

## COMMERCE COMMISSION

### Decision No. 429

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

**MCCAINS FOODS (NZ) LIMITED**

**and**

**HEINZ WATTIE'S LIMITED**

**The Commission:** M N Berry  
P R Rebstock  
P J M Taylor

**Summary of Application:** The acquisition by McCain Foods (NZ) Limited, or any of its interconnected bodies corporate, of the potato and vegetable processing assets and business (excluding the retail business) of Heinz Wattie's Limited at Feilding.

**Determination:** Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition.

**Date of Determination:** 11 May 2001

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BRACKETS**

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## **INTRODUCTION**

1. On 12 April 2001, the Commerce Commission (“the Commission”) registered a notice pursuant to section 66(1) of the Commerce Act 1986 (“the Act”), in which clearance was sought by McCain Foods (NZ) Limited, or any of its interconnected bodies corporate (together “McCains”), for the acquisition of the potato and vegetable processing assets and business (excluding the retail business) of Heinz Wattie’s Limited (“Heinz Watties”) at Feilding.

## **THE PROCEDURES**

2. The notice was registered on 12 April 2001. Section 66(3) of the Act requires the Commission either to clear or to decline to clear a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. The Commission sought an extension. Accordingly, a decision was required by 11 May 2001.
3. In its application, McCains sought confidentiality for specific aspects of the application. A confidentiality order was made in respect of the specific information for a period of 20 working days from the Commission’s determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply to the information.
4. The Commission’s determination is based on an investigation conducted by staff. In the course of its investigation, Commission staff discussed the application with the following parties:
  - Progressive Enterprises
  - Foodstuff (Auckland)
  - Woolworths
  - Mr Chips
  - Fresher Foods
  - Talley Foods
  - Makikihi Foods
  - Potato Growers Federation
  - Retail Merchant Association
  - Burger King
  - Restaurant Brands
  - McDonalds
  - Wendys
  - MAF
  - Alex McDonalds Merchants
  - Wrightsons
  - Simplot
  - Heinz Watties

5. Commission staff have also sought further information from the applicant.

## **THE PARTIES**

### **McCain Foods (NZ) Limited**

6. McCains is a wholly owned subsidiary of Weyville Holdings Limited, a New Zealand resident company, which in turn is owned by McCain Foods Limited, a privately owned Canadian company. The McCain family of Canada, ultimately owns this company.
7. McCains' primary activity is the manufacture of frozen foods, especially "french fries". Globally it supplies around one third of total production. It also manufactures and makes a variety of other frozen food products, including pizza, ready meals, vegetables, juices, and cakes and other desserts.
8. McCains started production in New Zealand in 1990 when it bought New Zealand Alpine Foods Limited, a vegetable processor based in Timaru, and renamed it McCains Foods (NZ) Limited. It has expanded the plant several times since the purchase. It acquired Growers Foods Limited, Hastings, in 1996. Its major brands relevant to this application are McCains, Pict, Valley Farms, and Growers.
9. McCains produces frozen chips from its factory in Timaru, which it uses for supply to New Zealand and export markets. McCains also imports speciality potato products (hash-browns, seasoned chips, and pompoms), frozen meals, and pizzas from associated companies in Australia.

### **Heinz Watties**

10. Heinz Watties is owned ultimately by HJ Heinz Company, a global food products manufacturer based in Pennsylvania. Its major product groups include ketchups, condiments and sauces, frozen food products, convenience meals, infant foods, tuna and petfood.
11. Heinz Watties processes potatoes at its plant in Feilding. From this plant it supplies a range of fries and speciality potato products (hash browns, potato pom poms, medallions, wedges etc). It supplies to the retail outlets (principally supermarkets) and to the food service industry. Its major brands used in NZ relevant to this application are Watties, Oak, and Jim Bull.

### **Other Parties**

#### *Talley Foods*

12. Talley Foods ("Talleys") is a family owned business operating out of Motueka. Talleys' main interest is in fisheries. It holds a significant amount of quota and has a 50% share in a joint venture, Amaltal Corporation, which is a deep sea fishing operation. Talleys also owns and operates mussel plants, cool-stores, freezer trucks and specialist fish processing plants. Talleys has also been involved in vegetable processing since 1978 and in 1995 opened an ice cream processing plant.
13. In 1997 Talleys built a processing plant in Fairton, Ashburton. This plant is used to process peas, carrots, and potatoes. These are supplied to the retail and export markets. Talleys currently produces around [ ] tonnes of frozen chips annually at its Fairton

plant, although has capacity for around [ ]. [ ].

#### *Mr Chips*

14. Mr Chips is a publicly-listed company based in East Tamaki, Auckland. Mr Chips has produced frozen/chilled chips for around twenty years. It mainly supplies to food service outlets such as restaurants and takeaways. It also exports around [ ] of its produce. Its annual production is around [ ] tonnes.

