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Commerce Commission

Decision No. 562

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

FONTERRA CO-OPERATIVE GROUP LIMTED

and

NEW ZEALAND DAIRY FOODS LIMITED

The Commission:	David Caygill Denese Bates QC Peter JM Taylor
Summary of Application:	An application by Fonterra Co-operative Group Limited for clearance for it, or one of its wholly-owned subsidiaries, to acquire the branded butter and spreads business of New Zealand Dairy Foods Limited.
Determination:	Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance to the proposed acquisition.
Date of Determination:	9 November 2005

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EXECUTIVE SUMMARY

The Proposal

1. On 29 August 2005, Fonterra Co-operative Group Limited (Fonterra) gave notice, pursuant to s 66(1) of the Commerce Act 1986 (the Act), seeking clearance to acquire by itself, or through one of its wholly-owned subsidiaries, specified assets relating to the branded butter and spreads business of New Zealand Dairy Foods Limited (NZDF). The specific assets are the 'Anchor', 'Fernleaf' and 'Country Soft' brands and related business and inventory (the proposed acquisition).

2. The proposed acquisition would result in an aggregation in respect of the wholesale supply of consumer butter and butter blends.

Market Definition

3. The Commerce Commission (the Commission) has found that the relevant markets for the proposed acquisition are:

   - the national market for the wholesale supply and distribution of consumer butter (the consumer butter market); and
   - the national market for the wholesale supply and distribution of consumer yellow spreads, excluding butter (the consumer yellow spreads market).

4. Previous Commission decisions, relating to similar acquisitions, defined the relevant product market as being consumer yellow spreads. The reasons for the change in market definition in this case are new evidence arising from the Commission's econometric analysis of supermarket scanner data of consumer preferences, and the unanimous views of supermarket operators interviewed, suggesting that butter does not have close substitutes in the eyes of consumers.

Counterfactual

5. In the counterfactual, NZDF would retain its branded butter and spreads business, and continue to be supplied butter both from Fonterra's ingredients business pursuant to the Dairy Products Supply Agreement, and from Westland Co-operative Dairy Company Limited (Westland). Fonterra Brands (New Zealand) Limited's (Fonterra Brands) already concluded acquisition of NZDF's unbranded butter business would stay in effect. These house brand contracts are for specified terms and would be contestable on expiry.

Factual

6. In the factual scenario, Fonterra Brands would become the major wholesale supplier of consumer butter and butter blends. NZDF's Dairy Products Supply Agreement with Fonterra would be amended to [ ]. NZDF's arrangement with Westland for supply of branded butter in the South Island up to [ ] would be assigned to Fonterra Brands.

Competition Analysis

Consumer Butter Market

Existing Competition

7. The market for the wholesale supply and distribution of consumer butter is strongly influenced by the structure of production at both the manufacturing and retailing levels of the butter supply chain.

8. Wholesalers acquire butter to their branded specifications from Fonterra and Westland, the only two butter manufacturers in New Zealand. At the retail level, approximately [ ] percent of consumer packaged butter is sold through the two supermarket chains, Foodstuffs and Progressive Enterprises. These supermarket chains also have house branded butter that competes with the wholesalers' brands.

9. At the wholesale level, there are primarily four wholesalers: NZDF, Fonterra Brands, Universal Foods Limited ('Classic Farm') and National Foods Limited ('Dairymaid'). The proposed acquisition would reduce the number of wholesalers from four to three, with NZDF no longer having its own butter brands [ ]. Fonterra's market share based on supermarket sales volumes would increase from [ ] to [ ] percent, of which [ ] percent relates to house brands and would be contestable. The proposed acquisition would result in Fonterra owning the main butter brands, excluding the house brands.

10. Currently, there is active competition between suppliers at the wholesale level. The supermarkets facilitate this competition with [ ] percent of butter being sold on promotion.

11. The Commission considers that the proposed acquisition would weaken the competitive constraints on Fonterra's ability to exercise unilateral market power. This would occur through the removal of the major branded competitor that held [ ]. Consequently, all else equal, Fonterra might be able to reduce the frequency and levels of discount promotions and, as the supplier of house brands, might be able to influence the wholesale price for the house branded butter, [ ].

12. The ability of the remaining two competitors to expand to counter Fonterra's market power depends on their ability to access supplies of butter. Westland has sufficient capacity to enter the wholesale market itself, or support the expansion of one or both of these competitors. Westland's current packing capacity is [ ] tonnes, which with diversion of exports would equate to approximately [ ] percent of the market.

13. [ ]. Other sources of supply of butter would require some investment or would incur additional freight costs, and they are considered as part of the discussion of potential competition.

14. The Commission considers that, while existing competition would provide some constraint, it would be insufficient on its own to constrain Fonterra's unilateral market power post-acquisition.

Potential Competition

15. A new entrant to the market for the wholesale supply and distribution of consumer butter would need to secure sufficient supplies of butter, develop good brands and gain access to distribution assets. These requirements would also be relevant if the new entrant sought to supply the house branded butter, as the Commission considers that this business would ordinarily be undertaken to supplement an existing butter business rather than being undertaken on a standalone basis.

16. Of the three entry requirements outlined, the Commission considers that securing sufficient supplies of butter is likely to pose a potential constraint on entry. The options to secure supplies of butter are:

- to enter at both the manufacturing and wholesaling levels;
- to use Westland as an independent source of supply; and
- to import butter.

17. The Commission considered the viability of entry through each of these options.

18. Entry at the manufacturing level requires access to sufficient quantities of cream or anhydrous milk fat (AMF), and capital investment in butter manufacturing and packing machinery. Economies of scale in butter production would likely require the product to be exported, as well as delivered to the domestic market. The Commission considers that entry at the manufacturing level is unlikely within the Commission's timeframe.

19. Westland is an independent source of supplies of consumer butter. [ ].

20. Butter is an internationally traded commodity and the prices and quantities of consumer butter supplied domestically are closely linked to the international market. The Commission considers that the prices of consumer butter would be constrained by the threat of imports, particularly from the potential for Australian manufacturers to supply house branded butter. One supermarket operator advised that [ ]. Woolworths Australia's acquisition of Progressive Enterprises, and its long term relationship with Murray Goulburn for house brand butter contracts in Australia, might enhance this threat of imports.

21. The Commission considers that [ ], would impose some constraint on Fonterra's

unilateral market power post-acquisition. In addition, the Commission considers that the threat of imports, particularly in relation to the wholesale supply of house brand contracts, would impose some constraint on Fonterra's ability to raise prices of butter relative to import parity prices post-acquisition.

Countervailing Power

22. Supermarkets consider butter to be a headline product and place considerable emphasis on ensuring it is priced competitively. The Commission considers that the supermarkets would be able to exercise considerable countervailing power over Fonterra's ability to raise prices post-acquisition by:

- threatening or imposing sanctions on Fonterra across its portfolio of products, such as in those markets where Fonterra faces competition (eg yoghurt);
- facilitating entry or expansion by existing or potential competitors through allocating shelf space and promotional spots, and
- encouraging contestability for the house brand contracts and tightly monitoring contract performance.

23. The Commission considers that supermarkets would be able to exercise countervailing power in order to constrain Fonterra post-acquisition. The threat of imports would enhance this countervailing power.

Threat of Regulation

24. Section 115 of the Dairy Industry Restructuring Act 2001 (DIRA) provides for an extremely broad power to make regulations (by Order in Council) for the supply of goods and services by Fonterra, and for ancillary matters. Regulations are authorised to be made to require the supply by Fonterra of, among other things, "products derived from milk" and the "transportation, processing and packaging of ... products derived from milk".

25. If post-acquisition, Fonterra refuses to supply processed and packaged butter on reasonable terms, there is an option for regulations to be imposed, but only to the extent of five percent of Fonterra's production. The Commission considers that the threat of regulation might impose some constraint on Fonterra's ability to exercise unilateral market power. However, this from of regulation is seen as providing a potential backstop measure only and the Commission does not rely on such potential regulation as an imminent prospect.

Conclusion

26. Post-acquisition, Fonterra would own the major butter brands and would be the sole supplier of house branded butter. The removal of the major branded competitor would likely result in Fonterra having the ability to raise wholesale prices of butter, all else equal. However, there would be a number of other constraints on Fonterra post-acquisition. In particular, in order of importance:

- Westland is an independent source of consumer butter, and it has the capacity and flexibility to enter itself, or support entry or expansion by existing or potential competitors, by up to [ ] percent of market share (by diverting exports) or more (subject to investment in additional packing capacity). [

].

- Supermarkets would be able to exercise significant countervailing market power over Fonterra, through the threat of sanctions on Fonterra, facilitating entry or expansion by existing or potential competitors [ ], and their operation of house brand contracts (which would be backed up by the threat of imports for toll manufacturing).
- The threat of imports of branded consumer butter, particularly from Australia.
- Potentially, the threat of regulation under s 115 of the DIRA to require Fonterra to supply packaged and processed butter up to five percent of its production.

27. While none of these factors on its own is determinative, the Commission on balance considers that the combined influence of the first two factors, with the backstop of the last two factors, is likely to impose a sufficient competitive constraint on Fonterra post-acquisition.

28. In conclusion, the Commission considers that the acquisition is unlikely to result in a substantial lessening of competition in the consumer butter market.

Consumer Yellow Spreads Market

<u>Existing Competition</u>

29. The major participants in the consumer yellow spreads market are: NZDF, Goodman Fielder, Fonterra Brands, Unilever, and Peerless. The total size of supermarket sales for the market is approximately [ ] tonnes and is valued at approximately [ ] million, of which [ ] tonnes and [ ] million relate to butter blends. As a consequence of the proposed acquisition, Fonterra Brands's market share will increase from approximately [ ] percent to [ ] percent of the value of supermarket sales.

30. These market shares fall within the Commission's safe harbours for a three firm concentration ratio above 70 percent, where the market share of the combined entity is less than 20 percent. However, given the market is differentiated and the proposed acquisition results in Fonterra Brands' consolidating its holding of the butter blends segment of the market, the Commission considered whether the proposed acquisition would result in localised market power for the butter blends brands.

31. The Commission concludes that there is evidence that consumers consider butter blends and certain margarine products as substitutes. In addition, supply-side factors such as product innovation, [ ] and the potential for imports, would constrain Fonterra Brands from exercising localised market power.

<u>Conclusion</u>

32. The Commission is satisfied that the proposed acquisition is unlikely to substantially lessen competition in the consumer yellow spreads market.

THE PROPOSAL

1. On 29 August 2005, Fonterra Co-operative Group Limited (Fonterra) gave notice, pursuant to s 66(1) of the Commerce Act 1986 (the Act), seeking clearance to acquire by itself, or through one of its wholly-owned subsidiaries, specified assets relating to the branded butter and spreads business of New Zealand Dairy Foods Limited (NZDF).

2. The specific assets to be acquired are the 'Anchor', 'Fernleaf' and 'Country Soft' brands and related business and inventory (the proposed acquisition). The acquisition would also result in amendments to the Dairy Products Supply Agreement between NZDF and Fonterra [ ]. Arrangements for supply of butter from Westland [ ] and for manufacturing of butter blends by Goodman Fielder Limited would also be assigned to Fonterra Brands.

3. As a consequence of this proposed acquisition, an aggregation would occur in respect of the wholesale supply of consumer butter and butter blends.

