts, and product allocation decisions can have significant impacts on the performance of a co-operative.

#### *Impact of the Proposed Merger on Competition*

- 433 The application before the Commission seeking authorisation to create NewCo has been made in the context of Government proposals involving deregulation and removal of the Dairy Board's monopsony export powers. NewCo would then capture the bulk of New Zealand's dairy exports within the new vertically integrated company. The barrier to competition in dairy exports is then no longer on the acquisition side of this market, but on the supply side.
- 434 Most competition on the supply side would disappear, replaced by internal competition and controls within NewCo. However, some of the fringe companies would be free to export products through the marketing channel of their choice. In the longer term, further competition could develop from companies that enter the manufacturing market.

#### *Conditions of Entry*

- 435 On the acquisition side of this market, the market is global and competitive. A marketer could easily purchase New Zealand dairy produce with no physical presence in New Zealand. The barrier to becoming an exporter post deregulation is on the production/supply side.
- 436 The analysis of entry conditions to production has been documented in the competition analysis for unprocessed milk. The conclusion of dominance reached in that market extends dominance to the market for dairy exports. The proposal would prevent other companies contesting the supply of almost 100 percent of New Zealand's dairy exports, by virtue of securing access to virtually all of the unprocessed milk in New Zealand.

#### *Conclusion*

- 437 Therefore the Commission concludes that it is not satisfied that NewCo would not, or would not be likely to, acquire or strengthen a position of dominance in the market for the acquisition/supply of manufactured dairy products in New Zealand for export.

#### **Conclusion on Dominance in the Relevant Markets**

- 438 The Commission concludes that it is not satisfied that NewCo would not, or would not be likely to, acquire or strengthen a position of dominance in the following markets:

- the acquisition/supply of unprocessed milk in the North Island;

- the acquisition/supply of unprocessed milk in the South Island;
- the secondary market for the wholesale acquisition/supply of unprocessed and near-milk in the North Island;
- the secondary market for the wholesale acquisition/supply of unprocessed and near-milk in the South Island;
- the processing and wholesale supply of town milk in the North Island;
- the processing and wholesale supply of town milk in the South Island;
- the manufacture and wholesale supply of cheese in New Zealand;
- the manufacture and wholesale supply of cultured dairy products;
- the manufacture and wholesale supply of dairy ingredients in New Zealand; and
- the acquisition/supply of manufactured dairy products in New Zealand for export.

439 The Commission concludes that it is satisfied that NewCo would not, or would not be likely to, acquire or strengthen a position of dominance in the following market:

- the manufacture and wholesale supply of consumer spreads in New Zealand.

## **PUBLIC BENEFITS AND DETRIMENTS**

### **Introduction**

440 Given the conclusion that the Commission is not satisfied that the proposed merger would not result, or would not be likely to result, in NewCo acquiring a dominant position in a number of different markets set out above, the proposed merger cannot be cleared under s 67(3)(a) of the Act. The Commission must therefore consider whether the proposed merger can be authorised under s 67(3)(b) of the Act.

441 The authorisation procedure requires the Commission to identify and weigh the detriments likely to flow from the acquiring of a dominant position in the relevant markets, and to balance those against the identified and weighed public benefits likely to flow from the proposed merger as a whole. It is important to note that because of the wording of the Act, the detriments may only be found in the market or markets where dominance is acquired or strengthened, whereas benefits may arise both in those and in any other markets.<sup>32</sup> Only where the benefits clearly outweigh the detriments can the Commission be satisfied that the proposed merger will result, or be likely to result, in such a benefit to the public that it should be permitted, and thus be able to grant an authorisation for the proposed merger.

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

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<sup>32</sup> See: Commerce Commission, *Decision 201A: Goodman Fielder/Wattie*, May 1987, pp. 68-69.

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

- 443 The Commission considers that within the relevant markets, a public benefit is any gain, and a detriment is any loss, to the public of New Zealand, with an emphasis on gains and losses being measured in terms of economic efficiency. In contrast, changes in the distribution of income, where one group gains while another simultaneously loses, are generally not included because a change in efficiency is not involved. The Commission is also mindful of the observations of Richardson J in *Telecom*<sup>33</sup> on the Commission's responsibility to attempt to quantify benefits and detriments where and to the extent that it is feasible, rather than to rely on purely intuitive judgement. This is not to say that only those gains and losses which can be measured in dollar terms are to be included in the assessment; those of an intangible nature, which are not readily measured in monetary terms, must also be assessed.

### The Counterfactual

- 444 The benefits and detriments likely to flow from the proposed merger in the future have to be assessed against a counterfactual of what might otherwise happen in the future in the absence of the proposed merger. Thus, a comparison has to be made between two hypothetical future situations, one with the proposed merger and one without. The differences between these two scenarios can then be attributed to the impact of the proposed merger in question. In framing a suitable counterfactual, the Commission bases its view on a pragmatic and commercial assessment of what is likely to occur in the absence of the proposed merger.<sup>34</sup>
- 445 The formulation of the appropriate counterfactual is particularly difficult in the present case because it depends upon how the industry might evolve under the influence of various commercial, regulatory and political pressures. As the counterfactual would come to pass only in the event that the proposed merger were not to proceed, the events which might then unfold could be influenced by perceptions as to the reasons why it had failed, whether because of farmer opposition, an inability of the dairy co-operatives to agree terms, or Commission refusal to grant an authorisation. At the same time, the proposal represents the industry's response to the Government's request in the May 1998 Budget statement that it develop a plan for deregulation. A failure of the proposal may not signal an end to the Government's (or a successor's) efforts to deregulate the industry. In its s 26 statement the Government did not indicate what its attitude to deregulation might be in the event that the proposed merger should fail.
- 446 Discussions between the Commission and a wide range of industry participants produced a limited number of suggestions as to what the counterfactual might be, and all recognised the extreme difficulty of predicting what might happen much beyond two years into the future. Moreover, the Dairy Board has indicated that it does not have a fall-back position should the proposed merger fail to eventuate.<sup>35</sup>

<sup>33</sup> *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1992) 3 NZLR 429,447.

<sup>34</sup> See the discussion in: Commerce Commission, *Decision No. 277: New Zealand Electricity Market*, 30 January 1996, especially page 16.

<sup>35</sup> Disclosed by John Storey, Chairman of the Dairy Board. See: "No mega co-op. fallback position", *Dairy Exporter*, June 1999, p. 89.

- 447 The NZIER, for the Applicant, contends that in principle the counterfactual may fall anywhere between the continuation of the *status quo* at one extreme, and at the other the emergence of two, vertically-integrated, duopolists operating in a deregulated market. However, according to the NZIER's calculations, the choice of counterfactual may not have a major bearing upon the public benefit assessment, as public benefits in total do not differ markedly between the two counterfactuals specified. The Commission has considered the views of the participants in developing its counterfactuals.

### *The Status Quo Counterfactual*

- 448 The NZIER has suggested that the Government would not be likely to deregulate the industry without the support of the industry. The proposed deregulation through the Restructuring Bill is conditional upon the industry's current proposed merger proceeding. The immediate consequence of the failure of the proposal is likely to be a halting of current moves towards deregulation, and a continuation of the *status quo*.
- 449 Among the industry participants spoken to by the Commission, most of those who had a view favoured the *status quo* as the counterfactual, at least over a two year time frame. Dairy Group and Kiwi thought that after a period of reflection, the two major dairy co-operatives might "have another go" with a proposal similar to the present one, perhaps after first merging with some of the smaller dairy co-operatives. The Commission notes that such mergers would require a clearance or authorisation under the Act.
- 450 Some people have suggested to the Commission that the *status quo* counterfactual would not be an unchanging one, but would be likely to involve further gradual changes within the constraints provided by the current industry structure, the objectives of the various participants, and the regulatory framework. This view is supported by the observation that the industry has not stood still in recent years. For example, it has experienced several amalgamations between dairy co-operatives leading to the emergence of Kiwi and Dairy Group as the major dairy co-operatives; the deregulation of the town milk industry, and its consequent reorganisation and rationalisation; and the recent major change to the pricing and product allocation mechanism by which the Dairy Board purchases export products from the dairy co-operatives. Each of those changes has had a large impact upon the way the industry operates.
- 451 The Commission's preliminary view is that the *status quo* in which there continues to be industry-driven structural change is a likely counterfactual. The Commission also considers that these changes are likely to incorporate at least some of the developments – and hence, associated public benefits – which have been claimed would flow from the proposed merger. These could include the following: fair value entry and exit; unbundling payments; changes to the internal pricing mechanism; and liberalisation of export licensing. The further development of overseas joint ventures also seems likely. Changes which could be implemented under current conditions cannot be claimed as benefits flowing from the proposed merger.



### Fair value entry and exit

- 452 The introduction of fair value entry to, and exit from, dairy co-operatives by suppliers is possible under the current legislation. The introduction of such a measure seems to the Commission to be an important step in facilitating the entry of competing dairy processors. The fact that the industry has not yet chosen to make that step suggests that, left to its discretion, it is unlikely to do so in the foreseeable future. As noted earlier, while the Restructuring Bill makes provision for the introduction of fair value entry and exit, and the Government through its s 26 statement has indicated an expectation that it be introduced by the industry, there is no compulsion on the industry to do so.
- 453 The introduction of fair value entry and exit is therefore unlikely to be part of the *status quo* counterfactual.

### Unbundling payments

- 454 Product bundling has several dimensions: it includes the bundling of the pay-out to suppliers from dairy co-operatives of the raw milk and shareholder dividend components (“pay-out bundling”); the bundling of the processing returns to dairy co-operatives from the Dairy Board (“processor bundling”); and the bundling of the rents earned in quota markets (“quota rents bundling”). A typical consequence of the bundling of the prices of different products or services is allocative inefficiency through the distortion of price signals to, and hence of production decisions by, market participants. In the case of quota rents bundling, this also acts as a barrier to new entrants who cannot access quota markets.
- 455 Processor bundling has to a large extent already been removed through the introduction of the CPM model discussed below. The ending of quota rents bundling is a part of the Restructuring Bill, but seems unlikely to be introduced without such legislative change. Without deregulation, there would be no compulsion on the industry to share access to those lucrative markets with entrants. The unbundling of the pay-out is stated to be part of the proposed merger, and to yield benefits accordingly, but there seems to be no reason why this measure could not be introduced in the absence of the proposal. The industry appears to have identified the benefits that would flow from this measure; the Dairy Board is now, under the CPM, paying an unbundled price to the dairy co-operatives; and nothing prevents the industry from implementing unbundling the pay-out now.
- 456 The Commission concludes that the *status quo* counterfactual could include pay-out unbundling.

### Changes to internal product pricing

- 457 An important issue faced by the industry is the internal pricing mechanism used to determine the allocations of export products between dairy co-operatives, and the prices which the Dairy Board pays for those products. As described earlier, the industry has moved this season to the full implementation of the CPM pricing model, after a transitional period last season during which the new system was phased in from the old. In broad terms, this change was designed to move the industry from a

cost-based pricing system, where the dairy co-operatives were remote from the marketplace and from international prices, to one where they are confronted with market-based prices, and have the opportunity to respond accordingly. The new pricing system was designed to reward and encourage dairy co-operatives to produce those products which have better market returns.

458 The Commission considers that while the new system has some advantages over the old, the essential problem remains that product allocations and prices have to be decided by protracted negotiations between the Dairy Board and dairy co-operatives. The disputes between the two remain, although their nature has changed. The Dairy Board as industry marketer appears to be motivated to ensure that the product mix to be produced is that which it believes will maximise industry export returns. In contrast, each dairy co-operative appears to be motivated by the desire to make a pay-out to its shareholders which at least matches those of its rivals, regardless of the wider industry good. For the dairy co-operatives, it is the pay-out relativity which is important, rather than the absolute level of pay-out.

459 As a result, conflict has arisen between dairy co-operatives over product allocations for non-quota products, since all want to produce more of the higher margin products and less of the lower margin, even though all recognise that their collective demands would generate lower returns overall through a sub-optimal product mix. For example, for bulk commodities the dairy co-operatives are required individually to respond to price and volume information supplied by the Dairy Board for each product class by indicating the products and volumes they desire to manufacture. In the recent planning round, this has led to wide discrepancies between the aggregate of different products dairy co-operatives wish to produce, and the Dairy Board's marketing requirements. In its submission, the Dairy Board has stated that the dairy co-operatives have indicated a preference to produce [ ] tonnes of skim-milk powder against a forecast market demand of [ ] tonnes, while for wholemilk powder the comparable figures are [ ] tonnes and [ ] tonnes respectively. All wish to produce more of the wholemilk powder because of its high returns, but the Dairy Board has commented that it has never managed to sell more than [ ] tonnes in a year, a figure which the dairy co-operatives appear to accept.

460 A similar, more general, problem from the Dairy Board's perspective is that a dairy co-operative may choose to make a range of products to safeguard against the risk faced by a single product company that market demand may change, whereas its production costs would be lower if it were to produce only one, or a more limited range, of products.

461 The central problem appears to be that there is no entity within the industry which has the mandate to determine the product mix and allocation. The Dairy Board argues that to achieve an optimal allocation of products to different plants would require it to operate on an arms' length basis without the current regard for historical production patterns and equity considerations. However, the Dairy Board is owned by the dairy co-operatives, and hence at all times is dealing with suppliers which are also its owners.