#### *Fresher Foods*

15. Fresher Foods (“Fresher”) is a privately-owned company based in East Tamaki, Auckland. Fresher produces frozen and chilled chips, as well as its own brand of potato crisps. It mainly supplies the food service outlets, but also supplies a small amount to supermarkets. Its annual production is around [ ] tonnes.

## **MARKET DEFINITION**

### **Introduction**

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

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

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

18. Relevant principles relating to market definition are set out in *Telecom Corporation of New Zealand Ltd v Commerce Commission*,<sup>1</sup> *Commerce Commission v Carter Holt Harvey Building Products Limited*,<sup>2</sup> and in the Commission’s *Business Acquisition Guidelines* (“the Guidelines”).<sup>3</sup> A brief outline of the principles follow.

19. Markets are defined in relation to three dimensions, namely product type, geographical extent, and functional level. A market encompasses products that are close substitutes in the eyes of buyers, and excludes all other products. The boundaries of the product and geographical markets are identified by considering the extent to which buyers are able to substitute other products, or across geographical regions, when they are given the incentive to do so by a change in the relative prices of the products concerned. A market is the smallest area of product and geographic space in which all such substitution possibilities are encompassed. It is in this space that a hypothetical, profit maximising, monopoly supplier of the defined product could exert market power, because buyers, facing a rise in price, would have no close substitutes to which to turn.

20. A properly defined market includes products which are regarded by buyers or sellers as being not too different (‘product’ dimension), and not too far away (‘geographical’

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<sup>1</sup> (1991) 4 TCLR 473.

<sup>2</sup> Williams J, 18 April 2000, HC, yet to be reported.

<sup>3</sup> Commerce Commission, *Business Acquisition Guidelines*, 1999, pp. 11-16.

dimension), and are therefore products over which the hypothetical monopolist would need to exercise control in order for it to be able to exert market power. A market defined in these terms is one within which a hypothetical monopolist would be in a position to impose, at the least, a “small yet significant and non-transitory increase in price” (the “*ssnip*” test), assuming that other terms of sale remain unchanged.

21. Markets are also defined in relation to functional level. Typically, the production, distribution, and sale of products takes place through a series of stages, which may be visualised as being arranged vertically, with markets intervening between suppliers at one vertical stage and buyers at the next. Hence, the functional market level affected by the application has to be determined as part of the market definition. For example, that between manufacturers and wholesalers might be called the “manufacturing market”, while that between wholesalers and retailers is usually known as the “wholesaling market”.

### **The Relevant Markets**

22. The applicant has argued that there are three markets that are relevant to the proposed acquisition. These are:
  - the markets for the supply/acquisition of raw potatoes in New Zealand (“the raw potato markets”);
  - the market for the manufacture and wholesale supply of frozen/chilled potato products to “food service” businesses in New Zealand (“the food service market”); and
  - the market for the manufacture and wholesale supply of frozen/chilled potato products to retail businesses in New Zealand (“the retail market”).

### **Product Dimension**

#### *Raw Potatoes*

23. The Commission agrees with the applicant that the most appropriate product market is that for the supply of raw potatoes. It is recognised that, from a demand point of view, the market could be defined to specify the actual potato varieties used in manufacturing frozen and chilled chips (those being Russet Burbank, Shepody, and Ranger Burbank), but the Commission believes this would be an unnecessarily narrow approach. It is noted that on the supply side, growers are likely to be able to switch between varieties without difficulty.

#### *Frozen/Chilled Potato Products for supply to the “retail” market*

24. The applicant proposes that the product market be defined as the market for “frozen/chilled potato products”, including french fries as well as “speciality” and seasoned products such as wedges, hash-browns, and potato pompoms. In its discussion on product market definition, the applicant also notes that there would be some aggregation in terms of other vegetables, in particular frozen peas and carrots. However on the basis of a relatively low market share in these products, the applicant does not consider these product markets to require further analysis.
25. Heinz Watties manufactures specialities at its Feilding plant from the off-cuts from producing its standard frozen chips. McCains imports speciality potato products from a

plant in Tasmania owned by its parent company. Seasoned varieties include seasoned chips and wedges.

26. The Commission agrees with the applicant's view relating to the retail market and vegetable markets. The various potato products are considered to be close enough substitutes to justify inclusion in a single market. As a matter of terminology, because virtually all of the sales in the retail market are through supermarkets, the Commission uses "supermarket" and "retail" interchangeably.