4. The proposed acquisition is related to a more extensive transaction between Fonterra (the Applicant) and NZDF for the swap and realignment of their respective domestic consumer dairy businesses (the main transaction). Of relevance to the proposed acquisition, Fonterra has acquired NZDF's unbranded butter and spreads business as part of the main transaction. The specific assets that were the subject of this acquisition are contracts for the wholesale supply of house branded butter to Progressive Enterprises and to Foodstuffs' three companies, and the associated contract to procure the manufacture and packing of these products in the South Island from Westland Co-operative Dairy Company Limited (Westland). This acquisition took effect on 31 August 2005.

5. Details of the two acquisitions are set out in Annex One. The proposed acquisition that is the subject of the clearance is described in the last column of the table.

6. The Commission opened an investigation in respect of the main transaction and this will be the subject of a separate investigation report.

PROCEDURE

7. Subsection 66(3) of the Act requires the Commerce Commission (Commission) either to clear or to decline to clear a notice given under s 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. Extensions of time were agreed to by the Commission and the Applicant. Accordingly, a decision on the application was required by 11 November 2005.

8. The Applicant sought confidentiality for specific aspects of the notice and subsequent submissions. Confidentiality orders were made in respect of commercially sensitive information for up to 20 working days from the Commission's determination in respect of the notice (or on the conclusion of the Commission's investigation, as relevant). When the orders expire, the provisions of the Official Information Act 1982 will apply.

9. The Commission's approach to analysing the proposed acquisition is based on the principles set out in the Commission's *Mergers and Acquisitions Guidelines*.[1]

STATUTORY FRAMEWORK

10. Under s 66 of the Act, the Commission is required to consider whether the proposal would have, or would be likely to have, the effect of substantially lessening competition in a market. If the Commission is satisfied that the proposal is not likely to substantially lessen competition, then it is required to grant clearance to the Application. Conversely, if the Commission is not satisfied, it must decline. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.[2]

11. The substantial lessening of competition test was considered in *Air New Zealand & Qantas v Commerce Commission*, where the Court held:

> We accept that an absence of market power would suggest there had been no substantial lessening of competition in a market but do not see this as a reason to forsake an analysis of the counterfactual as well as the factual. A comparative judgment is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, i.e. dominance has been attained. We consider, therefore, that a study of likely outcomes, with and without the proposed Alliance, provides a more rigorous framework for the comparative analysis required and is likely to lead to a more informed assessment of competitive conditions than would be permitted if the inquiry were limited to the existence or otherwise of market power in the factual.[3]

12. In determining whether there is a change along the spectrum that is significant, the Commission must identify a real lessening of competition that is not minimal.[4] Competition must be lessened in a considerable and sustainable way. For the purposes of its analysis, the Commission is of the view that a lessening of competition and the creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.

13. When the impact of market power is expected to be predominantly upon price, for the lessening, or likely lessening, of competition to be regarded as substantial, the difference between the anticipated level of prices expected without the acquisition has to be both material, and ordinarily able to be sustained for a period of at least two years, or such other time frame as may be appropriate in any given case.

14. Similarly, when the impact of market power is felt in terms of the non-price dimensions of competition such as reduced services, quality or innovation, for there to be a substantial lessening, or likely substantial lessening of competition, the difference between the anticipated non-price dimensions also has to be both material and ordinarily sustainable for at least two years or such other time frame as may be appropriate.

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[1] Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004.
[2] *Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission* (1992) 4 TCLR 713-722.
[3] *Air New Zealand & Qantas Airways Ltd v Commerce Commission*, unreported HC Auckland, CIV 2003 404 6590, Hansen J and K M Vautier, Para 42.
[4] See *Fisher & Paykel Limited v Commerce Commission* (1996) 2 NZLR 731, 758 and also *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554.

ANALYTICAL FRAMEWORK

15. The Commission applies a consistent analytical framework to all of its clearance decisions. The first step the Commission takes is to determine the relevant market or markets. As acquisitions considered under s 66 are prospective, the Commission uses a forward-looking type of analysis to assess whether a lessening of competition is likely in the defined market(s). Hence, an important subsequent step is to establish the appropriate hypothetical future 'with' and 'without' scenarios, defined as the situations expected:

    - with the acquisition in question (the factual); and
    - in the absence of the acquisition (the counterfactual).

16. The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in the market between those two scenarios. The Commission analyses the extent of competition in each relevant market for both the factual and the counterfactual scenarios, in terms of:

    - existing competition;
    - potential competition; and
    - other competition factors, such as the countervailing market power of buyers or suppliers.

THE PARTIES

Fonterra

17. Fonterra is a co-operative dairy company incorporated under the Companies Act 1993 and registered under the Co-operative Companies Act 1996. Shares in Fonterra are held by approximately 12,000 supplier shareholders. Fonterra operates in New Zealand through its subsidiaries.

18. Fonterra's corporate structure reflects its different business activities. These business activities may be categorised in terms of:

    - Ingredients – involving the manufacture and packaging of more than 1,000 products, such as milk powders, cheese and value-added dairy ingredients. This activity also relates to the collection and processing of milk, and research and development of new value-added ingredients. The ingredients business accounts for approximately two-thirds of Fonterra's revenue. Fonterra is one of only two manufacturers of butter in New Zealand.
    - Consumer dairy products – Fonterra's dairy-based consumer and branded products business operates under the name Fonterra Brands. It has 35 manufacturing sites in New Zealand, Australia, the Americas, Asia and the Middle East.

19. For the year June 2005 to May 2006, Fonterra plans to produce approximately [ ] tonnes of butter, of which [ ] percent would be exported. Approximately [ ] tonnes of this butter will be packed as consumer butter, of which [ ] percent is intended for export.

20. Relevant interconnected bodies corporate of Fonterra are:

- Fonterra Brands (New Zealand) Limited (Fonterra Brands) – a wholly-owned subsidiary, and Fonterra's main consumer dairy products company in New Zealand. As a consequence of the main transaction, NZDF acquired 100 percent of the shares of Fonterra's subsidiary, Mainland Products Limited, which used to carry out Fonterra's consumer dairy business in New Zealand. The divested assets of Mainland Products Limited, and the assets of NZDF acquired in relation to the main transaction, have been transferred to Fonterra Brands. Fonterra Brands supplies 'Mainland' consumer butter and 'Mainland semi-soft' and 'Mainland Southern blend' butter blends.
- Bonlac Foods Limited – an Australian dairy company. On 4 August 2005, Bonlac Supply Company shareholders voted in favour of Fonterra's offer to restructure Bonlac Foods Limited, which as a consequence, will become a wholly-owned subsidiary of Fonterra. A subsidiary of Bonlac Foods Limited, Bonland Foods Limited, supplies cheese, butter and dairy ingredients to Australia and New Zealand. Bonland Foods supplies 'Western Star' consumer butter and 'Dairy Smooth' butter blends.
- Fonterra Brands (Tip Top) Limited – a wholly-owned subsidiary that manufactures butter blends for Fonterra under the 'Mainland' brand.

NZDF / Rank Group Limited (Rank Group)

21. NZDF is a wholly-owned subsidiary of Rank Group. Rank Group is a private equity investment company, 100 percent owned by a private investor, Mr G Hart. Rank Group also has a controlling interest in Burns Philp & Company Limited.

22. NZDF acquires, manufactures, wholesales and distributes a range of food products that are predominately dairy-based consumer branded products for domestic supply. Importantly, NZDF does not manufacture consumer butter or butter blends. It acquires consumer butter from Fonterra's ingredients business in accordance with the Dairy Products Supply Agreement (dated 16 October 2001).[5] In addition, NZDF acquires margarine and butter blends from Goodman Fielder Limited. NZDF sells consumer butter and butter blends under the 'Anchor', 'Fernleaf' and 'Country Soft' brands.

23. Relevant interconnected bodies corporate of NZDF/Rank Group are:

- Burns Philp & Company Limited – an Australian-based public company, listed on the New Zealand and Australian stock exchanges. Burns Philp & Company Limited is an investment company. It wholly owns the Goodman Fielder businesses.
- Goodman Fielder Limited (Goodman Fielder) – a major producer of edible oils and spreads in Australasia. Its consumer brands include 'Meadow Lea', 'Sunrise', 'Olivani', and 'Gold'n Canola'. In addition, Goodman Fielder currently manufactures and supplies Foodstuffs' house branded margarines under contract and NZDF's butter blends under the 'Anchor spreadable' and 'Country Soft' brands.
- Meadow Fresh Limited – (previously called Mainland Products Limited when it was owned by Fonterra). Meadow Fresh Limited is a wholly-owned subsidiary of NZDF and owns the assets acquired from Fonterra pursuant to the main transaction.

[5] As amended by the Deed of Agreement relating to Dairy Products Supply Agreement dated 30 June 2004.

24. On 29 September, Burns Philp announced its intention to list a new Australasian food company, under the name Goodman Fielder, together with the acquisition and merger of NZDF (including Meadow Fresh Limited), which will be included in the new listing. The new Goodman Fielder businesses will comprise Burns Philp's baking and spreads and oils divisions, and the majority of the assets of NZDF, which includes its bulk and speciality cheese business and Meadow Fresh's dairy and small goods business (excluding the piggeries). Burns Philp intends to list the new Goodman Fielder on the Australian and New Zealand stock exchanges in the latter part of this year.

Other Relevant Parties

Westland

25. Westland is one of two manufacturers and suppliers of bulk and consumer packaged butter in New Zealand. It is situated in Hokitika on the West Coast of the South Island. Westland is an independent co-operative dairy company, with 340 shareholders, and approximately 390 supplying farms. Westland produces a diverse range of ingredients for nutritional, food and beverage applications, including anhydrous milk fat (AMF). It exports to over 40 countries.

26. In 2004/05, Westland produced approximately [ ] tonnes of butter, which included approximately [ ] tonnes of consumer butter. The majority of this butter is exported.

Universal Foods Limited (Universal Foods)

27. Universal Foods is a wholesaler of consumer branded dairy products, primarily selling butter and cheese, based in Palmerston North. Universal Foods currently acquires its consumer butter from Westland and distributes that butter under its own 'Classic Farm' brand, with its principal customer being Progressive Enterprises.

28. The supply arrangement with Westland is for approximately [ ] tonnes of butter per month. Universal Foods' annual turnover is approximately [ ], of which approximately [ ] relates to butter.

National Foods Limited (National Foods)

29. National Foods is a wholesaler of consumer branded dairy products based in Palmerston North, with a cheese patting plant in Auckland. National Foods currently acquires its consumer butter from Fonterra's ingredients business and distributes that butter under its own 'Dairymaid' brand, with its principal customer being Foodstuffs (Wellington) and, to a lesser extent, the foodservice trade in the lower North Island.

30. National Foods' supply arrangement with Fonterra's ingredients business is for [ ] tonnes of butter per month and the prices are reviewed [ ]. National Foods' annual turnover is approximately [ ], with [ ] relating to butter.

Unilever plc

31. Unilever plc is an international public company based in London and Rotterdam, and is one of the largest fast-moving consumer goods companies in the world. Unilever carries on business in New Zealand through its subsidiary Unilever Australasia.

32. Unilever supplies consumer yellow spreads under the 'Flora', 'Olivio' and 'I Can't Believe it's Not Butter' brands. Unilever produces its yellow spreads at its Sydney plant, and these products are exported to New Zealand.

Peerless Holdings Pty Ltd

33. Peerless Holdings Pty Ltd, trading as Peerless Foods, is an Australian company that produces edible oils and spreads, mainly for use as ingredients. Peerless Foods manufactures 'Tablelands' as its retail branded margarine. It currently supplies the house brand margarine for Progressive Enterprises, which is imported from Australia.

