COMMERCE ACT 1986: BUSINESS ACQUISITION

17 November 2005

SECTION 66: NOTICE SEEKING CLEARANCE

The Registrar
Business Acquisitions and Authorisations
Commerce Commission
P0 Box 2351
Wellington

Pursuant to section 66(1) of the Commerce Act 1986 notice is hereby given seeking *clearance* of a proposed business acquisition.

EXECUTIVE SUMMARY

A Fonterra Co-operative Group Limited *(Fonterra* or *the Applicant)* seeks clearance for the acquisition of Kapiti Fine Foods Limited *(Kapiti)* and United Milk Limited *(UML)* from Foodstuffs (Wellington) Co-operative Society Limited *(Foodstuffs LNI)*.

B The acquisition will result in minor aggregation of market share in the markets for the acquisition of raw milk, the wholesale supply of town milk, the wholesale supply of cheese, and the take home and novelty/scoop ice cream markets.

C But, the impact of the acquisition on effective competition in those markets will be minimal. Each is characterised by low barriers to entry, a variety of competitors, and dynamic product innovation. With cheese and ice cream, aggregation will only occur in the specialty segments of those markets, where competition is more about new products than price.

D Further, the transaction must be viewed in the unique context of New Zealand's regulated dairy industry, and the international competition faced by Fonterra in global dairy markets. Fonterra was created to enhance the competitiveness of New Zealand's dairy industry in world markets, in combination with a regulatory regime designed to promote competition within New Zealand.

E The Dairy Industry Restructuring Act 2001 *(DIRA)* virtually eliminates barriers to entry to dairy markets within New Zealand. In the particular context of the acquisition, DIRA:

(a) provides for open entry and exit, and a non-discriminatory regime for dairy farmers in respect to the supply of raw milk;

(b) includes mechanisms to encourage and facilitate the independent supply of raw milk to competing milk processors, thereby ensuring competition in down-stream wholesale dairy markets; and

(c) requires Fonterra to provide up to 400 million litres of raw milk to competing processors at wholesale prices every season, again facilitating domestic competition.

F The dairy industry has responded quickly to that new environment. New participants – such as Open Country Cheese and Synlait – have emerged. Their presence, together with NZDF, Talley's, Westland, and other significant players, will continue to constrain Fonterra, post-acquisition.

G On the demand side, changes in consumer preferences toward key sales outlets has increased the countervailing power of supermarkets. This power derives from supermarkets' purchasing power, their private label ("house brand") products, and their control of product distribution to consumers.

H Meanwhile, changing consumer trends are driving the demand for constant innovation and development of new consumer products, and the expansion of food services as a distribution channel. Those demands are diverse. While such trends provide entry and expansion opportunities for new players, they also present a challenge for New Zealand's whole dairy industry. Fonterra, as a global player, must maintain alignment of its home base with its operations and sales in other parts of the world. This acquisition will enable Fonterra to enhance its brand portfolio in new products within New Zealand that, if they are suitable, can be rolled out globally.

I From the vendor's perspective, the sale of Kapiti and UML is part of Foodstuffs LNI's broader strategy to compete more effectively with Woolworths Australia (which is currently completing its acquisition of Progressive) in New Zealand. That strategy involves developing key long-term logistical relationships with strong suppliers, in preference to vertical integration, to ensure that product is delivered at competitive prices. In other words, the sale will not only help ensure that Foodstuffs LNI remains competitive, but also enhance upstream competition.

PART I: TRANSACTION DETAILS

1 The Business Acquisition for which clearance is sought

1.1 The acquisition by Fonterra, or any of its interconnected bodies corporate, of 100% of the issued shares in Kapiti and UML from Foodstuffs LNI.

1.2 The details of the transaction are set out in the Heads of Agreement between Fonterra and Foodstuffs LNI dated 14 November 2005 (*Heads of Agreement*), attached at ***Appendix A***.

2 The person giving notice

2.1 This notice is given by:

Fonterra Co-operative Group Limited
Private Bag 92032
Auckland

Telephone: 09 374 9000
Facsimile: 09 379 8281
Attention: David Matthews, General Counsel

2.2 All correspondence and notices in respect of the application should be directed in the first instance to:

Chapman Tripp
P0 Box 993
Wellington

Telephone: 04 499 5999
Facsimile: 04 472 7111
Attention: Grant David / Jim Sullivan

3 Confidentiality

Confidentiality is not required for the fact of the proposed acquisition. Confidentiality is requested for all the information deleted from the attached "public version" of this notice on the grounds that the information is commercially sensitive to the Applicant and/or the vendor. Disclosure of such information would be likely to unreasonably prejudice the commercial position of the Applicant and/or the vendor in terms of section 9(2)(b) of the Official Information Act 1982.

4 Details of the Participants

4.1 Fonterra's address and contact details are specified in paragraph 2.1 above.

4.2 Foodstuffs (Wellington) Co-operative Society Limited:
57 Kiln Street
Silverstream
Upper Hutt
P0 Box 38-896
Wellington Mail Centre

Telephone: 04 527 2510
Facsimile: 04 527 2662
Attention: Tony McNeil

4.3 Kapiti Fine Foods Limited:
29 - 33 Mako Mako Road

P0 Box 4680
Palmerston North

Telephone: 06 356 1456
Facsimile: 06 356 1484
Attention: Greig Shearer

4.4 United Milk Limited:
57 Kiln Street
Silverstream
Upper Hutt

Telephone: 06 356 1456
Facsimile: 06 356 1484
Attention: Greig Shearer

5 **Persons interconnected to or associated with the participants**

Fonterra

5.1 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.