- 462 The dairy co-operatives – particularly Kiwi and Dairy Group – appear to take the view that since they are compelled by regulation to export through the Dairy Board, they should have a say in product allocation decisions, rather than merely accept what is offered by the Dairy Board. The provision of overseas demand and price information by the Dairy Board as part of the CPM process has enhanced their ability to dispute and negotiate. Their incentive to do so is enhanced by the fierce competition between them over their relative pay-outs, so that neither would willingly cede control for fear that their position vis à vis their rival would be jeopardised. Their CEOs have also been recruited on performance-based contracts, where performance is measured in terms of their dairy co-operative’s performance.
- 463 The initial experience with the CPM model is that product mix and allocation decisions in the industry have become bogged down in an ineffectual process of negotiation likely to lead to sub-optimal outcomes. However, it would appear that the difficulties had started earlier under the previous cost-based model, and arose as the consequence of two developments: structural changes brought about by amalgamations which have resulted in the emergence of two large dairy co-operatives; and the enhanced influence of the dairy co-operatives over the Dairy Board by virtue of their becoming its shareholders following the enactment of the Dairy Board Amendment Act 1996. In pursuit of their shareholders’ interests, these dairy co-operatives routinely challenge Dairy Board production allocations, whereas previously, when there were a larger number of smaller dairy co-operatives, such production allocations were much more likely to be accepted.
- 464 The proposal is considered likely to overcome these external conflicts by internalising them within NewCo – essentially by NewCo replacing the Dairy Board as the industry’s product allocator. While the precise details of the internal structure of this new entity are not yet available to the Commission, it would appear that a centralised authority would be able to mandate prices, product mixes and allocations to the different manufacturing sites. While this centralisation of the decision-making process is unlikely to be without other flaws, which are discussed under “Detriments” below, it does hold out the prospect that the current allocation problems might be mitigated. Such improvements could then be cited as benefits flowing from the proposal, providing that they could not be attained by means other than the proposed merger.
- 465 However, at this stage the Commission is not convinced that improvements to the internal pricing and product allocation mechanism could not be made without a wholesale amalgamation of the industry. For example, it is possible that a move in the opposite direction - towards deconcentration of the ownership of processing facilities and with the Dairy Board remaining as the single exporter - might achieve the same outcome. Nonetheless, such problems of vertical integration are intrinsic to large companies, and different structures involve pluses and minuses to be traded off one against the other.
- 466 The Commission concludes that on the basis of the information currently available to it, improvements to the internal pricing and product allocation mechanism are possible under the *status quo* counterfactual.

## Export licensing

- 467 Some parties have suggested that there is not any further significant international pressure upon the Government to end the Dairy Board's regulated role as the country's single desk exporter of dairy products. For example, this form of regulation does not appear to pose a problem with the requirements of the World Trade Organisation. Hence, in this respect the Commission considers it feasible to envisage a counterfactual which does not include deregulation.
- 468 As explained earlier, the Dairy Board is able to, and does, issue export licences for companies to export dairy products independently of the Dairy Board. These are for exports of specific products to specific markets which do not compete with the Dairy Board's exports. However, a liberalisation to some degree in the Dairy Board's approach to issuing export licenses, which could introduce more competition, is conceivable. For example, the Commission understands that licences are issued typically for a period of three years, which can be restrictive when the exporter wishes to enter into a longer term supply relationship with an overseas buyer.
- 469 The Commission concludes that a degree of liberalisation of the licensing of dairy exports is possible in the *status quo* counterfactual.

## Overseas joint ventures

- 470 The large growth in the revenues of the industry claimed to follow from the formation of NewCo – from \$8 billion to \$30 billion over 10 years - would seem likely to require the extensive use of joint ventures on a large scale with overseas companies as a means of gaining access to overseas markets. There seems to be no other way in which such a large expansion could be achieved in the context of heavily regulated overseas markets for dairy products.
- 471 As explained below, the proposal does not claim any public benefits related to this forecast revenue expansion, nor mention the possibility of new joint ventures. Any consideration of these factors would require it to be shown that the proposed merger is a prerequisite for the formation of new large joint ventures, that such developments would not be likely to occur under the *status quo* counterfactual, and that public benefits would flow from them.
- 472 Some participants have suggested that there may be a legal impediment to the fuller development of joint ventures with overseas companies. Because the Dairy Board Act requires the Dairy Board to promote the interests of the New Zealand dairy industry, there appears to be an unresolved legal issue as to whether the Dairy Board can acquire milk produced overseas.
- 473 The Commission notes that in the 1998/99 season the Dairy Board had [ ] joint ventures, of which [ ] were with overseas parties in Europe, Latin America, the Middle East, North America, South-east Asia, and North Asia. In [ ] of the [ ] the Dairy Board had a [ ] percent ownership or higher, and the [ ] combined generated revenues of US\$[ ] million.

- 474 The Commission concludes that further joint venture developments are possible, and likely, under the *status quo* counterfactual.

Question 39:

The Commission seeks comment as to whether there are any legal impediments to the Dairy Board accessing overseas milk, and the extent to which that may impede its ability to form joint ventures.

*Conclusion on the Status Quo Counterfactual*

- 475 The *status quo* counterfactual assumes a continuation of the current industry structure and of the single seller desk for exports (i.e., there is no deregulation), but that efforts at further structural change within that structure and regulatory framework would continue. Structural changes are thought likely to include the following:

- the unbundling of the pay-out to suppliers;
- improvements to the internal pricing and product allocation mechanism; and
- further joint venture developments.

- 476 Structural change is unlikely to include fair value entry and exit. In addition, there are also a number of developments of a commercial nature which the industry might be expected to take, either individually or collectively, as a means of reducing costs. These will be indicated in the discussion on public benefits below.

- 477 It should also be noted that as this counterfactual does not envisage any further amalgamations between dairy co-operatives, it does not give rise to a loss of competition in domestic markets.

*The Deregulation Counterfactual*

- 478 An alternative to the *status quo* counterfactual with no deregulation is a counterfactual embodying the deregulation of the Dairy Board's export monopoly, even though that deregulation is presently conditional upon the proposed merger proceeding.

- 479 The NZIER argues that deregulation would come about because the *status quo* is incompatible with the industry realising its global expansion strategy. If the industry were to be thwarted from pursuing that goal by means of the proposed merger, the NZIER argues that the major players would seek alternative means of achieving it. Commercial pressures might drive the smaller dairy co-operatives to seek to join with one or other of the two major players – Kiwi and Dairy Group – out of which two, large, processing dairy co-operatives would emerge. This process would be fuelled by the increasing vulnerability felt by the smaller dairy co-operatives as the result, partly, of an (unexplained) increasing inability to influence the acquisition of dairy products for export, and partly, from an expectation that deregulation would occur eventually.

- 480 The NZIER argues further that ultimately the split in processing share between Dairy Group and Kiwi would likely settle in the region of 70:30. This imbalance is thought likely to encourage the disadvantaged Kiwi to seek an alliance with an overseas dairy multinational company, although it seems that this, in turn, would require two

additional developments: firstly, the deregulation of the industry; and secondly, some sort of split in, or cashing up of, the assets of the Dairy Board between the dairy co-operatives, who are the owners of those assets. On completion, this process would result in two, vertically integrated (i.e., processing plus marketing), competing, New Zealand-based, dairy exporting co-operatives.

481 The preceding discussion raises a number of issues as to the possible nature of this counterfactual, including the following:

- whether it is realistic to expect the Government to deregulate the industry at the behest of only one dairy co-operative;
- whether the pursuit of an overseas alliance is a realistic or likely strategy for one of the major dairy co-operatives; and
- whether it is feasible or desirable for the Dairy Board to be split, or for one major dairy co-operative to “cash up” its shareholding.

482 The Commission has been told by Australian dairy companies that an alliance between one of their number and a New Zealand dairy co-operative, while not impossible, was unlikely. They discounted the advantages of such an alliance. Several parties spoken to have expressed concerns about the difficulties, and likely disadvantages, of splitting the Dairy Board, and the likely opposition from suppliers.

483 A further possibility is that an alternative form of deregulation could render unnecessary the division of the Dairy Board. This might entail the Dairy Board being corporatised under non-dairy company ownership. Combined with the abolition of the single seller export desk, this would allow the dairy co-operatives to export independently, and the Dairy Board to deal at arms’ length with the dairy co-operatives (and to export product from other sources), thereby overcoming the internal pricing and product allocation difficulties discussed above. However, the Commission recognises that such a change is unlikely to be feasible with the current ownership links in the industry.

484 Given the considerable uncertainty over the nature, and consequences, of deregulation the Commission would not wish to specify in any detail the possible structure of the industry that might result. However, it seems likely that there would be at least two large entities which would export dairy products from New Zealand, although one or other might not remain New Zealand-owned. The Commission considers it likely that at least some of the smaller players would remain independent, and pursue their own strategies in domestic and international markets. Other changes, not necessarily embodied in the deregulation, might also follow. These could include the changes mentioned above in connection with the *status quo* counterfactual, as follows:

- the unbundling of the pay-out to suppliers;
- improvements to the internal pricing and product allocation mechanism; and
- further joint venture developments.

485 The further commercial developments mentioned above in connection with the *status quo* counterfactual may be less likely to occur under the deregulation counterfactual to the extent that concerted industry action would be required to achieve them. The

Commission also notes that competition in the domestic markets would not be impaired under this counterfactual.

### **Conclusion on the Counterfactual**

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

- the *status quo* with no deregulation but ongoing efforts at structural change (the “*status quo* counterfactual”); and
- the deregulation of the single seller export desk with ongoing efforts at structural change (the “deregulation counterfactual”).

487 However, the former is considered to be the most likely outcome at this stage.

**Question 40:**

The Commission seeks comment as to the likely counterfactual should the proposed merger not proceed, and the various features of that counterfactual.

**Detriments**

488 Given the dairy industry context in this case, detriment analysis has to be conducted within the context of the co-operative company form. The detriments are likely to arise from the loss of competition implied by the acquisition of dominance by NewCo in the markets for raw milk in the North and South Islands, in the market for the acquisition of export dairy products, and in the various domestic markets for dairy products. As noted above, the Commission uses an economic efficiency approach for the measurement of detriments. The assessment is carried out under the following headings: allocative inefficiency, productive inefficiency and dynamic inefficiency.

*Allocative Inefficiency*

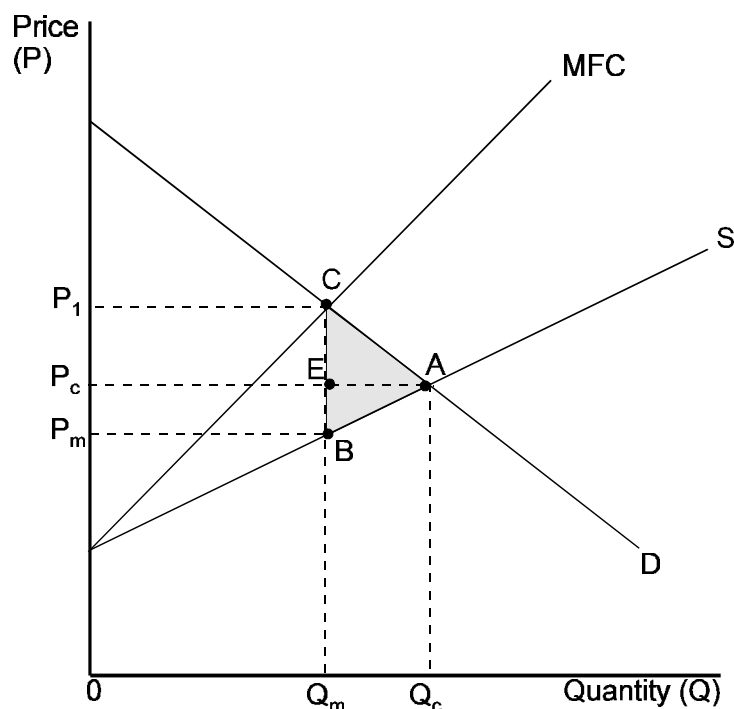
Introduction

489 Subject to certain limited reservations, the economy's scarce resources are allocated between alternative uses with maximum economic efficiency when, in any given market, the additional cost of producing the last unit of the good or service equals the price which a buyer is prepared to pay for that unit. Using economic theory, that optimum point is found where market demand equals market supply. Using the general market diagram shown in Figure 2 (and ignoring for the moment the line labelled MFC), the intersection at point A of the competitive demand (D) and supply (S) curves for a particular product determines the optimum price and output of  $P_c$  and  $Q_c$  respectively.

490 The outcome would be less than optimal if the arrangement were to result in too few units being produced (for reasons to be explored below), as shown in Figure 2 by the output  $Q_m$ . Here, the price which buyers would be prepared to pay for one more unit ( $P_1$ ) would exceed the cost incurred in producing that unit (equal to  $P_m$ ), implying that the benefit to the economy from greater production of the product (as measured by buyers 'willingness to pay') exceeds the sacrifice in terms of the resources used up (as measured by the costs of production). The shaded triangular area ABC thus represents the economic loss at  $Q_m$  from the under-production of the product. This triangle is a measure of the detriment from the loss of allocative inefficiency – often called the deadweight welfare loss - which potentially could result from the loss of competition in the market.



**FIGURE 2**  
**A Model of Allocative Inefficiency Under Monopsony**



491 In addition, the area in the Figure shown by  $P_1CBP_m$  represents the size of the surplus transferred from buyers to suppliers through the higher price. Since what buyers lose by paying the higher price is exactly offset in dollar terms by the extra surplus earned by suppliers, the social impact is generally taken to be zero. However, the presence of such monopoly rents can weaken the firm's incentives to maintain productive efficiency (see below).

#### Allocative inefficiency and monopsony

492 The present case concerns the potential detriment arising from the loss of competition between dairy co-operatives in the two geographic markets for the acquisition of raw milk. NewCo would obtain monopsony power through being the dominant buyer in the defined markets. Monopsony is the market power-equivalent on the demand side of the market to the monopolist on the supply side.<sup>36</sup> Whilst the latter is able to exert market power by raising the price of what it sells, a monopsonist can exercise market power by forcing down the price of what it buys. In both cases, the economic objection to the exercise of market power is the same: the restriction of output compared to the competitive outcome leads to a loss of allocative efficiency measured by the size of the deadweight loss triangle.