Progressive Enterprises Limited (Progressive Enterprises)

34. Progressive Enterprises is currently owned by Foodland Associated Limited (Foodland). Progressive Enterprises operates the 'Woolworths', 'Foodtown', and 'Countdown' supermarket banner groups and the two franchises 'SuperValue' and 'FreshChoice'. It has 150 supermarkets, 43 franchise stores and 22 convenience stores, which together account for approximately 45 percent of sales in the retail grocery sector.

35. Progressive Enterprises markets house branded products under the 'Basic' and 'Signature Range' brands. It currently acquires its house branded butter from Fonterra Brands (prior to the main transaction, it acquired house branded butter from NZDF). It currently acquires its house branded margarine from Peerless Foods.

Woolworths Limited (Woolworths Australia)

36. An Australian company, Woolworths Australia, announced on 25 May 2005 that it had entered into an agreement with Foodland and Metcash Trading Limited under which it would acquire Foodland's New Zealand business (ie Progressive Enterprises) and 22 Action stores in Australia. A commentary in the Australian business press notes that the acquisition of the New Zealand business adds both cost saving potential (ie the potential to restructure the NZ grocery supply chain) and market share growth opportunity for Woolworths Australia.[6]

Foodstuffs

37. Foodstuffs consists of three independent co-operatives based in Auckland, Wellington and the South Island. Membership of the co-operatives is largely based on being an independent grocer that trades as a member of one of Foodstuffs' banner groups – 'Pak'n Save', 'New World', 'Four Square' and 'On the Spot' (South Island only). Foodstuffs' main house brands are 'Pam's' and 'Budget'. Its contracts for house brands are managed on behalf of the three co-operatives by Foodstuffs Own Brands Limited. Foodstuffs' house brand margarine and butter blends are supplied by Goodman Fielder

[6] David Miller, *The Canberra Times*, 25 September 2005.

and its house brand butter is supplied by Fonterra Brands (prior to the main transaction, it was supplied by NZDF).

38. Foodstuffs (Wellington) owns Kapiti Fine Foods Limited. Kapiti Fine Foods produces a range of speciality cheese and ice creams under the ‘Kapiti’ brand. It also owns a raw milk processing facility, producing milk and cream under the ‘Pam’s’, ‘Farmgate’ and ‘Kapiti’ brands.

INTERCONNECTION

39. In determining the companies that comprise the acquirer, s 47(2) provides:

> For the purposes of this section, a reference to a person includes two or more persons that are interconnected or associated.

40. Section 2(7) of the Act provides:

> ...any 2 bodies corporate are to be treated as interconnected if–
>
> One of them is a body corporate of which the other is a subsidiary (within the meaning of sections 158 and 158A of the Companies Act 1955 or section 5 and 6 of the Companies Act 1993, as the case may be); or
>
> Both of them are subsidiaries (within the meaning of those sections) of the same body corporate; or....

41. The Companies Act 1993 provides that a company is a subsidiary of another company if that other company:

- controls over half the composition of the company's board;
- controls over half the votes exercisable at a meeting of the company;
- holds more that half of the company’s issued shares; or
- is entitled to more than half of every dividend paid by the company.

42. Furthermore, ss 5 and 6 of the Companies Act 1993 provide that if company A is a subsidiary of company B, and company B is a subsidiary of company C, the company A is a subsidiary of company C.

43. The Commission is satisfied that the companies that make up Fonterra Co-operative Group, including Fonterra Brands, Fonterra’s ingredients businesses, and Bonland Foods Limited, are interconnected for the purposes of this determination.

INDUSTRY BACKGROUND

Butter

44. Butter is a dairy product manufactured from cream, with a minimum of 80 percent milkfat content prescribed by statute. The first step in manufacturing butter is to produce cream from milk through a standardisation process, which separates wholemilk into its components. The cream is then churned until it forms a solid, leaving a liquid by-product known as buttermilk. Salt is generally added. Variations of butter sold include unsalted, ‘lite’, and semi-soft (double churned to reduce hardness).

45. Butter is traded as an international commodity. It may be sold in bulk for use as an ingredient or as consumer butter. Special patting and packing machinery is required to package butter for consumer use.

46. Figure 1 outlines a time series plot of the prices of Fonterra's international sales of commodity butter over three years to August 2005. It can be seen that international butter prices have been on an upward trend over that period.

Figure 1: Time series plot of NZD prices for Fonterra's international sales of butter, July 2002 – August 2005[

]Source: Fonterra

47. Fonterra and Westland are the only two commercial butter manufacturers in New Zealand. Fonterra manufactures butter at its plants in Kauri, Morrinsville, Te Rapa, Te Awamutu, Edgecumbe, Whareroa and Clandeboye. Westland manufactures butter at its plant at Hokitika. Other processors of wholemilk produce cream as a by-product, but the cream is either used for other purposes, such as producing AMF, or sold back to Fonterra. There are no major imports of butter.

Butter Blends

48. Butter blends are a consumer packaged good produced by adding vegetable oil to the cream during the manufacturing process. The proportions of cream and oil used in butter blends range from 15 to 50 percent oil. Current manufacturers of butter blends are Fonterra (including Bonlac Foods) and Goodman Fielder.

Margarines

49. In previous Commission decisions (see the discussion in the next section), possible substitutes of consumer butter and butter blends have included a wide variety of margarines, whose basic raw ingredients are one or more vegetable oils, including palm oil, sunflower oil, soybean oil, olive oil, avocado oil, or rapeseed/canola oil, among others. Some margarines include buttermilk as an ingredient to add a butter flavour.

50. Margarines are commonly distinguished on the basis of premium (or high value) margarines and standard margarines, with the distinction generally relating to the health characteristics of the products. For the purposes of this investigation, the Commission has identified high value margarines as being the olive and canola oil based, and omega-rich, margarines. These include Unilever's 'Flora Pro-Activ', 'Flora buttery spread', 'Bertolli', and 'I can't believe' ranges; and Goldman Fielder's 'Olivani', 'Meadow Lea Logicol', 'Meadow Lea Omega', and 'Gold'n Canola' ranges.

51. Current major manufacturers of margarines are Unilever, Goodman Fielder, and Peerless Foods, with a high proportion of these products being imported from Australia.

Relative Shares of Consumer Yellow Fats Products

52. Consumer butter, butter blends and margarine may be collectively referred to as consumer yellow fats. Table 1 shows the relative size of consumer butter, butter blends,

and high-value and low-value margarines as a share of the total supermarket sales of consumer yellow fats for the 12 months ended 10 July 2005.

Table 1: Breakdown of supermarket sales of total consumer yellow fats by volume (tonnes) for the twelve months ended 10 July 2005

Butter	Blends	High-value margarine	Low-value margarine	Total
[ ] t	[ ] t	[ ] t	[ ] t	[ ] t
[ ]%	[ ]%	[ ]%	[ ]%	100%

Source: Aztec data provided by the Applicant

53. Table 1 shows that margarine makes up the bulk of supermarket sales of consumer yellow fats. In addition, the majority of sales by volume are for consumer butter and low value margarine, being the lower value products. Butter blends make up the smallest portion of total sales.

54. Consumer butter sales are declining in volume and as a proportion of total consumer yellow fats sales. The quantities sold for the 12 months ended 10 July 2005 are approximately [ ] percent less than the previous year's sales. Market participants advised the Commission that the reasons for the general decline in butter sales are:

- consumer concerns about health; and
- changes in consumer habits; for example, consumers don't do as much home baking or making of sandwiches for children's lunches as they used to.

55. In comparison, low value margarine sales have increased slightly, while high value margarine and blends sales have remained relatively stable.

PREVIOUS COMMISSION DECISIONS

56. The Commission has on a number of occasions considered acquisitions relating to consumer butter, butter blends and margarine. The most recent decisions are:

- Decision 487: Burns Philp & Company Limited and Goodman Fielder Limited (Burns Philp decision) – the relevant aggregation related to Burns Philp's consumer butter business (through interconnection with NZDF) and Goodman Fielder's margarine business.

- the 'NewCo' Draft Determination dated 27 August 1999 (this Application was subsequently withdrawn) – the relevant aggregation related to the various dairy companies' butter businesses.

57. A summary of these decisions, and the reasons for the relevant market definitions, are outlined below.

Burns Philp Decision

58. On 21 February 2003, the Commission cleared Burns Philp & Company Limited to acquire up to 100 percent of the ordinary issued share capital of Goodman Fielder and share options, subject to a divestment of the New Zealand yeast business of one of Burns Philp's wholly-owned subsidiaries.

59. Prior to that acquisition, Burns Philp, through its wholly-owned subsidiary, NZDF, wholesaled butter and a small amount of margarine; and Goodman Fielder manufactured and wholesaled margarine. In concluding in favour of a single consumer yellow spreads market (rather than having separate markets for butter and margarine) to assess the competition implications of the acquisition, the Commission took into account:

- The Commission's draft view in 'NewCo' (see below) that a single market was appropriate, and the Australian Competition and Consumer Commission's (ACCC) similar view in its decision not to intervene in the proposed merger of Bonlac Foods Limited and the New Zealand Dairy Board in 2000.
- A balancing of the following factors for and against a single consumer yellow spreads market:
  - in opposition, some supermarket operators reported that price reduction promotions of butter and margarine were offered contemporaneously because they did not believe sales of one were affected by the price of the other;
  - in support, evidence from other supermarket operators suggesting that margarine is a reasonably close substitute for butter, as an increase in the retail price of one would lead to an increase in the demand for the other; and
  - in support, Fonterra considered it competed with margarine worldwide in respect of its butter sales.
- The adoption of a single consumer yellow spreads market in the case of this specific acquisition was a more conservative approach than adopting two separate product markets. The reason that it was seen as being more conservative was that the acquisition would have resulted in only a small aggregation in respect of margarine and no aggregation for butter, given the minimal overlap in the two companies' businesses. The Commission noted that, if it found no substantial lessening of competition in the consumer yellow spreads market (as it did), then neither would there be any issues if the alternative separate product markets were adopted.

60. In this Decision, the Commission determined the relevant market to be that for the manufacture and wholesale supply of consumer yellow spreads in New Zealand. The Commission noted that it was a differentiated product market, but "not so differentiated as to cast doubt on there being a well-defined market for consumer yellow spreads."[7] The Commission was satisfied that the proposed acquisition was unlikely to substantially lessen competition in this market.

'NewCo' Draft Determination

61. On 27 August 1999, the Commission released its Draft Determination on the Application for authorisation of the merger between the New Zealand Dairy Board, eight co-operative dairy companies and Tasman Milk Products. This acquisition would have resulted in the merged entity manufacturing 100 percent of the butter produced in New Zealand.

62. In determining the relevant markets for this acquisition, the Commission firstly distinguished between classes of acquirers based on product specification and use. This

[7] Paragraph 58.

led to separate markets being defined for butter sold in consumer packs and that sold for industrial use as an ingredient.

63. In terms of the consumer butter, the Commission took into account the following factors:

- econometric evidence from the United States showing a relatively high cross-price elasticity of demand between butter and margarine, indicating that the two products were close substitutes in that country;[8]
- the experience of all supermarket chains approached by the Commission, indicating that the two products were reasonably close substitutes, such that an increase in the retail price of one would lead to an increase in the demand for the other; and
- market research data showing that the demand for butter was in long-term decline and this was explained by consumers switching to non-dairy substitutes, principally margarine.

64. The Commission specified in its draft that the relevant market was that for the manufacture and wholesale supply of consumer yellow spreads. Applying the former dominance threshold, the Commission made a draft determination that the potential and actual constraints by competition from non-dairy substitute products would be sufficient such that the merged entity would be unlikely to strengthen or acquire a dominant position.