*Frozen/Chilled Potato Products for supply to the "food services" market*

27. The applicant's definition of food service encompasses all types of eateries that purchase frozen or chilled chips for cooking and supplying to consumers. This includes restaurants, takeaway bars, quick service restaurants ("QSRs"), cafes, and bars. The demand and supply characteristics of this market appear to be quite different from those of the market for potato products supplied to the retail sector. For example, branding is generally less important in the food service industry because the ultimate consumer receives the good after it has been cooked and is unaware of the brand. The product is also supplied in bulk form, typically 5-10kg bags, whereas product sold through the retail distribution channels is in smaller packages (typically up to 1kg).
28. Discussions with a number of purchasers of potato products indicate that a general food service market is too broad. In particular, the general view of the industry was that supply to QSRs (including McDonalds, Burger King, KFC, and Wendys) constituted a separate market. This separation is based on the strict product specifications and quality standards demanded by QSRs. For example, the Information Memorandum on the possible sale of Heinz Watties frozen food assets at Feilding refers to the "exacting requirements" of QSRs, as distinct from the non-QSR or food service market for frozen potato and vegetable products.
29. These requirements relate to all aspects of the production and distribution of the french fries including:
- Type of potato used (the Russet Burbank);
  - Size of chip, including setting guidelines on percentage that must be within a certain range;
  - Quality of chip, including guidelines on number of defects, blemishes, and broken chips;
  - Cleanliness standards of factory;
  - Technology used within the factory;
  - Temperature control within the factory and during delivery.
30. The specifications are used to ensure that the QSRs sell a standardised chip throughout the world. The QSRs are obliged to abide by these specifications under their franchise agreements. Failing to produce a standardised chip meeting the specifications could result in having their franchise revoked. The master franchise holder must approve a supplier. The implication is that a potential supplier requires certain equipment beyond what is required for general food service supply.
31. Branding is also likely to be more important for QSRs compared to general food service. The QSRs must be confident a supplier is able to maintain a consistent supply. QSRs will

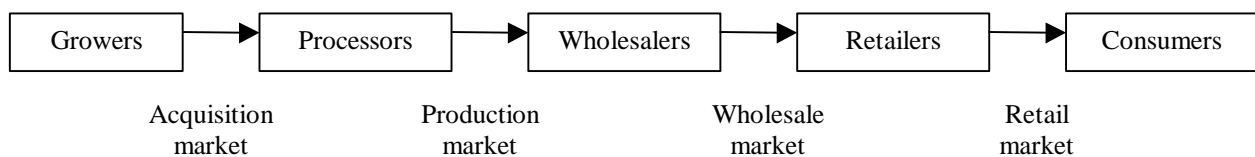
have a lot more confidence in a proven supplier such as Heinz Watties or McCains, compared to a new entrant.

32. Therefore, from a demand-side perspective, the QSRs are restricted in what chips they can purchase. Using a supply-side approach, for those not currently supplying QSRs, it would take a significant investment in plant to be in a position to supply. Suppliers such as Mr Chips and Fresher could not quickly and economically alter their production, such that their inclusion in the market is justified using a supply-side approach.
33. The Commission, therefore, is of the view that the food service market should be delineated into supply to QSRs and supply to non-QSRs (which will be referred to as “the food service market”). Although a wider market could be argued, the Commission has taken this conservative approach on the basis that if there are no dominance concerns in the narrower market there is not likely to be any dominance concerns in the wider market (that being for food service).

### Functional Dimension

34. The production, distribution, and sale of potato products proceeds through a series of functional levels, as summarised in the following diagram:

**Figure 1: Function Levels for Potato Products**



35. The markets proposed by the applicant indicate that there are two functional levels that are relevant to the application, namely the acquisition market with respect to raw potatoes, and the market for the manufacture and wholesale supply of frozen/chilled potato products. The applicant’s discussion on functional levels also distinguishes the “food service” market from the “retail” market on the basis that different requirements on the demand side justify such a distinction. However, this appears to relate to the type of product being supplied rather than the different levels in the chain of production and distribution. This distinction is therefore considered in the above discussion on the product dimension.

#### *The Market for the Acquisition of Raw Potatoes*

36. The relevant functional level in respect of raw potatoes is the acquisition market in which processors purchase potatoes from growers. As the proposed acquisition brings together two major purchasers of raw potatoes, this procurement market may be of interest if there is any aggregation leading to monopsony power.

#### *The Market for the Production of Frozen/Chilled Potato Products*

37. The applicant has proposed a functional definition encompassing the manufacture and wholesale supply of frozen/chilled potato products. The manufacturing or production



level is clearly relevant, as the proposed acquisition will result in aggregation of processing facilities. However, it may be helpful to separate the applicant's definition of a manufacturing and wholesale supply market. Although in some cases processors do organise delivery to customers, distribution also takes place through regional distributors who in turn supply smaller outlets such as restaurants.

38. In particular, Heinz Watties will continue to supply supermarkets through the co-packing arrangements with McCains. As Heinz Watties will continue this wholesaling function post-acquisition, it may be useful to define the wholesale function as being separate from the production level.
39. Such a distinction will also avoid any confusion arising from the applicant's claim that there will be no aggregation in "manufacturing and wholesale supply" to the retail (supermarket) market (paragraph 12.11). This claim is made in relation to market share figures which appear to relate to retail sales by supermarkets (see the applicant's table 2 which is sourced from AC Nielson scan data). Although these retail supply shares may remain unchanged as a result of Heinz Watties continued presence as a supplier to supermarkets, there will be aggregation at the manufacturing level.
40. It is therefore proposed that a distinction be made between the manufacturing and the wholesale supply functions. Given that there does not appear to be any aggregation at the wholesale level, it is the manufacturing market that is relevant in analysing the competitive implications of the proposed acquisition.