493 Figure 2 can now be taken to represent the relevant markets for raw milk – aggregated for convenience - where quantity is measured in kilograms of milk solids, and the

<sup>36</sup> Roger D. Blair and Jeffrey L. Harrison, *Monopsony: Antitrust Law and Economics*, Princeton, N.J.: Princeton University Press, 1993, pp. 37-39.

price is expressed in cents per kilogram. The demand curve  $D$  is the processors' derived demand for milk solids, and  $S$  is the supply from suppliers. The competitive outcome would be at a price of  $P_c$  and quantity of  $Q_c$ . Here, each of the many small processors needed for a competitive market would view the price of milk solids as effectively being fixed at the going market rate of  $P_c$ , and each would buy the quantity determined by its individual demand curve, the total of which would generate a demand of  $Q_c$ .

- 494 In contrast, a single buyer or monopsonist would recognise that the quantity of milk solids it buys does influence the supply price: because the supply curve is upward sloping, the greater the quantity purchased, the higher the price. Consequently, in order to buy one more unit of milk solids, the monopsonist has to offer a slightly higher price to induce that marginal unit to be supplied. However, in the normal course of events, that entails paying the higher price to all of the units purchased. As a result, the cost of buying one more unit - called the "marginal factor cost" (MFC) - is not just the price paid for it. Also included is the tiny increase in the price paid to all of the other units purchased. The MFC to the monopsonist of the last unit of milk solid purchased will thus exceed the price paid for that unit.<sup>37</sup>
- 495 The MFC curve which relates to the  $S$  curve is shown in Figure 2. When the supply curve is upward sloping, the associated MFC curve lies above it and slopes upwards at a faster rate. For example, when the last unit purchased is at  $Q_m$ , the price paid will be  $P_m$  (point B), but the MFC will be  $P_1$  (point C).
- 496 The monopsonist, if it is to maximise profit, will stop buying units of milk solids at  $Q_m$ . This is because the cost of additional units beyond that point, as measured by the MFC, would exceed the value to the firm of each of those additional units, as reflected in the demand curve. The monopsonist thus maximises profits by buying units up to the point where MFC equals demand ( $D$ ). The extra monopsony surplus or rent earned is shown by the rectangle  $P_1CBP_m$ , of which the area  $P_cEBP_m$  is the portion formerly enjoyed by farmers in the competitive outcome and transferred from them.
- 497 To sum up, the monopsonist is expected to buy fewer units of the input, and produce a smaller output, than the socially optimal competitive outcome, leading to a loss of allocative efficiency represented by the triangular area  $ABC$ . The size of this triangle depends upon a number of factors:
- the price elasticity of demand and of supply (i.e., the responsiveness of the buyer and of suppliers respectively to changes in price) in the market;

<sup>37</sup> It might be objected that if the monopsonist pushes up the price of milk solids slightly by buying one more unit, then the same must happen when a competitive buyer buys one more unit. While that must be correct, the impact of the very small increase in price is different in the two cases. For the small competitive firm, the increase in the bill for the small number of units already purchased will be very small, so that the MFC will hardly be different from the price paid for the additional unit (the impact of the tiny increase in price will be spread across all of the many purchasers of milk solids). In contrast, the monopsonist, as the only buyer, will bear the full brunt of the slight increase in price which, over a large number of units bought, will cause the MFC to be significantly larger than the price.

- the extent to which the usage of the product falls below the allocatively efficient one; and
- the size of the market measured by the total outlay (represented by area  $P_cAQ_cO$  in Figure 2).

- 498 In order to assess the possible detriment from the loss of allocative efficiency from the proposed merger, the general model of monopsony outlined above has to be adapted to the circumstances of the relevant markets, and to the likely loss of competition therein. One potential difficulty is that co-operatives appear to have as a prime objective the maximisation of the margin paid to their suppliers, where the margin may be characterised as an average surplus. This is a different objective to that of profit maximisation used in the conventional theory of monopsony, which may then not predict accurately the behaviour of co-operatives.
- 499 As explained earlier, suppliers receive a bundled pay-out which incorporates a return for raw milk and the surplus generated by the downstream processing and marketing activities. Bundling is thought likely to disappear both with the proposed merger, and under either counterfactual. If monopsony power were to be exerted by NewCo, it would be done through the so-called commodity (or raw) milk price. Unfortunately, as that price is difficult both to define, and to estimate from the bundled price, the current pay-out has had to be used as a proxy. This will lead to an upward bias in estimates of the size of the deadweight welfare loss.
- 500 Information from the Dairy Board indicates that the industry weighted average pay-out last year was \$3.40. Total milk solids production in the industry in 1997/98 was 892 million kilograms. These are the values assumed for  $P_c$  and  $Q_c$  respectively in Figure 2.
- 501 Values for the price elasticities of demand and supply are also required. The NZIER argues that these curves would be expected to be highly inelastic in the short term, which would serve to reduce the size of the deadweight loss, albeit, the Commission notes, with the potential for much larger transfers from suppliers to dairy co-operatives – which in turn raises the size of the margin which could be absorbed by productive inefficiency (see below).<sup>38</sup> The source of the inelasticity claimed by the NZIER is that suppliers have an incentive to produce all the milk they can, given that the bulk of their costs in the short-run are fixed, and because co-operatives are obliged to take all of the milk they are supplied with. Those factors would bear upon supply only. In the longer term perspective favoured by the Commission the supply curve will be somewhat less inelastic, as the NZIER notes. Econometric studies indicate that even the long-run supply elasticity is rather low. The Commission proposes to use the latest estimate of 0.32 by the Ministry of Agriculture.
- 502 There appear to be no estimates for the price elasticity of the derived demand curve, but it is known in principle to depend upon two factors: the price elasticity of demand of the final product to which the input contributes, and the proportion of the input's cost to the total cost of that final product. Because the cost of an input typically

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<sup>38</sup> It might be argued that the reduction in the price and associated allocative inefficiency could arise as a consequence of the elevation of costs through the productive inefficiency discussed below.

accounts for only a small proportion of total costs, any change in its price will have only a muted effect on the price of the final product, and hence in final product demand. Consequently, the price elasticity of the derived demand curve for the input is usually much lower (in absolute terms) than the price elasticity of the final product's demand curve.

- 503 Studies of the demand for dairy products on international markets have produced widely varying price elasticity estimates, both between studies and between individual product categories. This appears to reflect the use of different data, time periods, modelling techniques and focus. Here, the focus is on the question as to what would happen if NewCo were to reduce its demand for raw milk, and hence its supply of dairy products onto world markets. A likely consequence is that other exporting countries would fill this gap by exporting more product, so that the impact on price (in terms of an increase) would be quite small, at least in the longer term when the necessary adjustments can take place. The assumption of a highly elastic demand curve for exports would therefore seem to be warranted.<sup>39</sup> In the absence of any estimates for an aggregated export product demand curve, a figure of -10 has been used.
- 504 In 1997/98 the Dairy Board earned total revenues (excluding the consolidated revenues of Livestock Improvement Corporation) of about \$6,614 million, of which farmer pay-out comprised \$3,043 million. Hence, the cost of the milk solid input was about 46 percent of total cost. The price elasticity of the derived demand for milk solids can therefore be estimated as -4.6 (i.e.,  $-10 \times 0.46$ ).
- 505 For the purposes of an initial estimate, monopsony power is taken to reduce the pay-out by one percent, i.e., by 3.40 cents (in Figure 2 this is represented by the distance  $P_c P_m$ ). Combined with the calibration assumptions outlined above, the deadweight loss triangle would equal only about \$57,000 per annum. The resulting transfer to company surplus would be about \$32.5 million. The corresponding figures if the pay-out reduction were to be five percent (17 cents), or 10 percent (34 cents), are shown in Table 4.

**TABLE 4**  
**Estimates of Annual Allocative Efficiency Losses and Transfers**  
**in the Raw Milk Markets with Specified Pay-out Reductions**

<b>Pay-out reduction</b>	<b>Deadweight loss</b>	<b>Transfer</b>
1% (3.4c)	\$57,300	\$32,521,300
5% (17.0c)	\$1,427,800	\$160,322,200
10% (34.0c)	\$5,711,200	\$314,933,200

<sup>39</sup> The impact of allocative inefficiency in certain domestic markets for dairy products where dominance would be acquired by the merged entity is considered separately below.

- 506 The magnitude of the potential loss from the exerting of dominance in the raw milk market by NewCo, relative to the counterfactual where competition would be preserved, is a matter of judgment. The NZIER has argued that bundled pay-out potentially has the effect of encouraging suppliers to over-produce milk, with the result that any monopsonistic restriction in demand could have the effect, at least initially, of improving allocative efficiency. However, as indicated above, the Commission considers that pay-out bundling is likely to cease under either the proposal or the counterfactuals, in which case that potential source of inefficiency would disappear anyway.
- 507 It has also been argued by the Applicant that because the suppliers are also the shareholders, the effect of lower margins designed to increase profit merely results in larger surpluses being returned to shareholders at a later stage. The incentive to exploit market power by reducing the margin thus appears to be limited. Alternatively, the ability to extract surpluses would allow productive inefficiency to grow in an environment where the company faced little or no competition.
- 508 Given the uncertainties inherent in making forecasts of the kind involved here, the Commission prefers to attempt to specify a range within which the actual outcome is likely to occur, rather than to fasten upon a precise figure. In the light of the above discussion, and with the information currently to hand, the Commission's preliminary assessment is that the exercise of monopsony power by NewCo could result in the raw milk price falling by between five and ten percent. This suggests that the loss of allocative inefficiency could fall in the range between \$1.4 million and \$6.0 million per annum.

### Domestic markets

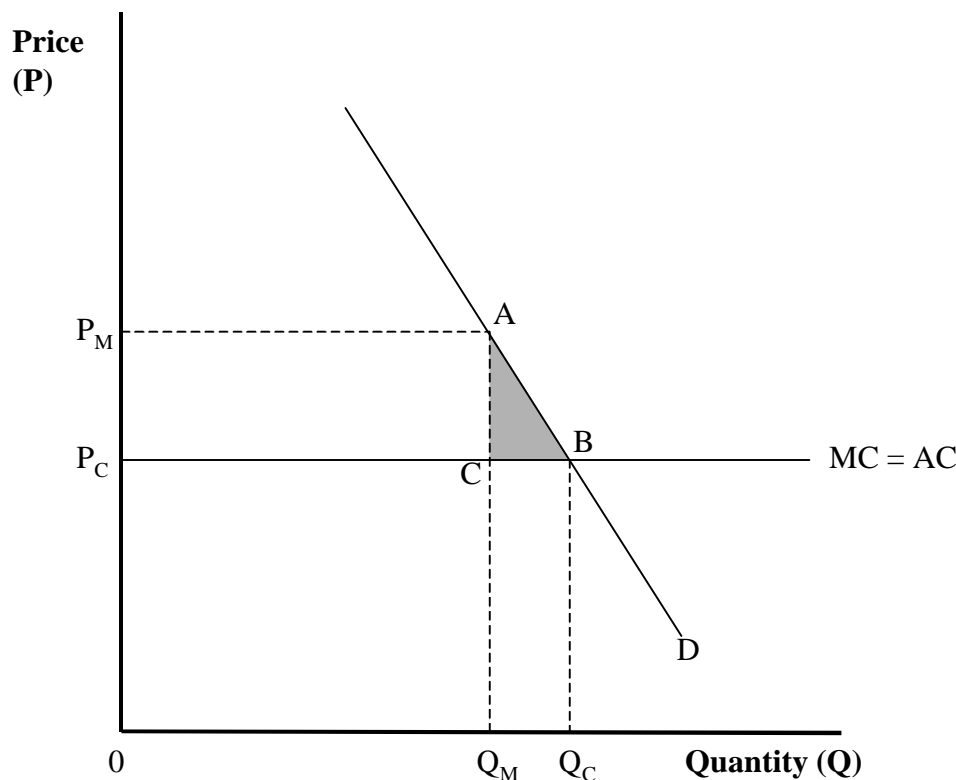
- 509 A small proportion of the raw milk – about eight percent - is used by the dairy industry to process products for sale in the domestic market. As indicated earlier, the Commission's preliminary assessment is that NewCo would acquire a dominant position in all of the domestic markets for dairy products except that involving butter (the consumer spreads market). This would give it the power to raise the price and restrict the quantity so as to earn profits in excess of those available in competitive markets, which would continue to exist under either counterfactual. As a result, a further loss of allocative efficiency, and associated transfer of wealth from consumers to producers, would occur.<sup>40</sup>
- 510 The size of this potential loss can be estimated by using Figure 3, which represents the aggregate of the domestic markets in which dominance would arise. The market demand curve is labelled D, and the industry unit cost curve is assumed to be horizontal (because no significant scale effects are expected from likely output changes), so that average cost (AC) equals marginal cost (MC). The pre-merger competitive outcome is found at price  $P_c$  and quantity  $Q_c$ . A post-merger monopolistic output restriction to  $Q_m$  would cause the price to rise to  $P_m$ . The result is

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<sup>40</sup> The derived demand curve in Figure 2 assumes that the merged entity is close to being a price taker on international markets. Hence, the allocative inefficiency discussed in the monopsony analysis above does not incorporate the impact of monopoly pricing should it arise in any of the downstream final product markets.

a deadweight welfare loss represented by the triangular area ABC, and a wealth transfer equal to the area of rectangle  $P_mACP_c$ .

**FIGURE 3**  
**A Model of Allocative Inefficiency in the Domestic Dairy Products Market**



- 511 The domestic markets for dairy products in which dominance would arise currently yield revenues of about \$775 million to the participants that would comprise NewCo. The Ministry of Agriculture has estimated that the price elasticity of the domestic demand curve for dairy products is  $-0.27$ .<sup>41</sup> Using these figures, and assuming that the elasticity estimate applies to point B in Figure 3, the magnitudes of the potential annual deadweight welfare loss and wealth transfer can be calculated using different assumptions about the size of the post-merger increase in price ( $P_C P_M$ ). Some illustrative examples are given in Table 5.
- 512 Although the income transfers are not considered directly to be welfare losses, they provide margins which could be absorbed by the production inefficiencies discussed below.