Commission's View of These Decisions

65. These Commission decisions have defined the product market as being that for consumer yellow spreads. The Commission recognises the value of precedent in guiding the exercise of its discretion and, as a consequence, applies a standard framework to its analysis of acquisitions as outlined in its *Merger and Acquisition Guidelines*. However, the value of precedent should not prevent the Commission from carrying out a full analysis to see if a different outcome is more appropriate in any given case given different facts or better information.

MARKET DEFINITION

66. The Act defines a market as:

> … a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.[9]

67. For competition purposes, market participants include all those suppliers, and all those buyers, between whom there is close competition, and exclude all other suppliers and buyers. The focus is upon those goods or services that are close substitutes in the eyes of buyers, and upon those suppliers who produce, or could easily switch to produce, those goods or services. Within that broad approach, the Commission defines relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration, bearing in mind the need for a commonsense, pragmatic approach to market definition.

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[8] See D. Salvatore, *Managerial Economics in a Global Economy* (2nd edition), New York: McGraw-Hill, p. 100.
[9] Section 3(1) of the Commerce Act 1986.

68. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power might be exercised is defined in terms of five dimensions, namely the product type, the class or classes of acquirer, the functional level, the geographical extent, and (not relevant to this determination) a particular time period. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

THE RELEVANT MARKET

The Applicant's Submission

69. The brands that are the subject of the acquisition are 'Anchor' and 'Fernleaf' in consumer butter, and 'Anchor Spreadable' and 'Country Soft' in butter blends. The closest substitutes to these branded products owned by Fonterra Brands (and its interconnected bodies corporate) are 'Mainland' in consumer butter, and in butter blends, 'Mainland Semi-Soft', 'Mainland Southern Blend' and Bonland's 'Dairy Smooth'. The proposed acquisition would result in an aggregation in relation to consumer butter and butter blends.

70. The Applicant has submitted that, for the purposes of the proposed acquisition, the relevant market should be the market for the wholesale supply of consumer yellow spreads in New Zealand.

Product Dimension

71. Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. For each initial market so defined, the Commission considers whether the imposition of a SSNIP would be likely to be profitable for the hypothetical monopolist. If it were, then all of the relevant substitutes must be incorporated in the market.

72. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market.

73. Two products might be technical substitutes, in that they might be utilised for essentially the same function, but still be sufficiently differentiated that they are not considered close substitutes by consumers. For example, two products having similar uses might not be close substitutes if the price of one of the products is much higher, or the performance of one of the products is significantly inferior, that it might be a poor substitute in an economic sense, at least for the great majority of buyers.

74. There may be a chain of substitution between products and, so long as there is no break in the chain of close substitution possibilities such that each adjacent pair of products are close substitutes, all of these products might be included in the same market. However, the more widely spaced are any two products in that chain, the less close they

might be as substitutes to each other, and the more likely is there to be a break in the chain such that the products should be grouped into two or more markets.

75. Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so by a small change in their relative prices, quality or performance.

76. Close substitute products on the supply-side are those between which suppliers can shift production easily and in the short-run, using largely unchanged production facilities and little or no additional investment, when they are given a profit incentive to do so by a small change in relative product prices.

The Applicant's Views on Product Market Definition

77. The Applicant (supported by NZDF/Rank Group) informed the Commission that consumer yellow fat products are differentiated based on a number of factors, but this differentiation is not sufficient to break the chain of substitution between the respective products.

78. The parties provided the Commission with extensive market research and internal reports that discussed each of these factors. In summary, the factors are:

- Functionality – the products have common uses for baking, for spreading, in frying or as a garnish, but their relative performance in each of these uses varies. A consumer survey of 791 respondents, commissioned by Fonterra in August 2005, found that [ ] percent of respondents who had bought butter primarily use it for baking, while those who buy butter blends and margarine primarily use them as spreads. [10] Butter's cooking and blending abilities were preferred over other products, and only [ ] percent of respondents thought that butter was good to use as a spread.

- Taste - butter was generally preferred on taste and used as a benchmark for other yellow fats. Butter blends were seen as retaining the taste advantages of butter, while having enhanced performance as a spread. Some manufacturers added buttermilk to the margarines to enhance the buttery taste.

- Health – the products are differentiated by whether they contained any or varying proportions of saturated, trans (natural or hydrogenated), mono-unsaturated or poly-unsaturated fats; various vitamins or minerals (eg Omega 3 or 6, and salt); additional water to reduce fat content per gram (as in 'lite' products); or cholesterol reducing plant sterols.[11] Health factors were generally identified as a reason for consumers switching away from butter.

- Brand loyalty – market research indicated limited brand loyalty for butter, as evidenced by the successful market penetration of house branded butter. A possible exception to this lack of brand loyalty was the same consumer survey showed greater consumer awareness of 'Anchor' brands, particularly in the North Island.

[10] Focus Research, Report 7, in Fonterra submission of 10 October 2005.
[11] Consumer Online Report: Table Spreads – 5 September 2005.

- Packaging – most butter is sold in parchment wrap. Spreadable butter, blends and margarines are sold in plastic tubs, in either round, oval or rectangular shapes. The same consumer study found that most consumers prefer [

  ].

- Price and promotions – butter, butter blends and margarine are frequently discounted or subject to in-store promotions (with the exception of some premium health spreads). Approximately [ ] to [ ] percent of butter was sold as part of promotions.

79. In determining the relevant market for these products, the Applicant submits:

- The factors that the Commission considered previously in defining the consumer yellow spreads market have not altered, or if anything, have become more pronounced. Butter volumes have continued to decline due to consumer switching.

- Many consumers use margarine and butter products for the same functions (eg spreading and baking). The extent of common usage means that suppliers cannot price discriminate among consumers between these uses.

- Product development is moving away from basic butter and margarines to increasingly focus on spreadable butters, butter blends, and premium margarines. Margarine manufacturers are targeting butter consumers through product development, building on naturalness of olive-oils and performance in baking. Butter manufacturers are targeting margarine consumers through product development building on spreadability and lower fat.

- The rate of product innovation means that any benefits from differentiation at any point in the product chain, unless refreshed, will be diminished over time.

Views of Interested Parties

80. The supermarket operators' interviewed unanimously considered that consumer butter was in a different market from other yellow fats. The supermarket operators submitted:

- promotional programmes for butter are planned separately from those for butter blends and margarine, and no account is taken of the impact of one on the other; and

- any switching by consumers from butter to margarine is due to health reasons rather in response to changes in relative prices.

81. In general, supermarket operators advised that consumers might buy both margarines and butter as the products were preferred for different uses. However, Progressive Enterprises provided the Commission with an analysis of 661,804 Onecard holders' purchasing profiles of butter and other yellow fats (ie butter blends and margarines) over a 13 week period to 4 September 2005. A summary of this analysis is outlined in Table 2.

Table 2: Onecard Holders' Purchases of Butter and Margarine Over 13 Week Period

	No. of Shoppers	% of Total	Sales ($)	% of Total
Exclusive butter shoppers	[ ]	[ ]	[ ]	[ ]
Exclusive margarine/blend shoppers	[ ]	[ ]	[ ]	[ ]
Total exclusive shoppers	[ ]	[ ]	[ ]	[ ]
Butter and margarine/blend shoppers	[ ]	[ ]	[ ]	[ ]

Source: Progressive Enterprises

82. Table 2 shows that [ ] percent of Onecard holders buy exclusively either butter or margarine/butter blends. This indicates very limited switching between the two product categories in that 13 week period in response to changes in relative prices.[12]

83. In the case of butter blends, supermarket operators saw some substitution with margarine in response to changes in prices.

Commission's Analysis

84. The Applicant provided the Commission with supermarket scanner data to analyse the proposed acquisition (sourced from Aztec data). The data was provided to the Commission in spreadsheet form and related to the period 20 July 2003 to 10 July 2005. The data set showed total national yellow fats volume and price data on a weekly basis, by product, summed by brand and separated out by product categories (butter, blends, and margarine). The Commission further disaggregated this data by splitting the margarine product category into high-value and low-value margarines.

85. The Commission received submissions from economic experts[13] on behalf of the Applicant and NZDF/Rank Group on the manner in which it aggregated the data and its analysis. The concerns raised were taken into account in interpreting the results.

86. A comparison of national average weekly prices for butter, butter blends and margarines over the two year period shows that the average prices are relatively widely dispersed. Figure 2 shows a time trend of the average prices of these products over two years to July 2005. It can be seen that butter and low-value margarines are priced lower than the other products.[14] Butter blends have a higher value-added component, and hence a higher price than butter, and high-value margarines are priced higher again. Significant price dispersion often indicates that the various products (and the sets of products represented by each) are differentiated.

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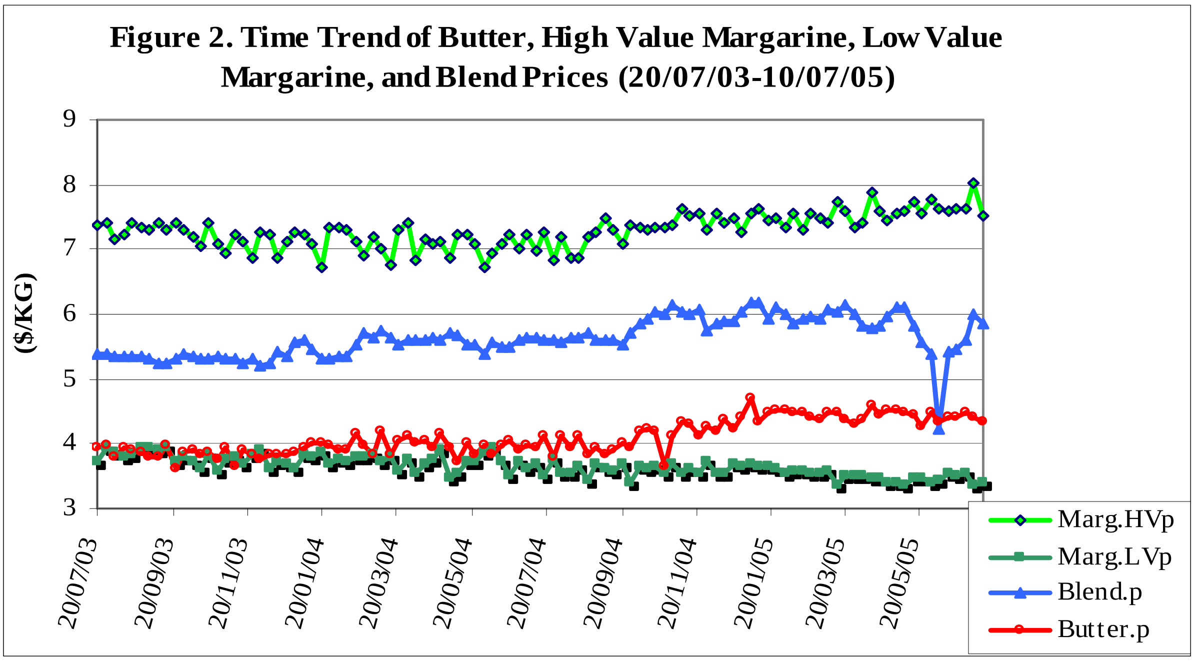
[12] These results are inconsistent with other studies provided to the Commission by the parties, which showed that a significant proportion of consumers buy both butter and one of the other yellow fat products. However, these other studies related to households rather than individuals and had much smaller sample sizes.

[13] The economic experts were Stephen Gale from Castalia Limited, J. Loren Poulsen from Competition Policy Associates, Inc, and James Mellsop, Lew Evans and Peter Boburg from CRA International.

[14] The butter category includes 'Fernleaf' semi-soft, a value added butter, which is priced at a higher level than the other standard butter products.