## **Geographic Dimension**

### *The Regional Markets for the Acquisition of Raw Potatoes*

41. The Commission agrees with the applicant that the geographic extent of the raw potato market is likely to be regional. Raw potatoes have a much lower value than the finished product. In addition, the ratio of kilograms of potatoes needed for every kilogram of finished product is roughly 2:1. These two factors mean that it is not economical to transport potatoes large distances. Suppliers generally source potatoes from immediate areas. The main growing areas are South Canterbury, Hawkes Bay, and the Manawatu. It could be argued that the geographic market should extend to include the entire North Island and South Island, respectively, but given that McCains produces only in the South Island and Heinz Watties in the North Island, it will make no material difference.
42. Given that the McCains and Heinz Watties operate in different geographic markets for the acquisition of raw potatoes there will not be any aggregation. If dominance exists in the acquisition of raw potatoes it will merely be transferred. For this reason, markets relating to raw potatoes will not be considered further by the Commission.

### *The National Market for the Production of Frozen/Chilled Potato Products*

43. The Commission agrees with the applicant that the geographic extent of the production markets is national. Suppliers typically operate from one factory and supply throughout New Zealand. Although the different locations of the suppliers allows them a small degree of pricing discretion in their immediate areas (due to freight costs), it is not significant.

## **Summary**

44. It is proposed that the following markets be adopted:

- the national market for the production of frozen French fries for supply to QSRs (“the QSR market”);
  - the national market for the production of frozen/chilled potato products for supply to other food service outlets (“the food service market”);
  - the national market for the production of frozen potato products for supply to supermarkets (“the retail market”).
45. As noted above in paragraph 42, there is no aggregation in the market for the acquisition of raw potatoes for processing and as such will not be considered further.

## COMPETITION ANALYSIS

### Introduction

46. The competition analysis assesses competition in the relevant markets in order to determine whether the proposed acquisition would not result, or would not be likely to result, in an acquisition or strengthening of **dominance**.
47. Competition in a market is a broad concept. It is defined in section 3(1) of the Commerce Act as meaning “workable or effective competition”. In referring to this definition the Court of Appeal said:<sup>4</sup>

“That encompasses a market framework which participants may enter and in which they may engage in rivalrous behaviour with the expectation of deriving advantage from greater efficiency.”

48. Section 3(9) of the Commerce Act states:

“For the purposes of sections 47 and 48 of this Act, a person has ... a dominant position in a market if that person as a supplier ... of goods and services, is or are in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market and for the purposes of determining whether a person is ... in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in a market regard shall be had to-

- (a) The share of the market, the technical knowledge, the access to materials or capital of that person or those persons;
- (b) The extent to which that person is ... constrained by the conduct of competitors or potential competitors in that market;
- (c) The extent to which that person is ... constrained by the conduct of suppliers or acquirers of goods or services in that market.”

### *The Dominance Test*

49. Section 47(1) of the Commerce Act prohibits certain business acquisitions:

“No person shall acquire assets of a business or shares if, as a result of the acquisition, -

- (a) That person or another person would be, or would be likely to be, in a dominant position in a market; or
- (b) That person’s or another person’s dominant position in a market would be, or would be likely to be, strengthened.”

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<sup>4</sup> *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554, 564-565

50. The test for dominance has been considered by the High Court. McGechan J stated:<sup>5</sup>

“The test for ‘dominance’ is not a matter of prevailing economic theory, to be identified outside the statute.”

...

“Dominance includes a qualitative assessment of market power. It involves more than ‘high’ market power; more than mere ability to behave ‘largely’ independently of competitors; and more than power to effect ‘appreciable’ changes in terms of trading. It involves a *high degree of market control*.”

51. Both McGechan J and the Court of Appeal, which approved this test,<sup>6</sup> stated that a lower standard than “a high degree of market control” was unacceptable.<sup>7</sup> The Commission has acknowledged this test:<sup>8</sup>

“A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint by competitor or customer reaction.”

52. The Commission’s *Business Acquisitions Guidelines* state:

“A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint by competitor {or} customer reaction.”

...

“A person in a dominant position will be able to initiate and maintain an appreciable increase in price or reduction in supply, quality or degree of innovation, without suffering an adverse impact on profitability in the short term or long term. The Commission notes that it is not necessary to believe that a person will act in such a manner to establish that it is in a dominant position, it is sufficient for it to have that ability.” (p21)

53. The role of the Commission in respect of an application for clearance of a business acquisition is prescribed by the Commerce Act. Where the Commission is satisfied that the proposed acquisition would not result, or would not be likely to result, in an acquisition or strengthening of a dominant position in a market, the Commission must give a clearance. Where the Commission is not satisfied, clearance is declined.

54. The Commission applies the dominance test in the following competition analysis.

## **The National Market for the Production of Frozen French Fries for Supply to QSRs**

### *Market Concentration*

55. An examination of concentration in a market provides an indication of whether a merged firm may or may not be constrained by others participating in the market, and thus the extent to which it may be able to exercise market power.