<sup>41</sup> Source: J. Prasad, R. SriRamaratnam and R. Wallace, "Determinants of Meat Consumption in New Zealand: Historical Patterns (1967-92) and Forecast Trends (1993-98)", in: Proceedings of the Eighteenth Annual Conference of the New Zealand Branch of the Australian Agricultural Economics Society, Blenheim, July 1993, Table 4, p.127.

**TABLE 5**

**Estimates of Annual Welfare Losses and Wealth Transfers in the Domestic Markets for Dairy Products under Different Assumptions about Price Increases**

<b>Price increase</b>	<b>Deadweight welfare loss</b>	<b>Wealth transfer</b>
1%	\$10,500	\$7,729,100
5%	\$261,600	\$38,226,900
10%	\$1,046,300	\$75,407,500
20%	\$4,185,000	\$146,630,000

- 513 The Applicant has argued that dominance concerns with respect to NewCo in the domestic markets for dairy products will be mitigated by the presence of Dairy Foods as an independent competitor to NewCo's domestic operation (i.e., Mainland). The Applicant argues that competition between them, combined with both accessing raw milk, butter and cheese from NewCo on equal terms, will ensure that competition would prevail. As noted earlier, the Commission has reached the preliminary view that Dairy Foods will not be a constraint on NewCo. Even if it were, however, the Applicant's argument overlooks the point that NewCo would remain dominant in the supply of those inputs. NewCo would thus be in a position to extract any monopoly profits available in the downstream markets for final goods through the prices it charges both Dairy Foods and Mainland for the inputs.
- 514 The Commission understands that currently Dairy Foods pays its parent (and, Mainland similarly) the going pay-out rate for its supplies of raw milk (aside from winter premiums). Since that pay-out is a bundled pay-out, it includes the suppliers' returns on their investment in dairy processing. This implies that the price paid by the domestic market processors is already above the competitive level, because it includes a component which should not be there. However, bundling is assumed to cease in the future with the proposal and under both counterfactuals. Hence, the competitive outcome is the relevant benchmark.
- 515 Moreover, the Commission questions whether the pay-out is the appropriate price for the internal transfer of milk since it is essentially an average return on the export sales of a variety of products in a variety of markets. Given the export focus of the dairy industry, it might be argued that the appropriate price would be one which reflects the marginal value of raw milk for export processing, rather than the average value. This would imply a significantly lower price than it currently obtains. All this suggests that even prior to the proposal, the industry has considerable discretion in setting the internal transfer price; that power would become even greater with the advent of NewCo.
- 516 On the basis of current information, the Commission has reached the preliminary conclusion that the price rise in the domestic dairy products markets in which dominance would be acquired is likely to be between 10 and 20 percent, so that the loss of allocative inefficiency would be likely to be in the range between \$1.0 million and \$4 million.



### *Conclusion on Allocative Inefficiency*

- 517 On the basis of the information and analysis to date, the Commission has come to the preliminary view as discussed in the analysis given above that the annual loss from allocative inefficiency through the exercise of monopsony power in the market for raw milk could fall in the range from \$1.4 million to \$6 million, and that the annual loss from allocative inefficiency through the exercise of monopoly power in the domestic dairy products markets where dominance is acquired could fall in the range from \$1.0 million and \$4 million. Hence, the aggregate detriment from allocative inefficiency arising from the proposal could fall within the range between \$2.4 million and \$10 million per year. This inefficiency loss applies against both counterfactuals.

#### Question 41:

The Commission seeks comment on the potential for losses of allocative efficiency to arise from the proposed merger in the relevant markets. Comments on any of the points raised above, and any other relevant points, are sought.

### *Productive Inefficiency*

- 518 A monopoly producer is normally considered to lack the competitive pressures to remain efficient in production. Organisational slack may creep into its operations, and costs may increase, because a satisfactory level of profit is assured even when the firm is less than fully efficient. When this generalisation is carried over to the co-operative dairy industry, and to a consideration of the effect of the dominance of NewCo – which would combine all of the dairy co-operatives – both in the domestic markets for dairy products, and in the market for the acquisition of dairy products for export, the potential losses of productive efficiency could be proportionally (and absolutely) significant.
- 519 The portion of NewCo's costs likely to be affected by market power are those related to the collection of unprocessed milk from suppliers and its manufacturing into dairy products for export. These costs form roughly 30 percent of the costs of operating a dairy co-operative, the balance being raw milk costs. In addition, there are the Dairy Board's domestic costs, together with the costs associated with domestic production, marketing and distribution. In short, the costs exposed to the risk of productive inefficiency are the non-milk costs incurred in this country. The relevant costs, which total about \$1,920 million, are set out in Table 6.
- 520 However, the Commission acknowledges that the costs in NewCo exposed to the risk of productive inefficiency may differ between the two counterfactuals. The degree of exposure will be greatest when set against the deregulation counterfactual, in which both the manufacturing (dairy co-operative) and marketing (Dairy Board) functions would face competition. Here, the costs at risk would be the figure of \$1,920 million cited in the previous paragraph. In contrast, against the *status quo* counterfactual, the Dairy Board's marketing functions would be uncontested, so that the costs at risk in NewCo would then be \$1,510 million (i.e., 1,920 less 390 and 20).
- 521 The potential impact on costs of production inefficiency arising from market power, and hence the size of the potential detriment, can be assessed by assuming that costs

might rise by a given percentage as inefficiency takes hold. The increase in costs is a measure of the value of the resources being wasted, which in turn indicates the value of the output foregone by the economy as a whole from those resources not being employed productively elsewhere. For the purposes of illustration, a one percent decrease in productive efficiency in the dairy industry, as reflected by a one percent increase in costs, would give rise to a detriment of either about \$15 million or about \$19 million per year, depending upon the counterfactual, and costs would increase by the same magnitude for each further percentage point decrease, or proportion thereof.<sup>42</sup> Productive inefficiency is also likely to rise over time as the experience of operating in markets where there is an absence of effective competition causes NewCo's internal checks and balances, managerial efficiency and constraints to become less effective.

**TABLE 6**  
**Listing of the Industry's Costs Likely to be**  
**Exposed to Productive Inefficiency**

Cost Item	Value (\$M)
Cooperative manufacturing costs	1,130 <sup>a</sup>
Dairy Board's domestic storage and processing costs	390 <sup>a</sup>
Dairy Board's spending on customer service	20 <sup>b</sup>
Local market production excluding butter – non-milk costs	380 <sup>c</sup>
<b>TOTAL</b>	<b>1,920</b>

Notes: a = sourced from Dairy Board; b = estimate provided by the Dairy Board;  
c = estimated as 50% of total costs.

522 It is a matter of judgment as to the potential size of such productive inefficiency. It has been argued that because the dairy industry is heavily export-orientated, and international dairy product markets are very competitive, the industry has little leeway to become inefficient before an inability to compete would become evident. Put another way, the need to compete internationally would force the industry to remain efficient despite its prospective dominance in several domestic markets. While, ultimately, international competition must put a "cap" on cost levels, the issue is how much inefficiency could be tolerated before costs rise to the point where a lack of competitiveness would emerge. Moreover, as the industry is said to face a stepped international demand curve, lack of competitiveness would appear in the marginal markets before it appeared in those which are more lucrative, but even then the industry's limited ability to price discriminate between markets might conceal growing inefficiency problems. The scope for productive inefficiency depends upon the size of the margin between the upper "cap" and a lower level set by fully efficient costs.

<sup>42</sup> In terms of Figure 3, the development of productive inefficiency in the domestic market would be reflected by an upwards shift in the unit cost (MC = AC) curve.

- 523 As indicated above, the ability of NewCo to exploit its market power in its price setting, both as a monopsony buyer of raw milk, and as a monopoly seller of dairy products in the domestic markets, could generate very substantial rents. These could provide a wide scope for rent-seeking behaviour by managers and others in NewCo, leading to the dissipation of rents through inflated costs. In addition, the industry is a successful exporter, despite the disadvantages imposed upon it by the considerable barriers to trade in dairy products found in almost all overseas markets, in large part because it has a lower cost structure than most (perhaps all) other dairying countries. This cost advantage stems primarily from the low costs of producing raw milk in New Zealand's pastoral-based farming system, together with accumulated experience and skills in dairy product volume processing and marketing. Hence, there would seem likely to be a significant margin here which could be eroded by productive inefficiency.
- 524 The presence of a significant margin puts an upper limit on the possible magnitude of productive inefficiency. The size it might reach in time would seem likely to be influenced by various factors, including the following:
- NewCo would be very large by New Zealand standards. Local managers lack experience in managing such large undertakings. Being very large, with a centralised bureaucracy and decentralised production units, there would be scope for delays in, and distortion to, information flows moving up and down the chain of command. Principal-agent problems, in which principals can neither fully control nor monitor their subordinates, would be likely to allow middle managers scope for opportunistic or self-serving behaviour. This might conflict with the goals of the organisation as a whole, but would be difficult to correct using incentive structures.
  - As already noted, the democratic structure of dairy co-operatives provide avenues for shareholder dissatisfaction to be voiced, but suppliers' rarely have the ability to "vote with their feet". NewCo will become so large, and cover such a diversity of geographic regions and farmer interests, that the voice of the individual suppliers or group of suppliers is unlikely to be heard or heeded. Moreover, the organisation would be so large and complex that it would be even more impossible than it is now for suppliers to monitor and assess performance.
  - Spokespersons for the Applicant have argued that internal checking and balancing mechanisms would be set up to replicate those which are today provided by the market. The powerful incentive to perform provided by the traditional competition between rival dairy co-operatives in terms of pay-out margins – which are closely scrutinised by shareholders – will disappear once NewCo is formed. The Applicant has said that internal benchmarking between sites within the organisation will be used instead. However, the Commission considers it likely that these would be clumsy compared to normal market disciplines, and hence it is doubtful whether they would come close to being as effective.
  - On the other hand, the need to maintain strict hygiene standards when handling unprocessed milk, and the technical constraints imposed by the nature of dairy processing, may act as a constraint upon the extent to which inefficiencies could

creep into either milk collection or processing, although this could be off-set to some degree by the risk of over-engineering of the industry's capital facilities. Costs incurred at the management and administration levels might be more susceptible to productive inefficiencies.

- 525 Likely efficiency effects of mergers are very difficult to predict. In a recent article on the proposed dairy merger, Professors Evans and Quigley made the following comment: "International studies suggest the absence of competition may often result in organisations having cost structures 10-20 percent higher than those of a firm facing vigorous competition."<sup>43</sup> While it is doubtful that overseas experience can be narrowed to such a specific band, there is much evidence that monopolies can suffer from substantial inefficiencies.
- 526 The best that can be done is to estimate a range within which the outcome may fall. After consideration of the above factors, and on the basis of the information received to date, the Commission has reached the tentative view that productive efficiency losses are likely to be in the range from five percent to 10 percent of NewCo's relevant costs. This gives rise dollar values of the potential loss of productive inefficiency of between \$75.5 million and \$151.0 million per annum against the *status quo* counterfactual, and between \$96.0 million and \$192.0 million per annum against the deregulation counterfactual.

Question 42:

The Commission seeks comment on the potential for NewCo, in a dominant position in several domestic markets, to suffer from an erosion of productive efficiency over time; the cost areas which would be susceptible to inefficiency; and the likely sizes of the inflated costs against the two counterfactuals.

*Dynamic Inefficiency*

Introduction

- 527 Dynamic efficiency is concerned with the speed with which an industry adopts superior new technology and produces improved new products, the first through advances in productivity allowing costs of supply to be reduced, and the second bringing the benefit of meeting buyer wants more fully. In terms of the graphical analysis used above, product innovation would be reflected in a rightward shift of the demand curve, indicating a buyer switch to the improved products of the innovating company or industry, whilst the lower costs associated with production innovation would be revealed by a downward shift in the unit cost curve.
- 528 Competition is generally considered to act as a stimulus to dynamic efficiency, and market power as a retardant. It is generally believed that in an industry which has at least a significant scope for technological advance, the potential losses associated with market power are likely to be greater in the longer term in respect of dynamic inefficiency than they are in respect of the static forms of inefficiency (namely,

<sup>43</sup> Lewis Evans and Neil Quigley, "Dairy farmers face tough choices", *National Business Review*, 30 July 1999, p. 43.

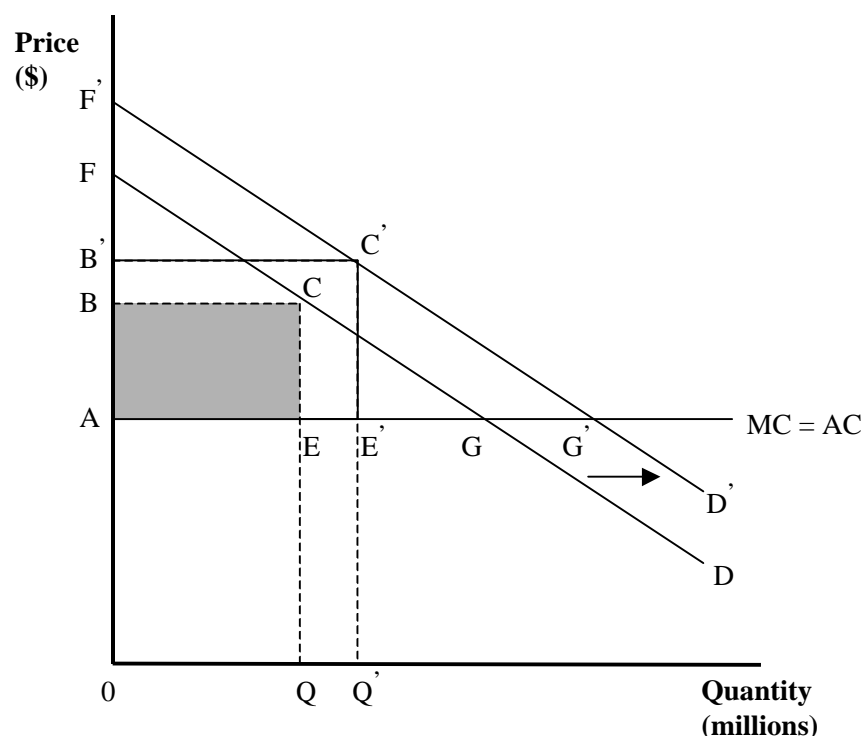
allocative and productive) considered above. This is because of the loss of the compounding effect of the improvements over time.