Source: Aztec data provided by the Applicant

87. If the relative prices of two products tend to be stable over time, this might indicate that the two products are in the same market. The Commission's statistical tests indicated that the prices of butter and low-value margarines were significantly diverging over the two year period. Butter prices have been steadily increasing, while the price of low-value margarine has been declining. This would tend to indicate that these two products are not close substitutes.

88. If two products are close substitutes, an increase in the relative price of one of the products would cause consumers to switch and increase the quantity demanded of the other product. Figure 3 is a simple plot of sales of butter, butter blends and margarine in response to a change in the price of butter during the two years to July 2005. The figure shows that butter sales decline with increases in the price of butter, but sales of butter blends and margarines are little affected. This is contrary to what would be expected if the other products were close substitutes of butter, all else being the same.

Figure 3: Changes in the Butter Price and Sales of Butter, Margarine, and Blends (20/07/03 – 10/07/05)

[ ]Source: Aztec data provided by the Applicant

89. The Commission also carried out price elasticity analysis to estimate own-price and cross-price elasticities for each of the products. Cross-price elasticity measures the change in the quantity demanded of a product as a result of a change in the price of another product. A high positive cross-price elasticity would ordinarily indicate that the two products are close substitutes.

90. The Commission found that the four products are substitutes to some extent and that some consumers would likely switch between them in response to small price changes. The Commission estimated that a ten percent increase in the price of butter would likely lead to a:

- 2.9 percent increase in the sales of high-value margarine;

- 4.6 percent increase in the sales of low-value margarine; and
- 1.6 percent increase in the sales of butter blends.

91. The Commission considers that these levels of consumer switching in response to changes in the butter price are relatively low. In particular, when the Commission applied statistical tests to determine if the SSNIP test was met, it found that this level of switching was insufficient to constrain a hypothetical monopolist of butter, for whom a price rise of ten percent or more would be profitable. In the case of butter blends, the results of the analysis were less clear on whether butter blends fall in a separate market.

92. The results of the Commission's quantitative analysis were compared with the views of the Applicant and interested parties, as a form of 'commercial reality' test.

93. Evidence that the industry and companies carry out market research in relation to the consumer yellow fats category is not inconsistent with separate product markets. The industry requires consumer yellow fats data to inform it on where to differentiate its product relative to other technical substitutes. These reports are not evidence that the products are close substitutes to consumers.

94. In addition, the reasons given for the decline in butter sales, such as a decline in home baking and changes in some consumers' perceptions of the relative health benefits of the products, are evidence of structural changes in the demand for butter. However, there was no evidence that consumers would switch in response to small changes in relative prices. Even in a declining product market it is possible for suppliers to exercise market power.

95. Finally, the Commission was not satisfied that there were close supply-side substitutes for butter, due to the requirements for entry to this market (which are discussed later in this decision).

Conclusion on Product Dimension

96. Market participants indicated that the various consumer yellow fats products are differentiated. Based upon the Commission's quantitative analysis, the Commission considers that this differentiation is of such an extent that there is not an unbroken chain of substitution between these products. Rather, butter has a number of unique attributes such that it does not have sufficiently close substitutes in the eyes of consumers.

97. In the case of butter blends, the quantitative analysis results were less clear. The evidence of supermarket operators and the parties is that there is some switching in response to price changes and some supply-side substitution due to product innovation. The Commission considers that butter blends and margarine are likely to be close enough substitutes to fall in the same market.

Customer Dimension

98. The Commission also examines the extent of, and potential for, suppliers to discriminate between customers within identified relevant markets.

99. Previous decisions of the Commission in similar cases have distinguished between classes of acquirers based upon whether yellow fat products were for retail distribution

or for industrial use as an ingredient. The products sold to these different classes of acquirers are differentiated based on branding, packaging and package size. As the proposed acquisition relates to consumer butter and butter blends only, the Commission considers that this market boundary does not need to be revisited. Consequently, the Commission determined to retain the current customer dimension of the market.

Functional Level

100. The production, distribution and sale of a product typically occurs through a series of functional levels, conventionally arranged vertically in descending order. Generally, the Commission identifies separate markets at each functional level affected by an acquisition, and assesses the impact of the acquisition on each.

101. Previous decisions of the Commission in similar cases have related to both the manufacture and wholesale supply of yellow fats. NZDF does not manufacture its own butter or butter blends. Rather NZDF acquires consumer butter from Westland and Fonterra, and butter blends from Goodman Fielder. Consequently, the proposed acquisition does not result in an aggregation at the manufacturing level of the market for consumer butter or consumer yellow spreads.

102. As supply arrangements with the product manufacturers would be assigned to Fonterra Brands as part of the proposed acquisition, and the customers of the products to be acquired are the retailers and foodservice trade, the Commission concludes that the proposed acquisition occurs at the wholesale and distribution level of the market.

Geographic Extent

103. The Commission defines the geographic dimension of a market to include all of the relevant, spatially dispersed sources of supply to which buyers would turn should the prices of local sources of supply be raised.

104. The supermarket operators advised the Commission that they applied a national pricing policy for purchase of house branded butter and consumer yellow spreads. [

]. In addition, NZDF, Fonterra Brands and Universal Foods each distribute their products to (mostly) supermarkets throughout New Zealand. The Commission concludes that the appropriate geographic extent of the market is national.

Conclusion on Market Definition

105. The Commission concludes that the relevant markets for analysing the proposed acquisition are:

- the national market for the wholesale supply and distribution of consumer butter (the butter market); and
- the national market for the wholesale supply and distribution of consumer yellow spreads, excluding butter (the consumer yellow spreads market).

COUNTERFACTUAL AND FACTUAL

106. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a 'with' and 'without' comparison rather than a 'before' and 'after' comparison. The comparison is between two hypothetical future situations, one with the acquisition (the factual) and one without (the counterfactual). The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

Counterfactual

107. The Applicant submits that the counterfactual to the proposed acquisition is determined by the main transaction. That is:

- NZDF would retain its branded butter and spreads business, and continue to be supplied butter from Fonterra's ingredients business; and
- the already concluded acquisition by Fonterra Brands of NZDF's unbranded butter business (that is, the wholesale supply of the two supermarkets' house brand butter contracts), would stay in effect.

Two Acquisitions in Butter Market

108. The Commission notes that the Applicant has split its acquisition of NZDF's butter business into two acquisitions, which the Commission is required to consider separately. While both acquisitions were 'entered into' in the one agreement,[15] the two acquisitions would be 'given effect to' separately, and the latter transaction is subject to various qualifications, including obtaining Commission clearance.

109. The Commission considers that, in this case, the splitting of the acquisition into two transactions has not prevented it from considering the full competition implications of the acquisition. As later discussed in this decision, it is the removal of NZDF as a major competitor that has the potential to lessen competitive constraints on Fonterra Brands, and this would not occur until the proposed acquisition. In addition, in analysing the proposed acquisition, the Commission is able to consider the competition impacts of the removal of NZDF from the wholesale market on the future contestability of the house brand contracts.

Acquisition of NZDF's Unbranded Butter Business

110. The assets associated with NZDF's unbranded butter business relate to three contracts, which are briefly summarised in Annex One. The key contracts are:

- a purchase agreement with Westland for the manufacture and packing of house branded butter for supply in the South Island (approximately [ ] tonnes per annum). The contract term is [ ] to [ ] and [ ];
- a wholesale supply agreement with Foodstuffs Own Brands Limited for Pam's branded butter on a national basis (approximately [ ] tonnes per annum). [

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[15] Heads of Agreement dated 6 August 2005 between Fonterra and Rank Group.

]; and

- a wholesale supply agreement with Progressive Enterprises for Signature and Basics' branded butter on a national basis (approximately [ ] tonnes per annum). This contract was held by NZDF, but has been assigned to Fonterra Brands. The contract is for [
  ].

111. NZDF's contracts for the wholesale supply of house branded butter to Foodstuffs and Progressive were transferred to Fonterra on 31 August 2005, as part of the main transaction. Pursuant to section 47 of the Act, the Commission undertook an investigation of the main transaction, which included the house brand butter contracts. In respect of the butter contracts, the Commission concluded that the transaction was unlikely to give rise to a substantial lessening of competition.

112. As this transaction has already occurred, and is not likely to have given rise to a substantial lessening of competition in the butter market, the Commission accepts the Applicant's submission that for the purposes of this Application, the appropriate counterfactual scenario is that where Fonterra owns the current house brand contracts and NZDF retains its branded butter and spreads business.

113. In this scenario, the Commission considers that NZDF might tender for house brand contracts on their expiry. In addition, NZDF would continue to supply its branded products to the supermarkets and foodservice and route trade.

General Developments

114. In wider developments, Burns Philp has announced its intention to acquire and merge the NZDF business with its other food business and list a new company called Goodman Fielder. This will consolidate Goodman Fielder as a major competitor in the wholesale supply of food products. In addition, [

]. Woolworths Australia would also acquire Progressive Enterprises. These developments would also occur in the factual.

Factual

115. In the factual scenario Fonterra Brands would be the major supplier of butter and butter blends. NZDF's Dairy Products Supply Agreement with Fonterra would be amended [

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COMPETITION ANALYSIS

National Market for the Wholesale Supply and Distribution of Butter

Existing Competition

116. Existing competition occurs between those businesses in the market that already supply the product, and those that could readily do so by adjusting their product mix (near competitors). Supply-side substitution by near competitors arises either from redeployment of existing capacity, or from expansion involving minimal investment, in both cases involving a delay of no more than one year.

117. An examination of concentration in a market can provide a useful indication of the competitive constraints that market participants might place upon each other, providing that there is not significant product differentiation. Moreover, the increase in seller concentration caused by a reduction in the number of competitors in a market by an acquisition is an indicator of the extent to which competition in the market might be lessened.

118. The Commission identifies market shares for all significant participants in the relevant market. Market shares can be measured in terms of revenues, volumes of goods sold, production capacities or inputs (such as labour or capital) used.

119. An aggregation that would result in a low concentration level is unlikely to be associated with a substantial lessening of competition in a market. On this basis, indicative safe harbours may be specified.

120. A business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:
    - if the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is below 70 percent, the combined entity (including any interconnected or associated persons) has less than in the order of 40 percent share; or
    - if the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is above 70 percent, the market share of the combined entity is less than in the order of 20 percent.

121. The Commission recognises that concentration is only one of a number of factors to be considered in the assessment of competition in a market. In order to understand the impact of the acquisition on competition, and having identified the level of concentration in a market, the Commission considers the behaviour of the businesses in the market. Specifically, the Commission seeks to understand the dynamics of the competition that would exist between the remaining firms in the market, compared to what would exist in the absence of the acquisition.

<u>Treatment of house brand contracts</u>

122. The Applicant submits that the house brands should not be amalgamated with its own-brands to establish its market shares for the purposes of the competition analysis. The Applicant submits:

- As a matter of commercial practice, the house brand contracts are treated as more short-term than the contractual terms might indicate (ie [ ] years respectively). There are continuous discussions with supermarkets regarding pricing. In the event that a contracted supplier's price was considered uncompetitive, the supermarket would not allow the situation to persist. If the supermarket decided to tender mid-contract, Fonterra would have no choice but to re-tender, and would be unlikely to sue for specific performance.
- International precedent – the European Commission bases its decision on whether to include house brands in the retailer's or manufacturer's market shares on whether there are available alternative suppliers. If barriers to entry are low, and the goods can be acquired elsewhere, the European Commission would not include the house brands in market shares.