56. The *Business Acquisitions Guidelines* specify certain “safe harbours” which can be used to assess the likely impact of a merger in terms of s 47 of the Act -

“In the Commission’s view, a dominant position in a market is generally unlikely to be created or strengthened where, after the proposed acquisition, either of the following situations exist:

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<sup>5</sup> *Commerce Commission v Port Nelson Ltd* (1995) 5 NZBLC 103,762 103,787 (HC)

<sup>6</sup> *Commerce Commission v Port Nelson Ltd* (1996) 5 NZBLC 104,142 104,161 (CA)

<sup>7</sup> *Commerce Commission v Port Nelson Ltd* (1995) 5 NZBLC 103,762 103,787 (HC)

and *Commerce Commission v Port Nelson Ltd* (1996) 5 NZBLC 104,142 104,161 (CA)

<sup>8</sup> *Business Acquisition Guidelines*, Section 7

the merged entity (including any interconnected or associated persons) has less than in the order of a 40% share of the relevant market;

the merged entity (including any interconnected or associated persons) has less than in the order of a 60% share of the relevant market and faces competition from at least one other market participant having no less than in the order of a 15% market share.” (p 17)

57. These safe harbours recognise that both absolute levels of market share and the distribution of market shares between the merged firm and its rivals is relevant in considering the extent to which the rivals are able to provide a constraint over the merged firm. The Guidelines went on to state that:

“Except in unusual circumstances, the Commission will not seek to intervene in business acquisitions which, given appropriate delineation of the relevant market and measurement of shares, fall within these safe harbours.”

58. Although, in general, the higher the market share held by the merged firm, the greater the probability that dominance will be acquired or strengthened (as proscribed by s 47 of the Act), market share alone is not sufficient to establish a dominant position in a market. Other factors intrinsic to the market structure, such as the extent of rivalry within the market and constraints provided through market entry, also typically need to be considered and assessed.

59. Market shares have been assessed in table 1 below. Market share has been estimated on the basis of tonnage supplied to New Zealand QSRs. It is recognised that the Commission would normally would include production for export in the volume figures. However, the Commission has taken a conservative approach and left out exports, in order to aid the analysis. For example, both Talleys and McCains produce significant amounts of French Fries for export. However, McCains supplies to the domestic market, whereas Talleys does not. The same approach to assessing market share will be used for the food service and retail markets.

**Table 1:**

**Estimated Market Share for the National Market for the Production of Frozen French Fries for Supply to New Zealand QSRs**

<b>Firm</b>	<b>Volume (tonnes)</b>	<b>Estimated Market Share (%)</b>
Heinz Watties	[ ]	[ ]
McCains	[ ]	[ ]
<i>Total</i>	[ ]	100

60. Currently, the only suppliers to the QSR chains are Heinz Watties and McCains. The market share will therefore be 100%. However, as mentioned above, market share is but one indicator of market power and other factors must be considered before conclusions are reached.

*Potential Competitors*

61. Given the structure of the market, the Commission has considered the possibility of new entry carefully. The Commission has had to assess whether a potential competitor could

enter the market if the merged entity were to impose a *ssnip*. An assessment of the conditions and barriers to entry is considered below.

### *Conditions/Barriers to Entry/Expansion*

#### Capital Investment

62. Greenfields entry is likely to cost at least [ ] and possibly as much as [ ]. The process of manufacturing frozen chips is capital intensive involving the following stages: storage, steam peeling, blemish spotting, warming, cutting, sorting, blanching, drying, frying, freezing, and packing. Generally, the entire process is automated, with each step requiring a separate machine.
63. The Commission is of the view that *de novo* entry to this market is likely to be risky. Given the few number of contracts, a new entrant basing its entry on one or two large contracts would leave itself exposed. A more realistic avenue of entry is by first entering the food service market, and building up a reasonable base volume before entering the QSR market. On this basis, the Commission believes entry to the QSR market is more likely to come from current suppliers to the food service or retail market.
64. There would appear to be a good second-hand market for machinery so obtaining a given piece of machinery is not difficult. However, expanding an operation with so many stages can be problematic. To increase overall capacity the firm must ensure each stage can handle the higher volumes, otherwise bottlenecks will occur. Therefore, expanding overall capacity may involve the purchase of several machines.
65. At present there are three producers of significance that could be classed as potential or near entrants. Those are Mr Chips, Fresher Foods, and Talleys who all operate in the national food service market. Each of these firms have the necessary capacity to enter into a QSR contract, although it is likely capacity currently being used for supply to the food service market would have to be diverted.
66. As indicated earlier, in general these potential entrants would have to make significant investments to their plant to enable them to supply to QSRs. For the identified potential competitors, accurate figures are not known for the investment that would be required. [ ] has advised that the cost for it would be significant, and in general, prohibitive. However, as noted in paragraph 13, Talleys is already making frozen French Fries for the QSR export market so it is a near entrant in the sense that it could divert export production or utilise spare capacity. Talleys has the necessary plant and equipment in place so would not require further investment. For Talleys, therefore, capital is not likely to be a barrier to entry into this market.