### Dairy processing

- 529 The dairy processing industry as a whole could perhaps be characterised as being moderately dynamic, both in terms of advances in technology and in products. In the past the New Zealand industry was mainly a supplier of bulk products, with Britain being the major market. In more recent times, as a result of the restricted access to Britain's market following its entry into the European Community, and in recognition of the need to improve returns, the industry has taken major steps to diversify into new markets and into new, more specialised, higher margin, products.
- 530 The Dairy Board claims that the industry as a whole spends about \$60 million per year on research and development, of which about \$13 million is funded by government monies gained by competitive tendering through the Foundation for Research, Science and Technology (FRST). This expenditure covers fundamental and applied research into dairy farming, processing and product development. A 1997 Dairy Board "Internal Benchmarking Study" found that the dairy industry invests a sum equivalent to [ ] of dairy product sales on R&D. This research intensity was found to be greater than that of the aggregated United States food industry of 0.75 percent, but [ ]. While this level of research intensity is quite high by New Zealand standards, the industry appears not to be performing particularly well by overseas standards. The same report also acknowledged the industry's [ ].
- 531 It is possible that NewCo, because of the absence of competitive pressures and the inability of dissatisfied suppliers to switch to other dairy co-operatives, might delay investment in new plant and equipment, and in technological improvements, compared to the pre-merger situation. While this might seem likely to be less of a problem in the markets in question, because the rapid growth in milk supply is forcing the dairy co-operatives continually to invest in expanded capacity, NewCo could use its monopsony power to restrict milk flows, as noted above. Moreover, the comments above in relation to productive inefficiency being constrained by the capping effect of competitive pressures in international markets are also likely to apply, perhaps to a lesser degree, with respect to dynamic efficiency, although as noted, this would not necessarily greatly constrain NewCo. The NZIER considers that the pressure to satisfy overseas customers' demands with respect to price, quality and timeliness will help to maintain dynamic efficiency. Internal controls, and the need to attract external capital, will also assist.
- 532 To gain some idea of the potential magnitude of any losses of dynamic efficiency, and of the factors which may influence it, it is possible to construct a simplified economic model of the losses arising from a decline in product innovation. Figure 4 represents the aggregate of those overseas markets in which the Dairy Board is not, or would not be (if it should enter), a "price taker", i.e., where a downward-sloping, albeit price sensitive, demand curve is faced. In such markets the Dairy Board claims that the volumes of products it supplies has an influence on the local price, with the price

falling as the volume increases. This phenomenon is examined below under “preservation of single seller marketing” in the section on public benefits. It is assumed that the markets in question are those for products which are differentiated to some degree, and which are therefore susceptible to further innovation which would enhance demand for the innovating supplier’s products. The demand curve facing the Dairy Board initially is the curve labelled D. By assuming for simplicity a horizontal industry unit cost curve, marginal cost (MC) equals average cost (AC). Further assuming that the Dairy Board seeks to maximise profits, it will supply that quantity of product at which MC equals marginal revenue (MR – not included in the Figure). This is found at quantity Q, which can be sold at price B. Total profits earned – the difference between revenues and costs – is represented by the rectangular area ABCE.

**FIGURE 4**  
**A Model of Dynamic Efficiency**



533 As indicated, product innovation is expected to cause the demand curve to shift rightwards, say, to curve D'. The profit-maximising response of the Dairy Board would be to expand the volume supplied to the point where  $MC = MR'$ , at output  $Q'$ , and to raise price to  $B'$ . Total profit increases as a result to the rectangle  $AB'C'E'$ . The increase in profit over the original position is the reward to successful product innovation. It is this additional profit which might be lost if dynamic efficiency were to be eroded because of a lack of competition.<sup>44</sup> This lost profit would amount to a

<sup>44</sup> This analysis simplifies the actual situation, which is likely to be one where product innovation is reduced but not eliminated, and where in consequence the rate at which the demand curve gradually migrates rightward over time is slowed. Nonetheless, the analysis above captures the essence of the detriment stemming from reduced product innovation.

detriment because it is extracted from overseas buyers, and hence is not treated in the same way as such a transfer would be had it occurred in the domestic market.<sup>45</sup>

- 534 The size of the lost profit in the model depends upon various factors: the initial values of price, quantity and marginal cost; the size of the rightward shift in the demand curve; and the price sensitivity of the demand curve. These have to be calibrated, but the relevant information to do so is largely lacking, and so assumptions have to be used. For the purposes of illustration, it is assumed that 10 percent of the Dairy Board's sales of \$6.6 billion, generating \$660 million in revenues, are in "price sensitive" markets; that the price elasticity of demand at point C is -2.0; and that the horizontal rightward shift in demand foregone is one percent of quantity. The profit lost is then found to be \$10.0 million.<sup>46</sup> As already noted, any savings in R&D costs which might accrue are considered below in the section on public benefits.
- 535 Changes in the calibration produce different estimates. For example, a larger estimate would flow from using any of a less elastic (or price sensitive) demand curve, a larger proportion of the Dairy Board's sales, and a bigger shift in the demand curve, and vice versa.
- 536 Moreover, the estimate relates only to the loss of product innovation. A loss of production innovation would add to the overall detriment from dynamic inefficiency, and would potentially be much larger because it would apply across the whole of the industry's (export-focused, but domestically located) cost manufacturing base. This would amount to some \$1,540 million for the deregulation counterfactual, being the sum of the items in Table 6 less local market production costs of \$380 million. For the *status quo* counterfactual, the relevant costs would be limited to the dairy co-operatives' export manufacturing costs of \$1,130 million. Hence, a loss of productivity growth which would have reduced unit cost by one percent would give rise to a further loss in the order of \$11.3 million and \$15.4 million against the *status quo* and deregulation counterfactuals respectively.

#### Question 43:

The Commission seeks comment on the recent dynamic efficiency of the New Zealand dairy industry, including its research intensity, and the extent to which its dynamic efficiency might be impaired by NewCo gaining a dominant position in the various markets indicated.

#### Domestic markets

- 537 In addition, there would be similar scope in the domestic markets for dairy products for dynamic efficiency to be impaired by the emergence of dominance. Figure 4 can now be viewed as representing the domestic market for dairy products. The initial competitive equilibrium price and quantity with demand curve D is A and G

<sup>45</sup> Similarly, the surplus gained by overseas buyers as the result of the enhanced product innovation is ignored in the New Zealand-focused public benefit test unless it leads to subsequent actions by those buyers which advantages New Zealand public benefit. See the discussion in: Commerce Commission, *Decision No. 278: Air New Zealand/Ansett Holdings*, 3<sup>rd</sup> April 1996, Wellington: Commerce Commission, pp. 81-83.

<sup>46</sup> Technical note: by standardising the "price" at a value of \$1, quantity equals 660 million. With the profit-maximising assumption and assumed value of price elasticity at C, marginal cost can be calculated to be \$0.5. Initial profit equals  $(\$1 - \$0.5)660m = \$330m$ . The equation for the new demand curve is then calculated, along with the new profit-maximising price, quantity and profit.

respectively (this ignores the monopoly pricing issue discussed earlier). Product innovation would cause the demand curve to shift rightward to D', increasing quantity to G', and increasing consumer surplus (the value of the product in terms of "willingness to pay") by the area represented by FF'G'G. This is the public benefit stemming from competition which is foregone with the implementation of the proposed merger, assuming that the demand is drawn away from other markets with only marginal impacts on those markets.<sup>47</sup>

- 538 Given the approximate size of the market (excluding butter) as being \$775 million as noted earlier, and adopting the other assumptions used for the domestic markets (price elasticity of -0.27), the loss from dynamic (product) inefficiency would be \$36.7 million.
- 539 In addition, a loss of production innovation in the same market would generate further detriments. For example, a one percent loss of productivity improvement on a cost base estimated at \$380 million would lead to a loss of a cost saving of \$3.8 million against either counterfactual.

### *Conclusion on Dynamic Inefficiency*

- 540 A summary of the illustrative estimates of dynamic efficiency losses made above are shown in Table 7. Those were calculated on the basis of one percent changes in demand and costs, as explained above. The actual detriment could be much larger.

**TABLE 7**  
**Illustrative Estimates of Dynamic Efficiency Losses Based on**  
**One Percent Changes in Demand and Costs (\$M per year)**

<b>Items</b>	<b><i>Status quo</i> counterfactual</b>	<b>Deregulation counterfactual</b>
Export-based		
- product	10.0	10.0
- production	11.3	15.4
Domestic market		
- product	36.7	36.7
- production	3.8	3.8
<b>TOTAL</b>	<b>61.8</b>	<b>65.9</b>

- 541 The Commission has formed the preliminary view, based on the information so far to hand, that the potential loss of dynamic efficiency arising from the proposed merger could be significant. However, such predictions are notoriously difficult to make, and hence a relatively wide range in the possible outcomes is necessary. The Commission's best estimate at this stage is that dynamic inefficiency could fall somewhere in the range generated by demand and cost changes of between one and five percent. This would give rise to annual losses from dynamic inefficiency of

<sup>47</sup> This model is described in: "The Evaluation of Public Benefit and Detriment Under the Commerce Act", Occasional Paper No. 7, Wellington: Commerce Commission, February 1998, p. 22.



between about \$60 million and about \$300 million against the *status quo* counterfactual, and between about \$65 million and about \$325 million against the deregulation counterfactual.

**Question 44:**

The Commission seeks comment on the extent of dynamic efficiency by the dairy industry, and the extent to which that innovation might be eroded by dominance in the various domestic markets, relative to the counterfactuals.

**Conclusion on Detriments**

542 The Commission has reached the preliminary view, based on the limited information currently before it, that the potential detriments from allocative inefficiency, productive inefficiency and dynamic inefficiency would be each likely to be moderate to large, although their actual magnitudes are clouded in uncertainty. These preliminary calculations are summarised in Table 8.

**TABLE 8**  
**Summary of Preliminary Estimates of Annual Detriments (\$M)**

<b>Category</b>	<b><i>Status quo</i> counterfactual range</b>		<b>Deregulation counterfactual</b>	
Allocative inefficiency	2.4	10.0	2.4	10.0
Productive inefficiency	75.5	151.0	96.0	192.0
Dynamic inefficiency	60.0	300.0	65.0	325.0
<b>TOTALS</b>	<b>137.9</b>	<b>461.0</b>	<b>163.4</b>	<b>527.0</b>

543 Overall, Table 8 suggests that the detriments would be likely to fall in the range between about \$138 million and about \$461 million against the *status quo* counterfactual, and between about \$163 million and about \$527 million against the deregulation counterfactual.

**Public Benefits**

544 As part of the proposal, the NZIER has identified four groups of public benefits which it claims would flow from the proposed merger. These are summarised under the following headings:

- Promotion of industry change
  - cessation of pay-out bundling
  - integration of marketing and processing stages
- Promotion of processing and structural efficiencies
  - reduction of duplication in ancillary activities
  - plant production flexibility and rationalisation
  - deferral of capital expenditure

- ❑ Preservation of single seller marketing
- ❑ Industry development
  - best practice transfers across dairy co-operatives
  - funding of “industry good” research

545 In addition, one further item – “overseas competitive advantages” – has been added by the Commission under the “Industry development” category on the basis of its understanding of the motivation for the proposal, and of information provided by the Dairy Board.

546 Each of the public benefit claims is now assessed in turn against each of the counterfactuals. It should be noted that the benefits claimed by the NZIER for its *status quo* counterfactual may differ from those discussed below under the Commission’s *status quo* counterfactual, because the former assumes that nothing changes, whereas the latter assumes gradual reform.

#### *Promotion of Industry Change*

547 Two benefits are claimed under the “promotion of industry change” category: an end to the inefficiencies associated with pay-out bundling, and the improved returns to export marketing from the vertical integration of industry processing and overseas marketing.

#### Cessation of pay-out bundling

548 By bundling in one payment the suppliers’ returns on their investments in their farms and in their dairy co-operatives, the pay-out provides a potentially misleading signal to suppliers. A ‘high’ pay-out may obscure a low marginal value for raw milk, thereby encouraging suppliers to increase milk supplies when, in fact, the opposite may be economically desirable. The NZIER cites a study by Scrimgeour and Thurman which estimated the allocative efficiency loss from bundling in the industry to be in the region of \$20 million per year, although such estimates, being difficult to make, are controversial.

549 The NZIER claims that pay-out bundling would cease both with the proposal and under the vertically integrated deregulation counterfactual, but not against its *status quo* counterfactual. Therefore, the latter counterfactual would give rise to a benefit of \$20 million. However, the *status quo* counterfactual used here allows for gradual change, including the abolition of bundling. Hence, the Commission does not accept this claimed benefit under either counterfactual.

#### Integration of marketing and processing stages

550 At present there is a structural separation between the processing (dairy co-operatives) and marketing (Dairy Board) parts of the industry. This is claimed to impose two types of cost. The first arises from the significant delay of about six weeks between the time that a temporary change in the prices in an overseas market opens the opportunity to conclude a profitable deal, and the resulting change being implemented in the product mix needed to supply the relevant product. The delay is caused by the

complex bargaining and negotiating between the Dairy Board and the dairy co-operatives in order to reach an acceptable price and allocation of production. The Dairy Board cannot unilaterally allocate the production, but must reach an agreement with the dairy co-operatives concerned. Each dairy co-operative is more concerned with achieving outcomes which benefit its shareholders, than with those which are best for the industry as a whole. The delay reduces the period over which the higher price can be gained, or eliminates the opportunity altogether. The separation also adds to costs from the significant numbers of staff in both the Dairy Board and dairy co-operatives whose time, along with that of executives, is taken up with the complex negotiations involved in product allocation.