123. The Commission has on a number of occasions considered the treatment of house brand or third party agency contracts in assessing market concentration.[16] In these previous decisions, the Commission aggregated house brand contracts with the participants' market shares. However, if these contracts were relatively short-term and contestable, then this was taken into account in the competition analysis, for which market shares are only a starting point. This approach enables a full discussion of the extent of competition for the contracts.

124. Consequently, the Commission proposes to include the house brand contracts as part of Fonterra's market share, but to identify them as being contestable, and to discuss the implications of this as part of its competition analysis.

Market Shares of Existing Competitors

125. The market for the wholesale supply and distribution of consumer butter is strongly influenced by the structure of production at the manufacturing and retailing levels of the butter supply chain.

126. Wholesalers acquire consumer butter to their branded specifications from Fonterra and Westland, the only two butter manufacturers. These two manufacturers also export consumer packaged and bulk butter. There are limited imports of butter, primarily of specialist premium brands from European manufacturers.

127. At the retail level, approximately [ ] to [ ] percent of consumer butter is sold through the two supermarket chains, Foodstuffs and Progressive Enterprises. These supermarket chains have house brands that compete with the wholesalers' brands. The balance is sold through the foodservice and route trade.

128. At the wholesale level, there are primarily four wholesalers: NZDF, Fonterra Brands, Universal Foods ('Classic Farm') and National Foods ('Dairymaid'). The proposed acquisition would reduce the number of wholesalers from four to three, with NZDF no longer having its own butter brands. In addition, the Dairy Products Supply Agreement with Fonterra would be amended to [ ].

[16] *Decision 487: Burns Philp & Company Limited and Goodman Fielder Limited (February 2003); Decision 529: Colgate Palmolive & Campbell Brothers Limited (July 2004); Decision 383: Pacific Dunlop and LWR Hosiery and Underwear (February 2000).*

129. The Applicant provided the Commission with supermarket scanner data for the 12 months to 10 July 2005 as a basis for assessing market shares. Table 3 shows competitors' pre- and post-acquisition shares of supermarket sales of consumer butter.

130. The proposed acquisition would result in Fonterra owning the main butter brands, excluding the house brands. Fonterra's market share based on supermarket sales volumes would increase from [ ] to [ ] percent, of which [ ] percent relates to house brands and would be contestable in [ ] and [ ] years time respectively.

131. Supermarket sales are a conservative estimate of market shares, as they do not include the foodservice and route trade. The Applicant provided estimates of route and foodservice sales of consumer butter for Fonterra Brands and NZDF, which showed that Fonterra Brands sold a higher proportion of butter than NZDF through this distribution channel in 2005. On the basis of this data, Fonterra's market share post-acquisition would be approximately [ ] percent.

Table 3: Impact of acquisition on existing competitors' shares of supermarket sales for the wholesale supply of butter pre- and post-acquisition (by volume) for the 12 months to July 2005

Participant	**Company**	**Brands**	**Pre-acquisition**			**Post-acquisition**	
			Volume (kgs)	Share	Total	Share	Total
Rank Group	Goodman Fielder		[ ]	[ ]%		[ ]%	
	NZDF	Anchor Fernleaf	[ ]	[ ]%		[ ]%	
Total Rank Group					**[ ]%**		**[ ]%**
Fonterra	Fonterra Brands	Mainland	[ ]	[ ]%		[ ]%	
		Foodstuffs	[ ]	[ ]%		[ ]%	
		Progressives	[ ]	[ ]%		[ ]%	
		NZDF brands (as above)				[ ]%	
Total Fonterra					**[ ]%**		**[ ]%**
Universal Foods		Classic Farm	[ ]	[ ]%	[ ]%		[ ]%
National Foods		Dairymaid	[ ]	[ ]%	[ ]%		[ ]%
Others			[ ]	[ ]%	[ ]%		[ ]%
Total			**[ ]**	**100%**	**100%**	**100%**	**100%**

Source: Aztec data provided by the Applicant

132. The post-acquisition market shares are outside the Commission's safe harbours.

Views of Market Participants on Existing Competition

133. The Applicant submits that strong competitive pressures operate in the consumer butter market and these would continue post-acquisition. The Applicant submits:

- The majority of butter is sold on promotion indicating that branding provides minimal product differentiation. The new independent brands, ‘Dairymaid’ and ‘Classic Farm’ are growing rapidly, and the supermarket house brands have strong market penetration. Consequently, these existing competitors would impose a competitive constraint on Fonterra Brands post-acquisition.
- Westland could divert export supplies to the domestic market with minimal investment. With these diverted exports, Westland could enter the market itself through contesting for the supermarket house brand contracts, or supporting expansion by one or more of the existing competitors.
- The supermarket house brand contracts are contestable. Foodstuffs’ contract is next contested in [ ], and Progressive Enterprises’ contract is next contested in [ ]. However, the Applicant submits that the supermarkets could contest these contracts at anytime during their term if they were concerned with Fonterra Brands’ performance under the contract.

134. The two remaining competitors, National Foods and Universal Foods thought that opportunities might arise for them to expand post-acquisition if they were able to access sources of supply of butter. [ ]. National Foods currently sources [ ] tonnes of butter per month from Fonterra’s ingredients business [ ].

135. The supermarket operators interviewed had mixed views on the impact of the acquisition on competition. In general, the supermarket operators considered that it would be more difficult dealing with one supplier holding the key brands. Other views included:

- the impact on competition would depend on Westland’s response, as it has the capacity to provide some competitive constraint;
- Fonterra Brands might be able to raise prices or reduce the extent of product innovation post-acquisition;
- Foodstuffs’ stores have contracted with wholesalers on an individual store basis, and in some cases, this has included exclusive supply arrangements in order to gain concessions. There could be some portfolio effects if Fonterra Brands owns the major butter brands that would need to be worked through; and
- in the case of house brand contracts, [ ].

<u>Analysis of Existing Competition</u>

136. Currently competition is strong between wholesale suppliers, with [ ] percent of butter sold on promotion either on four weekly rotations between the key brands or as a key coupon book item. Supermarket operators are able to leverage competition between the two branded competitors to ensure competitive prices for branded products. The wholesale prices of house branded butter are [

], and so this competition flows to the house branded butter.

137. In addition, there is competition for the house brand contracts through NZDF having rights to be supplied [ ] of consumer butter under a long term supply agreement with Fonterra. This agreement provides for consumer butter to be supplied at [ ].

138. The Commission considers that, if Fonterra Brands owns the major brands post-acquisition, all else equal, Fonterra Brands could reduce the frequency of promotions and the levels of discounts offered through revising its bidding for promotional spots. House branded butter would not impose a significant competitive constraint, as it would be supplied by Fonterra Brands for the current contractual terms, and [ ].

139. The ability of the two remaining competitors to expand the market shares of their branded butter to counter Fonterra's unilateral market power would depend on their ability to access supplies of butter. Similarly, the contestability of the supermarket house brand contracts could impose a competitive constraint in terms of existing competition if an independent contracted supplier were to have access to supplies of butter. Post-acquisition, the only existing independent source of supply of butter, which would not require significant investment or incur significant freight costs, is Westland.

140. Westland currently manufactures approximately [ ] tonnes of butter per year, of which [ ] tonnes is consumer butter (which is the maximum capacity of its existing patting and packing machine). Westland exports its consumer butter under its own 'Westgold' brand, [ ]. Westland's export contracts are generally for [ ] terms.

141. Currently, only [ ] tonnes of Westland's total output of consumer butter are sold on the domestic market, and approximately [ ] tonnes of this relates to the house brand contracts in the South Island (for which the term expires on [ ]). This house brand contract was assigned from NZDF to Fonterra Brands on 31 August 2005. This contract would be contestable on its expiry.

142. The proposed acquisition includes the further assignment to Fonterra Brands of arrangements for supply from Westland of 'Anchor' and 'Fernleaf' butter in the South Island. The arrangement was for approximately [ ] tonnes of butter per annum, but the assets to be acquired by Fonterra Brands relate to [ ].

143. Consequently, Westland has approximately [ ] tonnes of production that would be available to be contested [ ]. In addition, it has approximately [ ] tonnes of consumer butter that could be diverted to the domestic market at short notice and at minimal cost. Westland advised the Commission that, post-acquisition, it would consider its allocation of consumer butter between markets based on a number of factors including relative risks and returns. If Westland diverted its full consumer butter production at current packing capacity this would equate to approximately [ ] percent of the market.

144. Therefore, Westland has sufficient existing capacity and flexibility to support the expansion of one of the existing competitors, or enter the market itself through contesting for one of the house brand contracts, subject to relative market returns and risks.

145. [

].

146. In conclusion, the proposed acquisition would result in the removal of a major branded competitor that held [ ]. The removal of this competitor would likely reduce the competitive constraint on Fonterra Brands, such that it could raise prices or reduce product innovation post-acquisition, all else equal. The main constraint by existing competition post-acquisition would depend on Westland entering the market or supporting the expansion of one of the existing competitors. The Commission considers that Westland imposes some competitive constraint, but it is unlikely to be sufficient on its own to constrain Fonterra's unilateral market power post-acquisition.

Potential Competition

147. An acquisition is unlikely to result in a substantial lessening of competition in a market if the businesses in that market continue to be subject to real constraints from the threat of market entry.

148. The Commission's focus is on whether businesses would be able to enter the market and thereafter expand should they be given an inducement to do so, and the extent of any barriers they might encounter should they try. Where barriers to entry in a market are clearly low, it may be unnecessary for the Commission to identify specific businesses that might enter. In other markets, where barriers are higher, the Commission might seek to identify possible new entrants as a way of testing the assessed entry barriers.

149. Entry to the market for wholesale supply and distribution of consumer butter requires securing access to supplies of butter, developing marketable brands and gaining access to distribution assets. These requirements would also be relevant to the wholesale supply of house branded butter, as the Commission considers that this business would ordinarily be undertaken to supplement an existing butter business rather than being undertaken on a stand-alone basis.

150. The Commission considers that, as with existing competition, securing sufficient supplies of butter is the key potential constraint on entry. The available options to secure independent supplies of butter are:

- to enter at both the manufacturing and wholesaling levels to manufacture butter;
- to use Westland as an independent source of supply; and
- to import butter.

151. The Commission considered the viability of entry through each of these options.

Manufacturing Own Butter for Wholesale Supply

152. The Applicant submitted that butter can be produced from cream or AMF. It can be produced either by the 'butter churn' (or 'Fritz') technology or the Scraped Surface Heat Exchange ('SSHE' or 'Amix') technique. Fonterra uses both machines interchangeably to produce butter.

153. The Applicant submitted that:

- the ingredients for production of butter are readily obtainable in abundant supply;
- existing AMF manufacturers could convert their machinery to produce butter; and
- existing owners of SSHE machinery (such as ice cream or margarine manufacturers) could convert their machinery to the higher pressures necessary to produce butter.

154. In addition, NZDF/Rank Group submitted that a new entrant could acquire bulk butter and re-pat and package it for consumer use, although the double handling was generally not considered viable by participants.

155. The Commission did not identify a significant independent source of cream to produce butter. Synlait has not yet determined what it would do with its milkfat post-2007. Possible independent sources of AMF would be Westland, Tatua Cooperative Dairy Company Ltd or imports. Goodman Fielder and Bakels Edible Oils have imported AMF in the past.

156. Industry participants advised that, in order to achieve sufficient economies of scale for manufacturing butter, the cost of the necessary machinery would be in the order of $30 million. The quantities produced with machinery of this capacity would likely mean that it would also be desirable to export some of the product. The Commission did not identify any new entrant intending to enter on this scale. In addition, the Commission did not identify an existing AMF, ice-cream or margarine manufacturer that would convert their machinery to produce butter.