#### Increasing Supply of Raw Potatoes

67. Market participants have identified sourcing raw potatoes as a limiting factor in expanding volumes. Potatoes cannot be imported due to MAF regulations.<sup>9</sup> Potato processors contract independents to grow potatoes for them. Increasing the supply of potatoes can involve a significant time lag.
68. At present, the potato supply relationship is as follows:
  - Potato processors assess their likely requirements for seed in the coming year

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<sup>9</sup> Potatoes are understood to harbour a lot of diseases so MAF regulations does not allow importation. Tubers may be imported but become subject to quarantine testing. The symptoms of some diseases can take up to two years to appear so the goods must be quarantine for at least this amount of time.

- Processors contract a merchant to cultivate the seed
  - The cultivator supplies the seed to the processor
  - The processor supplies the seed to contracted grower
69. Cultivation of seed can take 1-2 years. From there, the potato takes around 150 days to grow. There can be a significant time lag for large volume changes in supply of raw potatoes.
70. Although increasing overall supply of raw potatoes can take some time, new entrants can solve the immediate problem by managing potato stocks. For example, a processor may divert Russet Burbanks currently being used for the food service or retail market for use in chips for the QSR market. Because there is not such an emphasis on consistency for the food service market, more common types of potatoes can be used for its supply until new Russet Burbank seed stock is available.
71. Processors can also increase flexibility by building potato storage facilities. Talleys, for example, stores around [ ] tonnes of Russet Burbank after the harvesting period is over. It holds this stock until later in the year when it can make more accurate decisions on what stock is required to meet demand. Similarly, McCains has around [ ] tonnes of storage on site which allows it to process Russet Burbank all year around.
72. Therefore, within the relevant timeframes, Talleys and others can overcome the problem of increasing their raw potato supply.

#### *De Novo Entry*

73. As mentioned earlier, the Commission does not believe the threat of *de novo* entry would be likely to constrain McCains following the acquisition. The capital cost involved is very high and could be severely under-utilised, given the excess capacity currently in the market. The risk of establishing a new plant would therefore be high.
74. *De novo* entry may not be timely either (that is, within two years) due to time lags in receiving potato seed. For example, [ ] has advised that building up a seed stock of around 500 tonnes of seed (which converts to around 10000 tonne of raw potatoes, and around 5000 tonnes of frozen chips) would take around 2 years.

#### *Potential Entrants*

75. As noted above, new entry is are most likely to be a current supplier in the food service market. These are Mr Chips, Fresher Foods, and Talleys.
76. Mr Chips is a publicly listed company based in Auckland. Mr Chips has advised the Commission that [ ] Second, taking on the QSR contract would be risky, as it would account for a large portion of its total volume. If it were to lose the contract, its volumes would be substantially reduced and its investments mostly sunk.
77. Fresher Foods (“Fresher”) is a privately owned company based in Auckland. Fresher would [ ]. When spoken to by Commission staff it indicated it was [ ]. It also indicated [ ] but, as with Mr Chips, would leave itself exposed by having such a large proportion of its sales based on one or two contracts.

78. Although Mr Chips and Fresher are potential entrants, the Commission recognises they face significant barriers in entering the market. The Commission is doubtful whether these players would be a constraint on McCains if the proposed acquisition goes ahead.
79. Talleys could be classed as a near entrant. Talleys is a privately owned company based in Motueka. Its main business is in fisheries although it also has extensive operations in frozen vegetables. Its potato processing plant is in Fairton (South Canterbury). This potato processing plant was built in 1997.
80. Talleys has a small presence in the food service and retail markets. It mainly processes chips for export to Australia and Asia. Among its overseas customers are various McDonalds in the Philippines. Given that McDonalds specifications are essentially the same throughout the world, Talleys is able to supply McDonalds and other QSRs in New Zealand. It, therefore, does not face the entry barriers that Mr Chips and Fresher Foods face. Talleys has around [ ] tonnes excess capacity with which it could service one or more of the QSR contracts. Talleys has advised the Commission [ ].
81. In addition, Talleys is a large company with a diversified portfolio. It is a better position to take on the risk of a QSR contract than (say) Mr Chips or Fresher Foods whose business is completely or predominantly around frozen/chilled chips. It is likely to provide a reasonable alternative to McCains.
82. The Commission has considered the possibility of imports supplying the market. Although importing has occurred on isolated occasions in the past, market participants were generally of the view that importing french fries is not cost effective. Frozen chips have a reasonably high freight/value ratio. Current exchange rates also make importation unlikely.
83. Importation may be possible if the exchange rate were to improve and a buyer were to enter into a long-term bulk agreement with an Australian supplier. However, given the uncertainty of the exchange rate, the Commission will not rely on the possibility of imports in providing a constraint.