- 551 The presence from time to time of such pricing opportunities is discussed below under “Preservation of integrated marketing”. A number of industry participants have confirmed that such delays do occur, and that alleviating them would be a benefit stemming from the proposed merger. The behaviour of the dairy co-operatives is expected to change – or be overridden - when they are absorbed within NewCo.
- 552 The Dairy Board, in its submission to the Commission, has outlined more generally the difficulties it presently faces in allocating export production between the dairy co-operatives. The recently introduced CPM was designed to reward and encourage dairy co-operatives to produce those products which have better market returns, but as the discussion on the *status quo* counterfactual indicated, it has led to considerable difficulties in determining the product mix and its allocation to dairy co-operatives. As noted there, a case could be made that a move in the opposite direction – towards deconcentration of processing and a stronger Dairy Board, as once applied – or indeed, some other changes, might achieve the same outcome. The Commission considers it not clear therefore, that the proposed merger is necessary to achieve the benefits claimed.
- 553 In addition, in at least some cases the available opportunities to secure short term higher prices in overseas markets could be met by supplying goods from stocks rather than from producing to order. This would appear to by-pass the need to allocate production. A case was related to the Commission where an opportunity in the US market was met out of stocks, although in that particular case the opportunity had disappeared by the time the ship had arrived. The ability to by-pass would depend upon the availability in store of the product in question, and the product life required by the purchaser.
- 554 The NZIER estimates conservatively that the cost of separation is \$20 million per year, although no supporting calculations have been provided. In principle, this benefit would accrue only against the *status quo* counterfactual, since the deregulation counterfactual would avoid the separation problem. However, on the basis of present information, and the concerns raised above, the Commission is not inclined to give great weight to this claimed benefit. A figure in the range between \$5 million and \$15 million is accepted at this stage.

Question 45:

The Commission seeks comment on the extent to which the proposal would promote changes in the dairy industry as compared to the counterfactuals, in terms of the cessation of pay-out

bundling and of the integration of marketing and processing stages, and the quantification of the resulting public benefits.

### *Promotion of Processing and Structural Efficiencies*

#### Reduction of duplication in ancillary activities

- 555 Under this heading a number of benefits are claimed, as follows: overseas marketing network economies; administrative function savings in dairy co-operatives; administrative function savings in the Dairy Board; savings in directors' fees; savings in insurance; savings in financing costs; rationalisation of laboratory testing; research and development savings; and input purchasing savings. A common feature of these claimed benefits is that they derive essentially from the economies of scale in delivering various types of services. Each is now examined in turn.
- 556 *Overseas marketing network economies:* the NZIER argues that the proposal (and the *status quo* counterfactual) avoids the duplication of overseas marketing network activities and fixed costs associated with having more than one export marketer. The savings that NewCo would bring relative to the deregulation counterfactual are not easy to calculate. In that counterfactual, it would not be necessary to bear the additional costs of sprouting another Dairy Board; the marketing arms of each exporting dairy co-operatives would individually be a good deal smaller than the present Dairy Board, although in aggregate their costs would be expected to exceed that of the Dairy Board. The size of the extra costs would also depend upon the extent to which the two dairy co-operatives in the counterfactual overlap in terms of product range and geographic scope; if they were both to produce the full product range and operate globally, the extra marketing costs would be greater than if each were to specialise in narrower and non-overlapping ranges of products and markets. The NZIER refers to a study by the Boston Consulting Group, which found that if one dairy co-operative were to concentrate on consumer products and the other on commodities and ingredients, the annual extra costs (presumably, over-and-above the costs of the Dairy Board) would be around \$30 million. This is the figure claimed as being conservative by the NZIER.
- 557 The Commission notes that in the deregulation counterfactual the barriers to new entrants would be reduced, and that this might lead to a new exporter becoming established, implying additional overseas marketing costs. The probability of this happening within the Commission's time frame appears to be low. However, the Commission is prepared provisionally to accept a benefit in the range between \$20 million and \$30 million.
- 558 *Administrative function savings in dairy co-operatives:* it is claimed by the NZIER that the proposed merger of the eight dairy co-operatives will facilitate a considerable rationalisation of their administrative functions, allowing substantial reductions in combined staff numbers and associated costs against either counterfactual. The estimates compiled by [ ] of the Dairy Board are summarised in Table 9.
- 559 The precise basis on which these estimates have been compiled is not known. While it is plausible that the proposed merger will lead to savings in the rationalisation of the administrative functions within the industry, it seems unlikely that the NZIER's claim

that typically “eight teams will be replaced by one team” will necessarily apply. For example, NewCo may require only one Chief Financial Officer, but it is likely that individual production sites will each have a Financial Officer. Also, it may well be that new functions will emerge in NewCo which will require additional administrative staff and resources. For example, the much greater size, geographic spread and complexity of NewCo will increase information flows up and down the chain of command. A new centralised headquarters is planned, with perhaps two or more regional offices. Functions which used to be accomplished by market forces may have to be “built in” to the organisation. For example, internal benchmarking, which is claimed will be a feature of the company, will require additional staff to implement and operate.

**TABLE 9**  
**Claimed Annual Savings of Administrative Costs in the Eight**  
**Co-operatives Against the Two Counterfactuals, 1998/99**

<b>Scenario</b>	<b>Staff numbers</b>	<b>Costs</b>	<b>Claimed savings from proposed merger</b>	<b>Provisionally accepted savings</b>
Status quo counterfactual	342*	\$62.7m*	\$35.4m	\$10m - \$15m
Deregulation counterfactual	279	\$51.1m	\$23.8m	\$5m - \$15m

\*Actual figures. The rest are estimates.

Note:

1 These calculations are based on staff numbers for NewCo of 149 and costs of \$27.3m.

2 The Applicant’s claimed savings are based on its own counterfactuals.

560 Hence, on the basis of the information received to date, the Commission’s preliminary view is that the savings are likely to be smaller than claimed, and also that the savings could be smaller against the deregulation counterfactual than the *status quo* counterfactual. The Commission therefore accepts provisionally a range of between \$10 million and \$20 million against the *status quo* counterfactual, and between \$5 million and \$15 million against the deregulation counterfactual.

561 *Administrative function savings in the Dairy Board:* the administrative savings in the Dairy Board made possible by the proposed merger were also investigated by [ ]. His estimates as given by the NZIER are summarised in Table 10. Given that the Dairy Board is the export marketing arm of the industry and the dairy co-operatives are the dairy product manufacturers, it is not clear why there should be any administrative savings in the Dairy Board beyond those claimed under “Integration of Marketing and Processing Stages” above. To allow for that prior claim of \$20 million, the NZIER has deducted that figure from the savings for the *status quo* counterfactual given in Table 10.

562 However, to accept this claimed benefit, the Commission would need detailed supporting evidence. While transaction costs between the Dairy Board and the co-operatives might be reduced with vertical integration, monitoring costs could increase. It should be noted that a mere “down-sizing” of the Dairy Board of the sort which

could be done in the absence of the proposed merger could not be accepted as a benefit of the proposal. In principle, it would seem likely that the potential for savings would be greater when assessed against the *status quo* counterfactual, where the Dairy Board and co-operatives would remain vertically separated.

- 563 On the basis of current information, the Commission is prepared provisionally to acceptd between \$5 million and \$15 million against the *status quo* counterfactual, and between \$5 million and \$10 million against the deregulation counterfactual.

**TABLE 10**  
**Claimed Annual Savings of Administrative Costs in the Dairy Board**  
**Against the Two Counterfactuals, 1998/99**

Scenarios	Costs	Claimed savings from NewCo	Provisionally accepted savings
Status quo counterfactual	\$207.0m*	\$40.7m	\$5m - \$15m
Deregulation counterfactual	\$179.9m	\$33.6m	\$5m - \$10m

\*Actual figure. The rest are estimates.

Note:

1 These calculations are based on costs for NewCo of \$143.3m.

2 The Applicant's claimed savings are based on its own counterfactuals.

- 564 *Savings in directors' fees:* the NZIER estimate of the savings of directors' fees assumes that all of the fees currently paid by the dairy co-operatives (about \$2.7 million) would be saved by the proposed merger against the *status quo* counterfactual, leaving only those currently incurred by the Dairy Board (\$1 million). These are shown in Table 11. However, it seems likely that the greater responsibilities of the new directors in the greatly enlarged NewCo would be reflected in a higher level of fees, which would reduce the savings claimed.
- 565 No information has been provided on how the directors' fees cost under the deregulation counterfactual were calculated, which puts the claimed savings in doubt. Moreover, it appears likely that additional costs will be incurred at the second and third tier levels of the governance structure.
- 566 On the basis of current information available, the Commission is prepared to accept benefits of \$1 million when assessed against the *status quo* counterfactual and \$0.5 million when assessed against the deregulation counterfactual.

**TABLE 11**  
**Claimed Savings in Directors' Fees**

Scenarios	Costs	Claimed savings from NewCo	Provisionally accepted savings
Status quo counterfactual	\$3.7m*	\$2.7m	\$1.0m
Deregulation counterfactual	\$2.0m	\$1.0m	\$0.5m

\*Actual figure. The rest are estimates.

Note:

1 These calculations are based on costs for NewCo of \$1.0m.

2 The Applicant's claimed savings are based on its counterfactuals.

- 567 *Savings in insurance:* dairy co-operative insurance covers insurance over product (preshipment insurance, negotiated for the industry as a whole), plant and business interruption. Savings in insurance are believed to be claimed for the latter two items. Two recent studies in the dairy industry, by Dairy Group and by AON Risk Services on behalf of Kiwi, found scope for annual savings conservatively estimated at \$[ ] million, and these are the savings from the proposal claimed by the NZIER. Areas where savings could be made are said to include rationalisation of commissions, bulk purchase arrangements, the increased opportunity for self-insuring attritional losses, and greater use of the “any one loss” concept in the insurance for catastrophes. The savings from the last item appear to arise from reductions in insurance risk from the pooling of risks, and so could then be regarded as a real (i.e., non-pecuniary) economy.
- 568 The scope for such savings is maximised by the proposal when measured against the *status quo* counterfactual; the Commission considers it might be smaller against the deregulation counterfactual, depending upon the industry's structure.
- 569 However, this claim could only be accepted if it were shown that similar savings were not attainable through the centralised purchase of insurance in the absence of the proposed merger. Without that assurance, the claimed benefit cannot be given much weight.
- 570 *Savings in financing costs:* the NZIER refers to a study carried out recently within the Dairy Board which examined how the cost of funding the industry's aggregate outstanding debt of around \$4 billion could be reduced by forming a consolidated financing vehicle for the industry. It is claimed that savings would arise from the ability of a larger organisation to secure a lower marginal cost of funds. For example, a reduction of ten base points on the interest rate charged on \$4 billion would result in an annual saving of \$4 million. It is also claimed that the periods of peak debts for the Dairy Board and the dairy co-operatives do not coincide, so that merging them would smooth out the peaks and reduce the total of the debt to be carried. It is not clear how the total of the debt could be reduced by that means.
- 571 On the basis of the study, the NZIER claims conservative savings of \$[ ] million per year against either counterfactual, although the savings would likely be smaller when

assessed against the deregulation counterfactual. However, the Commission believes that on the basis of current information, little weight can be accorded to such savings given that the Dairy Board study presumably envisaged that a consolidated financing vehicle could be introduced in the absence of the proposed merger.

- 572 *Rationalisation of laboratory testing:* laboratory testing on a daily basis of samples of raw milk and of products is an important feature of the dairy industry. Much of this testing can be carried out in centralised laboratory facilities, rather than at site-based facilities. For example, the laboratory at the Clandeboyne site in Canterbury was originally set up jointly by the Alpine and Southland co-operatives prior to their merger to form SIDCO to process their combined requirements, and that of third parties (although no third parties availed themselves of the facility). Similarly, when Kiwi acquired Tui, the Tui laboratory at Pahiatua was closed and testing was centralised on the Hawera site.
- 573 However, mergers appear not to be required to facilitate the establishment of centralised laboratories. For example, raw milk from Dairy Group, Northland and Tatua is tested at the South Auckland Independent Testing Laboratory. Hence, the claimed benefit in the form of savings from further rationalisation of laboratory testing of at least \$[ ] million per year permitted by the proposed merger under either counterfactual would be likely to be attainable in the proposal's absence, and cannot be accepted as a public benefit. The Commission considers that the argument that product (as opposed to raw milk) testing is too sensitive to be carried out in an independent facility, and therefore could not be done without NewCo, does not seem plausible.
- 574 *Research and development savings:* the NZIER states that the dairy industry currently spends about \$60 million per year on R&D, of which about \$40 million (a figure which is disputed below) comes from the Dairy Board, with the balance being contributed by the dairy co-operatives, mainly by Dairy Group and Kiwi. It is argued that the latter involves largely a duplication of effort by Dairy Group and Kiwi as each tries to get one step ahead of the other. The Dairy Board also states in its submission that the present system gives rise to what it sees as two difficulties: the potential for the duplication of resources by dairy co-operatives independently developing similar products; and the setting of inappropriate priorities, such that resources are devoted to developing products for which there is less potential market demand while other more promising opportunities are neglected.
- 575 The NZIER claims savings from two sources in respect of R&D: the minimisation of duplication of "certain roles and functions", and from improved outcomes from research programmes as a result of competition between research teams within NewCo.
- 576 The Commission takes the view that the latter argument is unsustainable, given the current competition noted to exist between research teams in the two independent companies. The savings from the avoidance of duplication then appear unlikely to be sufficient to support the claim of \$[ ] million against the *status quo* counterfactual, particularly as Commission inquiries suggest that the dairy co-operative contribution is much smaller, in the order of \$[ ] million, than the \$[ ] million claimed. The



Commission is therefore willing to accept a benefit of \$[ ] million against both counterfactuals.