157. The Commission considers that entry at the manufacturing and wholesaling level is unlikely within the Commission's timeframe.

Westland as an Independent Source of Supply

158. Under existing competition, the Commission considered the ability of Westland, at relatively low cost, to enter the market itself or to supply butter to support expansion by existing competitors. In terms of potential competition, the Commission considers entry options that would require some setup costs or investment. Two options are considered:

- a new entrant could set up in the wholesale market and source butter from Westland; and/or
- Westland could invest in expanding its own packing capacity and either enter itself or use its increased packing capacity to support other existing or potential competitors.

159. Westland advised the Commission that, if the business case warranted, it would consider expanding its patting and packing capacity beyond its current [ ]

tonnes limit. A key consideration for Westland is the desire to maintain a certain level of diversity of products and markets to minimise risk. However, if Fonterra Brands significantly raised domestic consumer butter prices post-acquisition, this would enhance the feasibility of this option.

160. [ ].

161. [ ].

162. The Commission considers that [ ] would impose some constraint on Fonterra's ability to raise prices significantly post-acquisition.

<u>Imports of Consumer Butter</u>

163. The Applicant provided the Commission with a number of submissions on the international commodity market for butter. Fonterra advised that the European landed price in an Asian or Australasian market establishes the main reference point for sales in this region. Butter is exported from Australia to many of the same overseas markets as served by New Zealand, and could easily be diverted to New Zealand, subject to returns and availability of supplies.

164. The Applicant submitted that:

- there are few barriers to importing; for example, there are no import tariffs, exchange rate risks are low, and there are no regulatory barriers;
- dairy products such as speciality cheeses and margarines are already imported from Australia;
- supermarket operators regularly seek tenders from Australian manufacturers for house brands, and there has been an occasion where an Australian manufacturer was awarded a house brand contract for tasty cheese to keep domestic manufacturers honest; and
- the Applicants' economic experts ran some price simulation modelling, from which it concluded that the two butter manufacturers were currently constrained on price by the threat of imports.

165. The supermarket operators considered that significant imports of butter were unlikely, although Foodstuffs (South Island) recalled that 'Western Star' butter had been imported from Australia in the past. Fonterra confirmed that it has from time to time imported Western Star butter from Bonlac on a spot purchase basis. Currently it imports small 10 g packs of 'Western Star' butter for the foodservice trade.

166. The supermarket house brand managers advised that they had sought tenders for house brand butter from Australian manufacturers in the past. [ ]. Woolworths Australia's forthcoming acquisition of Progressive Enterprises, and its long-term relationship with Murray Goulburn for house brand butter contracts in Australia, might enhance the opportunities for imports.

167. International butter prices are steadily increasing due to external factors. However, the Commission considers that the threat of imports, particularly in relation to the wholesale supply of house brand contracts, would impose some constraint on Fonterra's ability to raise prices of butter relative to import parity prices post-acquisition.

Countervailing Power

168. The potential for a business to wield market power might be constrained by countervailing power in the hands of its customers, or when considering buyer market power (oligopsony or monopsony), its suppliers. In some circumstances, this constraint might be sufficient to eliminate concerns that an acquisition would be likely to lead to a substantial lessening of competition.

169. The Applicant submitted that the supermarket chains derived countervailing power from the way they purchase from suppliers. The key factors were:

- [ ] percent of butter is sold through supermarkets;
- butter is a headline product for supermarkets and up to [ ] percent of butter is sold on promotion,[17] there is limited brand loyalty and supermarkets could support new entry;
- house brands have significant market share ([ ] percent of supermarket sales) and there is the option of sourcing house branded butter from an overseas manufacturer; and
- the aggressive conduct of supermarkets towards wholesalers of butter.

170. The Applicant submitted that suppliers have little control over butter price promotions. Suppliers pay for slots in the promotional calendars, with promotional costs deducted from the suppliers' margins rather than the supermarkets' margins. This calendar is reviewed by supermarkets' category managers, who choose the best offers (discounts) for each week or pressure suppliers to offer greater discounts. Supermarkets play off suppliers against one another for promotions to get the best deals, and then confirm the promotion calendar.

171. The supermarkets demand competitive pricing on headline products, including on supply of their house brands. Penalties for uncompetitive pricing that might be imposed by the supermarkets might include:

- doubling co-operative advertising fees by way of penalty;
- refusing to special the product, or other products supplied by that supplier, in an allocated week; and

[17] The Commission estimates the volume of butter sold on promotion is more in the order of [ ] percent of sales.

- threatening to de-list the product, or other products supplied by that supplier, either temporarily or permanently.

172. The Applicant submitted examples of past behaviour by supermarkets. [

].

173. The supermarket operators acknowledged that they had some countervailing market power. However, they considered that they would not be able to significantly harm Fonterra in butter as to do so would likely reduce the supermarkets' own butter sales, and it would have limited alternative suppliers in the short term.

174. The Commission acknowledges that there might be a reduction in the supermarket companies' countervailing power post-acquisition, but considers that this countervailing power would still be considerable. In particular, supermarkets would be able to:

- threaten or impose sanctions on Fonterra across its portfolio of products, such as in those markets where Fonterra faces competition (eg yoghurt);
- facilitate entry or expansion by existing or potential competitors through allocating shelf space and promotional spots; and
- encourage contestability for the house brand contracts and tightly monitor contract performance. The threat of imports would give the supermarket operators further leverage and enhance this countervailing power.

175. The Commission notes that it has previously considered the countervailing power of supermarkets in other consumer good categories where a high proportion of sales are in supermarkets.[18] In these investigations, the supermarket chains were found to have significant countervailing power to constrain the combined entity from exercising market power.

Threat of Regulation

176. The Commission has earlier identified independent sources of butter that would be available to support entry or expansion by potential or existing competitors to the wholesale butter market. To date, Fonterra's ingredients business has been willing to supply butter to downstream competitors, such as NZDF and National Foods. The Applicant submits that it would have continuing incentives to voluntarily supply butter in the domestic market post-acquisition. However, if Fonterra were unjustifiably to refuse to supply butter to the domestic market, there would be the potential for regulations to be imposed under section 115 of the Dairy Industry Restructuring Act 2001 (DIRA) to mandate the supply of butter.

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[18] *Decision 542: Fonterra Co-operative Group Limited / National Foods Limited* (December 2004); *Decision 529: Colgate Palmolive Company / Campbell Brothers Limited* (July 2004); *Decision 487: Burns Philp & Company Limited / Goodman Fielder Limited* (February 2003);

Section 115 of the DIRA provides:

(1) The Governor-General may, by Order in Council made on the recommendation of the Minister, make regulations that –

(a) require new co-op to supply in New Zealand 1 or more of the following goods or services:

(i) raw milk:

(ii) components of milk:

(iii) products derived from milk:

(iv) transportation, processing, and packaging of milk, components of milk, and products derived from milk; and

(b) prescribe the terms of supply for goods or services regulated under paragraph (a) and specify a price, or a methodology for determining a price, for those goods or services; and

(c) subject to subsection (2), limit the amount of goods or services that new co-op is required to supply, including different limitations for –

(i) different independent processors; and

(ii) different geographical areas; and

(d) allow new co-op to require independent processors to give new co-op advance notice of their requirements for the goods or services to which regulations under paragraph (a) apply, prescribe the maximum period of advance notice that it may require, and authorise new co-op to require buyers to buy the amount of goods or services in an advance notice; and

(e) empower the Commerce Commission to fix a discount rate in calculating the price of goods or services regulated under this section; and

(f) require new co-op and independent processors to provide periodic returns of milksolids collected from dairy farmers; and

(g) authorise new co-op to perform obligations imposed by the regulations through an associated person.

(2) Regulations made under subsection (1) must not require new co-op to supply a total amount of goods or services that exceeds, in the Minister's opinion, 5% of the amount of those goods or services produced by, or supplied to, new co-op, as the case may be.

(3) A regulation under this section is not invalid because it leaves a matter or thing to be decided by a person.

177. This section provides for an extremely broad power to make regulations (by Order in Council) for the supply of goods and services by Fonterra, and for ancillary matters. Regulations are authorised to be made to require the supply by Fonterra of, among other things, "products derived from milk" and the "transportation, processing and packaging of ... products derived from milk". This potentially extends to butter (as a product derived from milk) that is processed and packaged.

178. Section 115 presents a credible threat of mandated supply of processed and packaged butter, but only to the extent of five percent of Fonterra's production. If the regulations related to consumer butter, and based on Fonterra's forecast production in 2005/06, the regulations could mandate that Fonterra supply up to [ ] tonnes per year (or approximately [ ] percent of sales in the domestic market).

179. The Commission considers that the threat of regulation provides a potential backstop in the event that Fonterra unjustifiably refuses to supply butter to the domestic market, although the Commission does not rely on such potential regulation as an imminent prospect.

Co-ordinated Market Power

180. The Applicant submits that the market is not conduce to coordinated market power due to:

- the countervailing power of supermarkets;
- the presence of fringe and niche competitors; and
- low barriers to entry and expansion, including the threat of imports.

181. The Commission considers that the existence of fringe competitors in the wholesale market and the countervailing power of supermarkets would constrain the likelihood of coordination between wholesaler suppliers.

182. The Commission considered whether the removal of a major competitor at the wholesale level, where that competitor held long term contracts ensuring supply at [ ], would enhance the ability of the two butter manufacturers to coordinate to raise prices to the wholesalers up to a margin below import-price parity. The difference between the export-parity price and the import-parity price for an international traded commodity relates to the costs of freight and landing.

183. The Commission considers that the relative dispersion of international commodity prices, and the differences in the costs of packing and transport, would make it difficult to coordinate around a domestic price at import-price parity. In addition, [ ], and the threat of regulation under section 115 of the DIRA, might also constrain the potential for price creep by the butter manufacturers.

184. The Commission considers that the proposed acquisition would not increase the likelihood of co-ordinated market power at the manufacturing or wholesale levels.

Conclusion

185. In conclusion, post-acquisition, Fonterra would own the major brands and be the major supplier of house branded butter. Consequently, all else equal, Fonterra would likely have unilateral power to raise prices for consumer butter. However, there would be a number of other constraints on Fonterra. In particular:

- Westland is an independent source of consumer butter, and it has the capacity and flexibility to enter itself, or support entry or expansion by existing or potential competitors. If Westland diverted its full packing capacity to the domestic market it would constitute [ ] percent of market share. In addition, Westland could expand its packing capacity if the business case warranted, taking into account Westland's policy of diversifying products and markets. [ ].
- The supermarkets would be able to exercise significant countervailing market power over Fonterra, through the threat of sanctions, faciliting entry or expansion by existing or potential competitors, and their operation of the house brand contracts. The supermarkets' countervailing power would be enhanced by the threat of imports for house branded butter.

186. To a lesser extent, Fonterra's exercise of market power would also be constrained by the threat of imports for wholesale supply of branded butter, particular from Australia. In addition, s 115 of the DIRA provides a potential backstop in the event that Fonterra unjustifiably refuses to supply butter to the domestic market, although the Commission does not rely on such potential regulation as an imminent prospect.

187. While none of these factors on its own is determinative, on balance, the combined influence of the first two factors, with the backstop of the second two factors, is considered to impose a competitive constraint on Fonterra post-acquisition such that there is unlikely to be a substantial lessening of competition in the consumer butter market.