#### *Countervailing Power*

84. The QSRs are likely to have some degree of countervailing power. McDonalds has advised that it has systems in place that benchmark its suppliers' prices with others throughout the world. If prices are too high, it can seek global remedies that would make a *ssnip* unprofitable for McCains.
85. Burger King, Restaurant Brands, and Wendys are not likely to have such a degree of countervailing power. Their global structures are such that purchasing is regionalised. They are not likely to be able to seek the same global remedies from their parent companies as McDonalds.

#### *Conclusion*

86. The Commission recognises that there are only a few strong candidates for new entry and there are some entry barriers. However, the Commission notes the following points:
- Talleys represents a strong potential entrant; it currently meets specifications (so does not face the entry barriers), has [ ], and is a strong company with diversified interests (and hence is in a better position than others to take on some risk);

- Some countervailing power exists with QSRs.

87. The Commission is therefore satisfied that the acquisition would not result, or be likely to result, in any person acquiring or strengthening a dominant position in this market.

### **The National Market for the Production of Frozen/Chilled Potato Products for Supply to the Food Service Market**

88. Market share for the various competitors in the market have been assessed in Table 2 below. These figures have been assessed through consultation with the various parties.

**Table 2:  
Estimated Market Share for the National Market for the Production of Frozen/Chilled  
Potato Products for Supply to the Food Service Market**

<b>Firm</b>	<b>Volume supplied (tonnes)</b>	<b>Market Share (%)</b>
Heinz Watties	[ ]	[ ]
McCains	[ ]	[ ]
<i>Sub-Total</i>	[ ]	[ ]
Mr Chips	[ ]	[ ]
Fresher	[ ]	[ ]
Talleys	[ ]	[ ]
Makikihi	[ ]	[ ]
<i>Total</i>	[ ]	100

89. Market share of the combined entity is likely to be around [ ]%. The next biggest competitor is Mr Chips with a market share of around [ ]%, followed by Fresher Foods with around [ ]%. Talleys and Makikihi are relatively small competitors in this market. No provision has been made for self-manufacture because there is no reliable information available with which to estimate its volume and there are doubts whether it should be included in the market.

#### *Current Competitors*

90. Unlike the QSR market, there is no such emphasis on meeting exacting specifications. Obviously, a product must be reasonably priced for its quality. However, there is a far wider product space in which a firm can position their product. The firm can set its own specifications based on what equipment it has at its disposal. In addition, firms can increase raw potato supply more easily because there are no restrictions on what varieties of potatoes they can use.

91. Mr Chips is likely to be McCains main competitor in the market. Mr Chips is based in Auckland and supplies throughout New Zealand. As well as supplying the New Zealand market, Mr Chips exports around [ ] tonnes annually. Fresher is likely to be the next biggest competitor. It is also based in Auckland and supplies mainly to the North Island with some presence in the South Island. Both of these players have been in the market for some time and are likely to provide strong competitive constraint. [ ] has significant excess capacity, and has advised the Commission it could increase supply without difficulty.

92. Makikihi is based in Waimate in the South Island and mainly supplies to its immediate surrounding areas. Makikihi is understood to [ ]



] Talleys is also based in the South Island. Currently it only has a small presence in the market but could increase its supply without difficulty.

93. These competitors are likely to provide strong constraint on McCains.

*Potential Competitors*

94. Barriers to entry are similar to those for the QSR market although not as extreme. Entry into this market can be implemented on a much smaller scale with minimal equipment. There is no minimum volume or standard to meet such as in the QSR market. A new entrant can start off on a small scale supplying restaurants and takeaways in its immediate surrounding area, and grow from there. The firm can position its product at the budget end of the market until it is sufficiently resourced to purchase equipment such as blemish spotters and sorters.

*Conclusion*

95. The Commission notes the following points:

- The strength of current competitors and their ability to expand are likely to provide strong constraint to McCains;
- The potential for new entry is also likely to provide some constraint.

96. The Commission is therefore satisfied that the acquisition will not result, or be likely to result, in any person acquiring or strengthening a dominant position in this market.

**The National Market for the Production of Frozen Potato Products for Supply to Supermarkets**

97. Market share has been assessed in table 3 below. The production volumes have been derived from the AC Neilson data. In the table Heinz Watties has been referred as “Heinz Watties production”, which reflects the total contribution it makes to the market at the production level and distinguishes it from its presence in the retail level of the market (which will remain unchanged post-acquisition).

**Table 3:  
Estimated Market Share for the National Market for the Production of Frozen  
Potato Products for Supply to Supermarkets**

Firm	Volume (tonnes)	Market Share (%)
McCains	[ ]	[ ]
Heinz Watties production (incl house brands)	[ ]	[ ]
<i>Sub-total</i>	[ ]	[ ]
Talleys	[ ]	[ ]
Other Private Label	[ ]	[ ]
Fresher	[ ]	[ ]
Others	[ ]	[ ]
<i>Total</i>	[ ]	100

98. Following the acquisition McCains will produce around [ ]% of the product supplied to this market. Although this would appear to be high, the actual effect on the market must be considered.