- 577 *Input purchasing savings:* this item covers NewCo's ability to gain lower prices on the bulk purchase of inputs, such as sea freight services, engineering and vehicle spare parts inventories, fuel, cleaning chemicals, packaging and maintenance arrangements. The NZIER claims a benefit of at least \$[ ] million against either counterfactual on the basis of discussions with industry personnel. However, from the nature of the two counterfactuals, the Commission considers it would appear that any such savings could be smaller when assessed against the deregulation counterfactual.
- 578 For such savings to be counted as a public benefit, they would need to reflect comparable cost savings on the part of the various suppliers. If the savings accruing from lower input prices merely reflected the superior bargaining strength of NewCo, they would be pecuniary only – merely a transfer from the supplier to the buyer, with no net social gain – and therefore could not be counted as a public benefit. Public benefits would arise, for example, where suppliers experience lower costs from supplying a given volume of product in one large bulk order, than the equivalent in two smaller orders.
- 579 Similarly, “economies of massed reserves” may accrue with respect to inventories of engineering and spare parts, such that the size of an inventory need increase less than proportionately to the increase in the size of the operation it supports in order to provide almost the same degree of protection against the risk of breakdown. However, differences between plants and their geographic separation may reduce the scope for savings.
- 580 The Commission believes that on the basis of present information the savings which can be counted as public benefits are likely to be rather smaller than that claimed, so that a figure of \$[ ] million against both counterfactuals is accepted.
- 581 *Summary of benefit claims with respect to the reduction of duplication in ancillary facilities:* a summary of the benefits claimed by the Applicant, and accepted on a preliminary basis by the Commission, is given in Table 12. The claims provisionally accepted amount to between \$21.0 million and \$41.0 million when assessed against the status *quo* counterfactual, and to between \$35.5 million and \$60.5 million when assessed against the deregulation counterfactual.

**TABLE 12**  
**Summary of Annual Benefit Claims with Respect to the**  
**Reduction of Duplication in Ancillary Facilities (\$M)**

Category	Status quo counterfactual		Deregulation counterfactual	
	Claimed	Accepted	Claimed	Accepted
Overseas marketing network economies	0	0	30.0	20.0-30.0
Administrative function savings in dairy co-operatives	35.4	10.0 –20.0	23.8	5.0-15.0
Administrative function savings in the Dairy Board	40.7	5.0-15.0	33.6	5.0-10.0
Savings in directors' fees	2.7	1.0	1.0	0.5
Savings in insurance	[ ]	0	[ ]	0
Savings in financing costs	[ ]	0	[ ]	0
Rationalisation of laboratory testing	[ ]	0	[ ]	0
Research and development savings	10.0	2.5	10.0	2.5
Input purchasing savings	[ ]	[ ]	[ ]	[ ]
<b>TOTALs</b>	<b>113.6</b>	<b>21.0-41.0</b>	<b>123.2</b>	<b>35.5-60.5</b>

Note: The Applicant's claimed savings are based on its counterfactuals.

#### Plant production flexibility and rationalisation

- 582 The benefits claimed under this heading comprise two elements: the industry's product mix, and the allocation of production between manufacturing plants. These elements are inter-related, in that the daily supply of raw milk, comprising a mix of components, has to be processed into a range of products embodying those components in different proportions, using the existing processing facilities at a range of plants, so as to produce that combination of products which maximises the industry's contribution to overheads and profits. These daily decisions are constrained by plant capacities, the supply of milk components, and the costs of transporting milk to, and components between, plants.
- 583 Each of the two elements – product mix and the allocation of production - are now examined in turn.
- 584 *Industry product mix:* it is claimed by the NZIER that the flexibility of the industry to choose the "best" mix of products would be greater if all of the plants of the different dairy co-operatives were to be brought under the centralised control of NewCo. Industry personnel consulted by the NZIER suggested that a benefit of \$10 million per year would be a very conservative figure. This figure is claimed against both counterfactuals, although clearly the benefit from enhanced flexibility could be greater when measured against the deregulation counterfactual. Against the *status*

*quo* counterfactual there would remain scope for central direction through the Dairy Board.

- 585 As the plants exist already, it can be inferred that the degree of flexibility which would be allowed by the proposed merger must currently be inhibited by the fact that they are owned by different dairy co-operatives which are unwilling or unable to cede production control over their plants for the greater good of the industry as a whole. In the past when there were a larger number of smaller dairy co-operatives it appears that the Dairy Board used to exercise control over the product mix, but that system has subsequently been over-turned with the emergence of two large dairy co-operatives, as explained above. If that were correct, then the formation of NewCo would be only one way of securing the claimed product mix benefit. One alternative not involving merger would be to reinstate the Dairy Board as the industry's product mix designer.
- 586 The Commission cannot accept as claimed benefits those which could be achieved outside of the proposed merger. To do so in the present case against the *status quo* counterfactual might invite other firms in subsequent cases to engage in behaviour designed to promote the apparent benefits associated with a merger application. However, the Commission is prepared to accept on a provisional basis a benefit of \$5 million against the deregulation counterfactual.
- 587 *Allocation of production between plants:* the NZIER points out that in allocating the product mix between plants, it is important from a cost minimisation perspective to ensure that production is allocated to the lowest cost plants, and that available economies of full plant utilisation are not lost by splitting production between two plants when one plant could produce the total output required more cheaply. It is claimed that currently, production allocation decisions do not always produce efficient outcomes.
- 588 There are two reasons for this. Firstly, certain products – for example, butter destined for the UK quota market, consumer-packaged butter and mozzarella cheese – are considered to be of strategic importance, so that the largest dairy co-operatives have each decided that they need to be capable of producing those products themselves. This sometimes gives rise to over-capacity, with two or more plants producing an output which could more cheaply be produced in only one of them.<sup>48</sup> Secondly, a similar situation may arise when one dairy co-operative builds a more efficient plant to produce a particular product, but the existing older and less efficient plant of another dairy co-operative may be retained in production.
- 589 The NZIER claims that the industry is unwilling or unable to bring about the reallocation of production so as to increase production efficiency. Hence, it follows that the ability of NewCo to bring about that outcome through the centralisation of decision-making counts as a benefit for the proposed merger. This argument has been supported strongly by senior representatives of both Kiwi and Dairy Group in discussions with the Commission. Yet the argument is unconvincing when the two dairy co-operatives which would stand to gain most from the rationalisation of production say that the benefits can be obtained only if they are removed from

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<sup>48</sup> However, some customers are said to insist on there being “dual supply” capability to offset the risk of a disruption to supply through the catastrophic failure of a single plant.

production decision-making. There are likely to be gains and losses from each specific rationalisation move which involves shifting production from one dairy co-operative to another. However, it seems conceivable that a package of changes could be devised which would leave both better off, just as the changes associated with the proposed merger would leave the industry as a whole better off.

590 Alternatively, the counter-argument raised above that an independent Dairy Board could achieve the same outcome would need to be considered. If either of these arguments is supported, this claimed benefit for the proposed merger cannot be accepted. A further consideration is that specific rationalisation moves proposed often lead to production of a particular product being concentrated in the hands of a single plant and the associated owner, which could result in detriments from the ensuing loss of competition.<sup>49</sup>

591 For completeness, brief summaries are now provided of a number of specific rationalisation moves provided by the industry through the NZIER. The estimated savings figures are claimed not to differ for the two counterfactuals, but that is unlikely to be the case: the savings are likely to be greater when assessed against the deregulation counterfactual because of the separation of the vertically integrated dairy co-operatives. Against the *status quo* counterfactual similar improvements could potentially be introduced through the auspices of the Dairy Board.

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<sup>49</sup> These piecemeal changes may lead to lower production costs, but optimisation would require an industry-wide evaluation.



- 594 *Summary of plant production flexibility and rationalisation savings:* the discussion above over the claimed savings with respect to plant production flexibility and rationalisation is summarised in Table 13. The Commission provisionally accepts \$11 million per year against the deregulation counterfactual, but nothing against the *status quo* counterfactual.

**TABLE 13**  
**Summary of Annual Benefit Claims with Respect to Plant**  
**Production Flexibility and Rationalisation (\$M)**

Category	Status quo counterfactual		Deregulation counterfactual	
	Claimed	Accepted	Claimed	Accepted
Industry product mix	10.0	0	10.0	5
Allocation of production between plants	13.1	0	13.1	6
<b>TOTAL</b>	<b>23.1</b>	<b>0</b>	<b>23.1</b>	<b>11</b>

Note: The Applicant's claimed savings are based on its own counterfactuals.

### Deferral of capital expenditure

- 595 Continued investment is needed in the dairy industry to accommodate growth in the supply of raw milk, to supply new products, and to replace obsolete plants. Such investments are characteristically “lumpy” because of the capital-intensive nature of, and economies of scale inherent in, dairy processing plants. Consequently, plants when first commissioned tend to operate with substantial spare capacity, even at the seasonal peak in milk supply. Moreover, dairy co-operatives at different stages in their “investment cycles” will tend over time sequentially to reach full capacity at peak. New investments required by “peaking” co-operatives could then be deferred temporarily if their peak milk supplies were to be moved to other co-operatives’ sites which have excess capacity. This might save costs even after netting out increased transport costs.
- 596 The NZIER maintains that it is not possible for dairy co-operatives to reach an agreement to switch milk supplies using market transactions except in extreme circumstances where plant capacity has been destroyed. Some industry participants have also noted the difficulties involved in arranging market transactions between dairy co-operatives. In Kiwi/SIDCO, the Commission asked SIDCO why it considered that such benefits could only be attained through a competition-reducing merger, and not through mutually beneficial market transactions between the participants. SIDCO responded that while such transactions were feasible in principle, they were difficult in practice to negotiate. It is difficult to get agreement on pricing and the sharing of the benefits, and there are problems with permanent staff at a plant when production is diverted elsewhere (although this is unlikely to apply with capital deferrals). Also, such agreements may result in sensitive company information being revealed to the partner, which may be used against it at a later date. Finally, lengthy negotiations at management level brought to a successful conclusion may be overturned at company board level.

597 There is much contrary evidence that the trading of milk and of milk components is commonplace, as was discussed above in the context of secondary markets. This trade occurs between dairy co-operatives, between different sites belonging to one co-operative, and between town milk dairy co-operatives and manufacturing dairy co-operatives. It would be strange indeed if, in circumstances where both sides stood to benefit through the transfer of raw milk or milk components, a contractual arrangement in which the gains from trading were shared could not be negotiated. The reaction of farmer shareholders to failed negotiations (if they were ever to become aware of them) which could have increased their pay-out would also likely be unfavourable. If contractual arrangements could be established, the benefits of capital deferral could be gained in the counterfactual.

598 A further issue is whether the new plants discussed below will actually be needed. For example, it is not known how sensitive the deferral estimates are to weather-related variations in forecast milk supplies. Moreover, to the extent that the capacity is needed to take the new supply from farm conversions (particularly in Otago and Southland where the pay-out is already at the bottom of the range), the question is raised as to whether that additional supply will be economic. In this connection, the Commission notes that immediately after Dairy Group acquired SIDCO it put a moratorium on accepting new suppliers.

599 For the purposes of illustration, a brief outline of each of the NZIER's investment deferral cost saving claims is now given.<sup>50</sup> Unless indicated otherwise, deferrals of one year are involved. Savings of equal magnitude are claimed under both counterfactuals, although they could potentially be greater under the deregulation counterfactual because of the greater difficulty in achieving some deferrals which would involve co-operation between Kiwi and Dairy Group.

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<sup>50</sup> Given that there is doubt in the industry as to whether expansion at Longburn should be deferred or not undertaken at all, the NZIER has chosen not to claim any benefit in that connection.

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600 Because the benefits from the various deferrals arise at various points over a six year period, NZIER has calculated their combined value in terms of the equivalent annuity of \$13.76 million over that period. As noted above, the Commission's willingness to accept such claims would depend upon a convincing case being made that they could not be achieved by means other than the proposed merger. Hence, at present, these claims can be given no weight.

Question 46:

The Commission seeks comment on the extent to which the proposal may promote processing and structural efficiencies in the dairy industry, and the generation of public benefits, relative to the likely counterfactuals. The efficiencies potentially include a reduction of duplication in ancillary activities; enhancement of plant production flexibility and rationalisation; and deferral of capital expenditure.

*Preservation of Single Seller Marketing*

601 The benefit claimed under this heading relates to the preservation of the higher prices for some dairy products in some overseas markets achieved by having the Dairy Board as a single desk seller of New Zealand dairy exports. The claim relates to markets outside of the "quota markets". The view that New Zealand cannot wield any market power as it accounts for only 30 percent of world trade in dairy products is argued to be incorrect, because an homogeneous, unrestricted, international marketplace does not exist. Rather, it is claimed that some of these non-quota country markets are segmented or differentiated by a variety of factors, and these provide opportunities to gain price premiums. The presence of another New Zealand-based competitor operating in the same markets is argued to be likely, through competing for orders, to undermine this price advantage.