National Market for the Wholesale Supply and Distribution of Consumer Yellow Spreads (Excluding Butter)

Existing Competition

Market Shares of Existing Competitors

188. The major participants in the consumer yellow spreads market are: NZDF, Goodman Fielder, Fonterra Brands, Unilever, and Peerless. Goodman Fielder manufactures the margarine house brands for Foodstuffs, and Peerless manufactures the margarine house brands for Progressive Enterprises. Foodstuffs Own Brands Ltd also advised the Commission that it very recently launched a house brand in butter blends. Goodman Fielder is manufacturing and supplying the house branded butter blends under contract.

189. The total size of supermarket sales for the consumer yellow spreads market is approximately [ ] tonnes and is valued at approximately [ ] million, of which approximately [ ] tonnes and [ ] million of sales relates to butter blends. Approximately [ ] percent of consumer yellow spreads are sold through the supermarkets, with the remainder sold in the foodservice and route trade. The Commission considers that supermarket sales are a good proxy for actual market shares.

190. Table 4 outlines the likely impact of the proposed acquisition based on existing competitors' shares of supermarket sales (by volume and value) for the 12 months to July 2005. Fonterra's market share based on supermarket sales volumes would increase from [ ] to [ ] percent, or as a share of supermarket sales values would increase from [ ] to [ ] percent. Goodman Fielder and Unilever would continue to be significant competitors to Fonterra post-acquisition.

191. These market shares fall within the Commission's safe harbours for a three firm concentration ratio above 70 percent, where the market share of the combined entity is less than 20 percent. In this case, the three firm concentration ratio is [ ] percent by volume and [ ] by value, and Fonterra Brands would hold [ ] percent by volume and [ ] percent by value post-acquisition.

Table 4: Impact of acquisition based on existing competitors' shares of supermarket sales for the wholesale supply of consumer yellow spreads (by volume and value) for the 12 months to July 2005.

Participant	Company	Brands	Volume (kgs)	Share %	Value ($)	Share %
Fonterra	Fonterra Brands	Mainland blends	[ ]	[ ]%	[ ]	[ ]%
	Bonlac	Dairy smooth	[ ]	[ ]%	[ ]	[ ]%
Pre-acquisition total			**[ ]**	**[ ]%**	**[ ]**	**[ ]%**
	NZDF	Anchor Country soft	[ ]	[ ]%	[ ]	[ ]%
Post-acquisition total			**[ ]**	**[ ]%**	**[ ]**	**[ ]%**
Rank Group	Goodman Fielder	Meadowlea Butterlea	[ ]	[ ]%	[ ]	[ ]%
		Choice Gold-n Canola Meadowlea Mlea Logicol Mlea Omega Olivani Slimarine Sunrise	[ ]	[ ]%	[ ]	[ ]%
	for Foodstuffs	Pam's Budget Gilmours Chefs Pantry	[ ]	[ ]%	[ ]	[ ]%
Total Rank Group			**[ ]**	**[ ]%**	**[ ]**	**[ ]%**
Unilever		Bertolli Flora Flora Buttery I Can't Believe Miracle Pro-Active Praise regular	[ ]	[ ]%	[ ]	[ ]%
Peerless	for Progressive	Signature Basics	[ ]	[ ]%	[ ]	[ ]%
Others		Bakel Constantia Link Melrose Sunbeam Tableland Ultima Vitalite	[ ]	[ ]%	[ ]	[ ]%
Total			**[ ]**	**100%**	**[ ]**	**100%**

Source: Aztec data provided by the Applicant

192. However, in differentiated product markets, competition could be localised between businesses producing immediately adjacent substitutes and market share might be a poor indicator of the status of competition. The loss of localised competition between two products is likely to be most marked when an acquisition results in the two closest (and perhaps most popular) substitutes being merged.

193. In this case, Fonterra Brands is acquiring the ‘Anchor’ and ‘Country Soft’ brands for butter blends, which are likely to be the closest substitutes to its existing Mainland brands of butter blends. Consequently, the Commission decided to consider the potential for Fonterra Brands to exercise localised unilateral market power as a result of the proposed acquisition.

<u>Analysis of Existing Competition</u>

194. The Applicant’s previous points outlined in respect of the consumer butter market, would also apply to the consumer yellow spreads market, and if anything would be more pronounced. In particular:

- consumers use butter blends and margarine for the same functions (eg both products are predominately used for spreading);
- the rate of product innovation in this market means that any benefits from differentiation at any point in the product chain, unless refreshed, will be diminished over time; and
- there is the potential for imports of butter blends and new entry in the butter blend segment of the market, as evidenced by previous imports of Bonland’s ‘Dairymaid’ butter blends.

195. The Applicant and NZDF/Rank Group provided the Commission with market research data that showed butter blends and premium olive-based margarines were similarly positioned in the market, based on consumer preferences for naturalness, spreadability, and health.

196. The Commission considered the potential for supply-side factors as a means to constrain the potential for localised market power. Supply-side factors that would potentially constrain Fonterra post-acquisition include:

- Foodstuffs recently launched a new butter blend house brand to be manufactured by Goodman Fielder, which is likely to be a close substitute of the butter blend brands. [ ].
- Existing manufacturers of margarines could position their margarines closer to butter blends, through promoting their products’ naturalness or by adding more buttermilk to enhance the buttery taste.
- Approximately [ ] percent of products in the consumer yellow spreads market are imported and these imports include products in the butter blends category. If Fonterra sought to increase the prices of its brands of butter blends post-acquisition, it would likely attract further imports of butter blends.

197. The Commission conducted simulations to derive possible price effects resulting from the acquisition, all else equal.[19] The analysis used supermarket scanner data provided by the Applicant to identify the relationship between the quantity sold of a given brand of butter blends and the price of that brand and others in the market. The predicated price increases generated by the Commission's modelling for the brands of butter blends owned by Fonterra post-acquisition were nominal and not sufficiently material to result in a substantial lessening of competition.

Conclusion

198. The Applicant's acquisition of NZDF's 'Anchor' and 'Country Soft' branded butter blends would result in a small increase in concentration in the consumer yellow spreads market. This market concentration would be within the Commission's safe harbours for a market characterised by a three firm concentration ratio above 70 percent.

199. Despite this relatively low aggregation, given that the market is differentiated, the Commission considered whether the acquisition would result in localised market power for the butter blend brands. The Commission concludes that there would be sufficient existing competition post-acquisition to constrain Fonterra Brands from exercising localised market power. Consequently, the Commission is satisfied that the proposed acquisition is unlikely to substantially lessen competition in the consumer yellow spreads market.

OVERALL CONCLUSION

200. The Commission has considered the probable nature and extent of competition that would exist, subsequent to the proposed acquisition, in the national markets for:

- the wholesale supply and distribution of consumer butter; and
- the wholesale supply and distribution of consumer yellow spreads (excluding butter).

201. The Commission considers that in the counterfactual NZDF would retain its branded butter and spreads business, and continue to be supplied butter both from Fonterra's ingredients business pursuant to the Dairy Products Supply Agreement, and from Westland.

202. In the consumer butter market, Fonterra would hold approximately [ ] percent market share following the proposed acquisition, of which approximately [ ] percent relates to house brands and would be contestable. This is outside the Commission's safe harbour guidelines.

203. The Commission considers that the proposed acquisition would weaken the competitive constraints on Fonterra's ability to exercise unilateral market power. This would occur through the removal of the major branded competitor that held [ ].

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[19] The Commission's simulation model is the same as that used in *Decision 542: Fonterra Co-operative Group Limited / National Foods* (December 2004). The model is described in Appendix A of that Decision.

204. However, there would be a number of other constraints on Fonterra post-acquisition. In particular, in order of importance:

- Westland is an independent source of consumer butter, and it has the capacity and flexibility to enter the market itself, or support entry or expansion by existing or potential competitors by up to [ ] percent market share (by diverting exports). Westland could support higher levels of market share subject to investment in additional packing capacity. [ ].

- Supermarkets would be able to exercise significant countervailing market power over Fonterra, through the threat of sanctions on Fonterra, facilitating entry or expansion by existing or potential competitors, and their operation of house brand contracts.

- The threat of imports of branded consumer butter, particularly from Australia.

- Potentially, the threat of regulation under s 115 of the DIRA to require Fonterra to supply packaged and processed butter up to five percent of its production.

205. While none of these factors on its own is determinative, the Commission on balance considers that the combined influence of the first two factors, with the backstop of the last two factors, is likely to impose a sufficient competitive constraint on Fonterra post-acquisition.

206. In relation to the consumer yellow spreads market (excluding butter), Fonterra would hold approximately [ ] percent of supermarket sales by value following the proposed acquisition. The Commission considers that supermarket sales are a good proxy for market share. This level of aggregation is within the Commission's safe harbour guidelines. The Commission concludes that there would be sufficient existing competition post-acquisition to constrain Fonterra from exercising market power.

207. The Commission is therefore satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in any of the affected markets.

DETERMINATION ON NOTICE OF CLEARANCE

208. Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by Fonterra Co-operative Group Limited, or any one of its wholly-owned subsidiaries, of the branded butter and spreads business of New Zealand Dairy Foods Limited.

Dated this 9th day of November 2005

David Caygill
Division Chair
Commerce Commission

ANNEX ONE

NZDF'S BRANDED AND UNBRANDED BUTTER AND SPREADS BUSINESS

Contracts	Prior to transactions	Main transaction on 31 August 2005 (house brands)	Proposed acquisition (branded butter and spreads)
Supply contract from Fonterra. The 'Dairy Products Supply Agreement' (dated 16 October 2001, amended 30 June 2004).	[ ].	NZDF was acquiring house brand butter from Fonterra for the North Island. This was for approximately [ ] tonnes per annum. On 31 August 2005, NZDF ceased to order house brand products under the Dairy Products Supply Agreement.	NZDF is supplied Anchor and Fernleaf butter from Fonterra for the North Island. This is for approximately [ ] tonnes per annum. Following the acquisition, the Dairy Products Supply Agreement will be amended to [ ].
Supply contract from Westland	NZDF has supply arrangements with Westland for branded and house branded butter in the South Island. These arrangements relate to approximately [ ] tonnes per annum.	The house brand butter contract from Westland for the South Island was assigned to Fonterra Brands on 31 August 2001. This was for approximately [ ] tonnes per annum. The contract is up for renewal on [ ].	NZDF is supplied Anchor and Fernleaf butter from Westland for the South Island. This is for approximately [ ] tonnes per annum. Following the acquisition, the residual of this arrangement will be assigned to Fonterra Brands. This arrangement concludes at the [ ].
Manufacturing contract for blends with Goodman Fielder	Goodman Fielder manufactures NZDF's butter blends under the 'Country Soft' brand.		The Goodman Fielder manufacturing contract for butter blends will be assigned to Fonterra Brands.

Contracts	Prior to transactions	Main transaction on 31 August 2005 (house brands)	Proposed acquisition (branded butter and spreads)
House brand contracts (Pam's, Basics, Signature)	NZDF has the house brand contracts with Foodstuffs and Progressive Enterprises. The Foodstuffs contract is for [ ]. The Foodstuffs contract comes up for renewal in [ ]. This is for approximately [ ] tonnes per annum. The Progressive Enterprises contract is for [ ]. The contract is for approximately [ ] tonnes per annum.	The Foodstuffs and Progressive Enterprise house brand contracts were assigned to Fonterra Brands on 31 August 2005.	
Branded butter contracts (Anchor, Fernleaf, Country Soft)	NZDF supplies Anchor, Fernleaf and Country Soft. [ ] percent is sold through the supermarkets. The quantity of branded butter supplied is approximately [ ] tonnes per annum.		The proposed acquisition is for Fonterra Brands to acquire the Anchor, Fernleaf and Country Soft brands. This is for approximately [ ] tonnes per annum.