#### *Co-Packing Arrangement*

99. Heinz Watties intends to retain its brand at the retail level. The acquisition of the Feilding plant is subject to a co-packing agreement whereby the purchaser (McCains) will continue to produce and pack frozen chips and vegetables for Heinz Watties. Heinz Watties will act as a wholesaler of its product. In theory, if the co-packing arrangement enables Heinz Watties to source goods at a competitive price at the production level, competitive pricing should remain in downstream markets.

100. The Commission has reviewed the co-packing agreement. Key provisions include the following:

- [

]

101. [ ] It believes competition will be maintained in the retail sector of the market.

102. The initial co-packing agreement goes through to [ ], with extension clauses that potentially take the agreement out to [ ]. Consideration was given to the likely market structure once the co-packing agreement expires. Heinz Watties has advised that if it were unhappy with the arrangement, it would have the following options:

- Seek supply from another domestic potato processor;
- Import from Australia; or
- Import from United States (where associated companies still retain some manufacturing capabilities).

#### *Countervailing Power*

103. Heinz Watties is likely to retain significant countervailing power through the strength of its brand. The brand currently occupies a significant amount of product space in the retail market. If it were to be withdrawn McCains would be likely to lose a significant amount of volume at the production level. It may recoup some of this volume by gaining market share itself, but it is more likely the supermarkets will promote another competitor instead. Thus Heinz Watties could use the threat of withdrawal as a form of countervailing power. In essence, while market power is usually derived from the production level of markets, in this case a significant degree of power comes from the brand at the retail level.

104. At the end of its co-packing agreement, Heinz Watties will have the option of putting its production requirements out to tender or renegotiating with another supplier, such as Talleys, Fresher, or Chips. Such a contract would represent a opportunity for a smaller player or a near entrant to enter the market. The consistent volumes would give a smaller player the confidence to invest in new machinery.

### *Current Competitors*

105. Talleys will be the next biggest competitor in the market. Its own brand has around [ ] of the market. Its total contribution to the market is likely to be higher, as it also supplies product for a number of supermarket house brands. Heinz Watties was the other major supplier of house brand product.
106. Under the proposed acquisition McCains will take over the production of the house brands that Heinz Watties supplied. Some supermarkets will thus be affected by the acquisition. However, given McCains does not generally tender for the supermarket house brand business, Heinz Watties' position in the market has essentially been transferred to McCains.
107. It could be argued that the effect of the acquisition will remove a potential supplier of supermarket house brands. However Talleys will continue to offer a competitive constraint. It already supplies frozen chips for house brands. It has [ ]so would be in a position to increase supply to supermarkets should they wish to switch. Talleys also has a reasonably strong brand and is able to stand in the market in its own right.
108. Fresher Chips currently supplies a small amount into supermarkets. [ ]. It supplies a small amount of product for house brands. It has the ability to increase its supply into this market.

### *Potential Entrants*

109. Mr Chips could be classed as a potential competitor to the market. It has previously attempted entry into the retail market but was not successful. Comment was made from industry parties that having complementary frozen goods (such as peas and corn) is advantageous because it enables suppliers to "bundle" goods to retailers. Mr Chips does not supply any frozen processed vegetables apart from potatoes. However, bundling is not necessarily anti-competitive. In this case, the supermarkets would only accept the bundle if the products were at a cheaper price than purchased separately.
110. The presence of house brands in this market lowers barriers by removing the need for an entrant to establish its own brand. As such, there is nothing to prevent Mr Chips from supplying house brands if the opportunity arose.

### *Conclusion*

111. On the basis of the co-packing arrangement there should not be significant changes in the market. This co-packing arrangement will ensure Heinz Watties will remain competitive at the retail level of the market during the term of the contract. At the end of the contract Heinz Watties will still retain a strong degree of countervailing power, through the strength of its brand and its ability to source from other producers.
112. The Commission is, therefore, satisfied that the acquisition would not result, or be likely to result, in any person acquiring or strengthening dominance in this market.

### **OVERALL CONCLUSION**

113. The Commission has considered the likely effects of the acquisition in the following markets:
- the national market for the production of frozen French fries for supply to QSRs;

- the national market for the production of frozen/chilled potato products for supply to other food service outlets; and,
- the national market for the production of frozen potato products for supply to supermarkets.

114. On balance, the Commission is satisfied there are sufficient constraints in each of the relevant markets such that dominance will not be acquired or strengthened.

115. Having regard to the various elements of section 3(9) of the Act, and all other relevant factors, the Commission concludes that it is satisfied that the proposal would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in any market.

## **DETERMINATION ON NOTICE OF CLEARANCE**

116. Accordingly, pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by McCain Foods (NZ) Limited, or any of its interconnected bodies corporate, of the potato and vegetable processing assets and business (excluding the retail business) of Heinz Watties Limited at Feilding.

Dated this 11<sup>th</sup> day of May 2001

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M N Berry  
Deputy Chair