- 602 The Commission notes that higher export returns, even if they come from raising prices through the exploitation of market power overseas, are considered to be a public benefit in terms of the Act.<sup>51</sup>
- 603 The Business Roundtable, in its submission (p. 4), has referred to the “fallacy” that “monopoly exporting confers some advantage by reducing competition between New Zealand exporters.” It would appear to argue that competition from non-New Zealand sources of supply would remove the price premiums claimed for some overseas markets by the Dairy Board and others.
- 604 Some Australian domestic dairy companies have expressed the view to the Commission that the competition in overseas markets between the two major Australian exporters – Bonlac and Murray Goulburn – has undermined the returns from Australian dairy exports. They see the current single desk seller structure in New Zealand as offering a distinct advantage by comparison.
- 605 Assuming that a benefit claim in this category can be sustained, it could be made only against the deregulation counterfactual, since the *status quo* counterfactual would preserve the Dairy Board’s export monopoly. However, the benefit claim based on an avoidance of competition is weakened in the longer term to the extent that the industry deregulation associated with the proposed merger proceeding will encourage new entry, and hence the possibility that new New Zealand-based exporters will emerge. This is given a low probability of happening within the Commission’s timeframe. Any competition between those entrants and NewCo in overseas markets which, depending upon the market focus of the entrants, might emerge, could erode the premiums and hence the claimed benefit in the longer term.
- 606 In its submission, the Dairy Board outlines its overseas market experience with price premiums. It states that there is no single, homogeneous, international dairy market, but rather a large range of national and regional markets differentiated by a host of factors, including product differentiation, brand and country-of-origin differentiation, demand differences, government regulations, and single buyer structures. As a consequence, the Dairy Board maintains that it is able to earn significant and sustained premiums over international commodity prices from its sales of certain products into some non-quota markets. In those markets the Dairy Board submits that it is not a price-taker; rather, its decisions as to what quantities of products to sell, and to whom, do affect prices.
- 607 Some examples given by the Dairy Board of markets where it is not a price-taker are as follows:
- markets where the Dairy Board has a large market share, for example, [ ] and [ ];

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<sup>51</sup> See: Commerce Commission, *Decision No. 278: Air New Zealand/Ansett Holdings*, *op. cit.*, pp. 81-83.

- markets where local milk is regulated and/or subsidised, raising prices which benefit overseas exporters to those countries, for example, [ ];
- markets where the “New Zealand brand” has a strong presence, and where market frictions effectively prevent arbitrage operations;
- markets with “most favoured nation quotas” where would-be importers bid for licences to do import, such as the European Union, and where market rents are typically not bid away fully because of market imperfections; and
- markets with a single, centralised purchaser of certain dairy products [ ]].

608 In short, the Dairy Board argues that there are in practice a range of non-quota product and country markets where, for whatever reason, the volume of products it offers directly affects the price received. This ability to extract price premiums would be eroded by competition with another New Zealand-based exporter. In particular, the Dairy Board points to the danger of intra-brand competition, the reduced incentives to spend on developing and sustaining the brand, and the risk of free-riding by one participant (e.g., by reducing the quality or environmentally friendly nature of the product) eroding the value of the brand.

609 The quantification of this benefit has proved in the past to be controversial, because of data limitations and the difficulty of determining market outcomes in the counterfactual against which to assess the price premiums. The NZIER, using confidential Dairy Board data (relating to 33 individual product markets in 11 regions over eight quarters) in a study commissioned by the Dairy Board, put the total benefit figure at about \$40 million. The NZIER’s approach (1998) was subjected to critical scrutiny by Law and Economics Consulting Group (1998). Scrimgeour and Thurman (1997), in a government-commissioned study, using publicly available data, are claimed to have produced a figure of \$20 million in a paper by the Producer Board Review Team, although the Commission has not been able to locate the original source of that estimate.

610 If, for the sake of argument, the NZIER’s estimate of the total value of the price premiums of \$40 million is taken to be a reasonable one, the benefit which can be claimed in respect of the proposed merger is likely to be rather lower, for two reasons. The first, as explained above, relates to the fact that the deregulation associated with the merger proceeding may allow new entry to occur in dairy processing, and those processors may sooner or later turn to exporting. This, in turn, is likely to erode the size of the aggregate premium, although the probability of this happening within the Commission’s time frame is likely to be low.

611 Secondly, while the deregulation counterfactual may erode premiums, it is unlikely to erode them in their entirety, as implicitly assumed by the NZIER. Two smaller New Zealand exporters (with perhaps one or more new entrants) appear unlikely to be able individually to supply the same range of products and markets as would NewCo. Nor would they necessarily be able to erode all of the advantages listed above which the

Dairy Board currently enjoys. This would mitigate against a loss of premiums in all such markets.

- 612 On this basis, the Commission remains to be convinced of the sustainability of the argument for premiums in non-quota markets, but is prepared to accept a figure of between zero and \$20 million as a provisional estimate.

Question 47:

The Commission seeks comment on the public benefits to be gained from the preservation of single seller marketing of dairy products overseas, relative to the likely counterfactuals.

*Industry Development*

- 613 The NZIER suggests that two other important, but less quantifiable, benefits stem from the proposed merger: the facilitation of “best practice” transfers across the industry, and the preservation of incentives to continue funding of “industry good” dairy research. In addition, the Dairy Board has emphasised the overseas competitive advantages which would flow from the proposed merger. Each is now examined in turn.

Best practice transfers across dairy co-operatives

- 614 The NZIER claims that the proposed merger will enhance the spread of best practice knowledge about technology, costs, marketing and quality management from the best performing dairy co-operatives to the others. The various dairy co-operatives have different characteristics and areas of expertise, and therefore have much to share one with the other. The NZIER concedes that this happens to some extent already, as the result of staff transfers and hirings, the use of consultants, direct observation, the Dairy Board’s standard cost models, equipment suppliers, and knowledge gained from overseas trade fairs. In addition, much of the industry’s research is funded centrally by the Dairy Board through the Dairy Research Institute. However, the NZIER argues that competitive advantages derived from “learning by doing” and from the culture of the organisation are less easily transferred between competing entities, but could be transferred through the single management structure of NewCo.
- 615 The counter-argument to this is that each of the dairy co-operatives is good at doing what it specialises in, that existing conduits for best practice transfers would not be much enhanced by the proposed merger, and that the experiences of the smaller players which would benefit others might be lost in a combined entity dominated by Dairy Group and Kiwi.
- 616 The NZIER raises the possibility that the loss of competition through the proposed merger could both lessen pressures to perform and the incentive to aim for best practice, but consider that other sources of competitive pressure would off-set that. However, these issues have been dealt with above in the section on dynamic efficiency, under detriments.
- 617 The NZIER does not attempt to quantify this claimed benefit, but the Commission considers that on the basis of the information so far to hand it is likely to be small at best.

### Funding of “industry good” research

- 618 The precise scope of “industry good” research in the dairy sector is not clear, but it seems mainly to cover research based on the farm, together with TB and purely dairy-related disease control. The former is concerned with ways of improving dairy farm productivity, for the benefit of both the suppliers and the industry as a whole. Information from the Dairy Board suggests that the expenditure on the “industry good” areas as defined is in the region of \$[ ] million per year, of which about half is currently funded from Dairy Board funds, and about half through FRST.
- 619 In its report, the NZIER argues that this research funding on dairy farming is likely to continue against the *status quo* counterfactual, but suggests that since both the proposed merger and the deregulation counterfactual involve industry deregulation, this raises the issue as to whether the Government will continue with the present structure for industry good research. If it does not, the incentives for the industry to continue with a self-imposed scheme might weaken against the deregulation counterfactual, compared to NewCo, because of the scope for free-riding by one dairy co-operative on the funding provided by the other. Consequently, the proposed merger is likely to better promote on-farm productivity growth than that counterfactual. A benefit of \$29 million is claimed.
- 620 However, inquiries by the Commission indicate that farm-based research does not benefit from government levies, or requirements by the Government to impose levies, although under the Biosecurity Act levies are required to be paid on stock for slaughter at meat works to provide funds for TB research. Much of the farm-based research funding appears to come through FRST. Since these funds would be external to the dairy co-operatives in the deregulation counterfactual, there would not be the incentive to free-ride suggested by the NZIER.
- 621 The Commission is prepared to accept that there could be benefit related to the preservation of industry good research, in terms of the greater rate of reduction in on-farm costs, but at present is unclear as to its likely magnitude.

### Overseas competitive advantages

- 622 In its submission on the proposal, the Dairy Board emphasises the strategic importance of the proposal to the industry. The development of the proposal arose out of the government’s request in the May 1998 budget statement that it develop a plan for deregulation, as well its ongoing obligation under the Dairy Board Act to promote the efficiency of the industry in increasingly competitive international dairy markets. The approach adopted was to identify the strategy which would maximise returns from the export of dairy produce, and then to identify the industry structure best suited to achieving that strategy. With the aid of international business consultants, the outcome arrived at is the proposal for a single, vertically integrated, manufacturing and marketing company owned by New Zealand dairy farmers, with the potential for a separate consumer products subsidiary company to be spun off at some point in the future.

- 623 The proposed structure and strategy, if implemented, would result in the formation of possibly New Zealand's largest commercial organisation. The Dairy Board considers that this will bring significant benefits to New Zealand from having a world-leading multinational based here, and would also assist in raising New Zealand's international profile, and in retaining talented and highly skilled New Zealanders in the country.
- 624 The goal is to expand the present business, which currently has revenues of \$8 billion per year, to one of \$30 billion in ten years, an ambitious target which some have argued lacks specification of the means by which it is to be attained. As mentioned earlier, the entering into alliances with overseas dairy multinationals would presumably be high on the agenda and, indeed, the press has reported recently that four joint venture arrangements are being considered. Neither the Applicant nor the Dairy Board has attempted to outline to the Commission the public benefits that might flow from these arrangements, nor to explain why the proposed merger is required to achieve them. The Commission notes that the Dairy Board already has a number of joint venture operations in several countries, indicating that the proposed developments are not new in kind, although they may be in size.
- 625 On the basis of the present very limited information, the Commission is not able to attach much weight to the benefits advocated under this heading.

**Question 48:**

The Commission seeks comment on the potential industry development benefits that might be brought by the proposal, relative to the counterfactuals, and their possible quantification. These benefits might include best practice transfers across dairy co-operatives; the funding of industry good research; and overseas competitive advantages.

**Conclusion on Public Benefits**

- 626 On a general level, the pattern of savings may be questioned. For the most part, these are secured in the first year, and are then held at that level over the subsequent four years. On the basis of experience with other mergers in other industries, this pattern seems implausible. The integration of even two firms post-merger does not always proceed smoothly: unexpected difficulties can occur; tensions can build up between the acquiring and the acquired entities; and differences in organisation, practices and cultures can delay management from attending to implementing measures to secure the anticipated benefits. These difficulties may be more pronounced in the present case because of the multi-firm nature of the proposal, plus their merger with the Dairy Board. As a result, cost saving measures are likely to be implemented gradually and sequentially, so that cost savings build up gradually, both in individual categories and in total. However, at the same time the detriments may also build up gradually over time. Focussing on the annual estimates for both benefits and detriments may therefore not bias the balancing process to be conducted below.
- 627 As indicated above, the Commission could not accept on a preliminary basis many of the claimed benefits, on several grounds: it was not convinced that they would not be gained in the absence of the proposed merger; insufficient information was provided to substantiate the argument; and they were likely to be pecuniary economies. As a result of the review of the information currently available, the Commission has reached the preliminary view that the benefits from the proposed merger are as shown

in the “accepted” columns for the two counterfactuals in Table 14. These are between \$26 million and \$56 million when assessed against the *status quo* counterfactual, and between \$46.5 million and \$91.5 million when assessed against the deregulation counterfactual. The corresponding “claimed” benefits are also shown.<sup>52</sup>

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<sup>52</sup> The total claimed annual benefit against the *status quo* counterfactual given in Table 14 is \$190.5 million, as compared with the figure of \$210.3 million in the NZIER’s submission. The discrepancy of about \$20 million appears to have arisen from the mistaken inclusion by the NZIER of “funding of ‘industry good’ research” as a benefit under that counterfactual, when it is specifically stated that it should be included only under the deregulation counterfactual (pp. 67-68).

**TABLE 14**

**Summary of the Preliminary Estimates of Public Benefits per Year (\$M)**

Category	Status quo Counterfactual		Deregulation counterfactual	
	Claimed	Accepted	Claimed	Accepted
Promotion of industry change				
• cessation of pay-out bundling	20.0	0	0	0
• integration of marketing & processing stages	20.0	5.0-15.0	0	0
Promotion of processing & structural efficiencies				
• reduction of duplication in ancillary activities	113.6	21.0-41.0	123.2	35.5-60.5
• plant production flexibility and rationalisation	23.1	0	23.1	11
• deferral of capital expenditure	13.8*	0	13.8*	0
Preservation of single seller marketing	0	0	40.0	0-20.0
Industry development				
• best practice transfers across companies	N/Q	0	N/Q	0
• funding of “industry good” research	0	0	29.0	0
• overseas competitive advantages	N/Q	0	N/Q	0
<b>TOTALS</b>	<b>190.5</b>	<b>26.0-56.0</b>	<b>229.1</b>	<b>46.5-91.5</b>

Notes:

\* Annuity equivalent over a six year period.

N/Q = benefit not quantified.

Benefits quoted as estimates to one decimal place.

The Applicant’s claimed savings are based on its own counterfactuals.

## BALANCING

628 The determination of the application involves a balancing of the public benefits and the detriments which will, or will be likely to, result from the proposed merger. Only where the detriments are outweighed by the public benefits can the Commission be satisfied that the proposed merger will result, or will be likely to result, in such a benefit to the public that it should be permitted, and be able to grant an authorisation for the proposed merger.

629 The Commission has made a preliminary assessment of the benefits to the public arising from the proposed merger and the detriments caused by the acquisition of dominance.

- 630 A summary of the Commission's preliminary views as to the range within which the detriments are likely to fall, and the benefits which can be accepted, under each of the counterfactuals on the basis of currently available information, is shown in Table 15. As can be seen, the accepted benefits fall well short of the lower end of the detriment range for both counterfactuals. The Commission notes that even if the NZIER's benefit claims were to be accepted in full, they would still fall only towards the lower end of the detriment range provisionally established.

**TABLE 15**  
**Summary of Preliminary Estimates of Detriments and Benefits**  
**(\$M per year)**

<b>Category</b>	<b><i>Status Quo</i> counterfactual</b>	<b>Deregulation counterfactual</b>
Benefit	26-56	47-92
Detriment	138-461	163-527

## **DRAFT DETERMINATION**

- 631 On the basis of the information available to it to date, the Commission has reached the preliminary view that it cannot be satisfied that the public benefits of the proposed merger are likely to outweigh the competitive detriments.
- 632 If this conclusion is confirmed, following consideration of submissions on this draft determination, the Commission would decline to grant an authorisation pursuant to section 67(3)(c) of the Commerce Act.