5.2 Fonterra operates in New Zealand through its subsidiaries, as set out in the Fonterra corporate structure chart attached at ***Appendix B***. Fonterra's wholly-owned subsidiaries, Fonterra Brands (New Zealand) Limited *(FBNZ)* and Fonterra Brands (Tip Top) Limited *(Tip Top)*, are relevant to the current application.

Foodstuffs LNI

5.3 Foodstuffs LNI is a co-operative society specialising in grocery distribution and is registered under the Industrial and Provident Societies Act 1908. Along with two other co-operative companies, Foodstuffs (Auckland) Limited and Foodstuffs (South Island) Limited, it jointly owns Foodstuffs (NZ) Limited*,* which acts as their federation body.

5.4 Foodstuffs LNI is owned by its retail members and operates independently from the Auckland and South Island co-operatives, which have no common members or shareholders. The most recent corporate structure diagrams for Foodstuffs LNI is attached at ***Appendix C***.

5.5 Foodstuffs LNI operates a part of its New Zealand business through its wholly owned subsidiaries Kapiti and UML. Kapiti manufactures and processes dairy products (particularly specialty cheese, premium ice cream and town milk) and operates a raw milk processing facility at Palmerston North, from which it supplies Kapiti's *Farmgate* and *Kapiti* branded milk, *SUP* flavoured milk and Foodstuff LNI's *Pam's* (including *Calci Smart*) private label milk. The facility will also soon make *Pam's* private label ice cream (which is currently manufactured by Emerald Foods Limited). UML is used only as a manufacturing name for the manufacture of *Farmgate* and *Calci Smart* milk.

6 **Beneficial interests/entitlements between participants**
The only interests which each participant (or any of its interconnected bodies corporate) has in another participant are the interests and entitlements as set out in the Heads of Agreement. In particular, the Heads of Agreement sets out the terms on which Fonterra will acquire all the shares in Kapiti and UML, and will supply milk to Foodstuffs LNI post-acquisition for its *Pam's* private label brand pursuant to a milk supply agreement.

7 **Formal links between participants**

7.1 The participants currently have the following formal or informal production, supply, licensing and distribution arrangements, which are conducted on commercial arms-length terms:

(a) certain commercial arrangements between Fonterra and Foodstuffs LNI for the wholesale supply of cheese, town milk, ice cream and other dairy products; and

(b) last season Kapiti acquired **[ ]** million litres of raw milk from Fonterra pursuant to regulations 4 and 11 of the Dairy Industry (Raw Milk) Regulations 2001. The forecast requirement for the present season is **[ ]** million litres, with Kapiti having acquired **[ ]** million litres year to date. Kapiti has also requested (and Fonterra has agreed to provide) the supply of cream.

8 **The business activities of each participant (and interconnected or associated parties)**

Fonterra

8.1 The Commission will be familiar with the activities of Fonterra due to its regulatory under DIRA, and Fonterra's recent clearance to acquire NZDF's branded butter and spreads business: Decision 562 (*Fonterra/Rank – 2005*).

8.2 In summary, Fonterra is a vertically integrated dairy products manufacturer and marketer, operating in all dairy product markets in New Zealand and numerous other countries. Fonterra currently acquires virtually all unprocessed milk in New Zealand, and operates through two main business divisions:

(a) *Ingredients,* which produces and internationally markets dairy commodities, such as milk powders, butter, cheese and value-added dairy ingredients. It also collects and processes milk. The ingredients business accounts for approximately two thirds of Fonterra's revenue, and operates from 25 manufacturing sites in New

Zealand. It is also involved in the research and development of new value-added ingredients; and

(b) *Consumer Dairy Products,* which operates in 40 countries internationally under the name "Fonterra Brands". It has 35 manufacturing sites in New Zealand, Australia, the Americas, Asia and the Middle East. Its major brands include *Anchor, Anmum, Anlene, Soprole, Brownes, Bega, Mainland* and *Western Star.*

8.3 The Fonterra subsidiaries relevant to this application are FBNZ and Tip Top:

(a) FBNZ is a manufacturer of various consumer goods in New Zealand. It manufactures *Anchor* milk and milk variants, cream, butter, *Fresh 'n Fruity* yoghurt, and *Mainland* cheese. It also manufactures other processed goods under those and other brands, and contract manufactures products for various private label brands; and

(b) Tip Top is a manufacturer, distributor and wholesaler of ice cream products in New Zealand. It manufactures ice cream products for distribution under the *Tip Top* and *Peters New American* brands.

Foodstuffs LNI, Kapiti and UML

8.4 Foodstuffs LNI is a co-operative society specialising in grocery distribution through the *New World, Pak 'N' Save* and *Four Square* supermarkets. It also owns and manages warehousing and transport operations, and operates cash and carry operations (through Toops Wholesale Limited (*Toops*)) to service the needs of dairies, service stations, catering and institutional customers. Further information about Foodstuffs NZ (and each regional co-operative) is available at www.foodstuffs.co.nz.

8.5 Kapiti and UML are both 100% owned by Foodstuffs LNI. Foodstuffs LNI acquired Kapiti Cheeses Limited through its associated milk processing company United Milk Limited in September 2003, and acquired 100% of the shares in United Milk Limited in October 2003. Foodstuffs LNI then changed United Milk Limited's name to "Kapiti Fine Foods Limited". Foodstuffs LNI re-registered UML on 29 April 2005.

8.6 Kapiti produces a range of high-value specialty cheeses and ice creams under the *Kapiti* brand for the domestic and export markets. It also operates a raw milk processing facility at Palmerston North, producing milk and cream under the *Farmgate* and *Kapiti* brands, *SUP* flavoured milk, and for Foodstuffs LNI's *Pam's* brand. Kapiti launched branded milk earlier this year under the sub-brands *Circulait* and *Classic*. *Kapiti* branded milk is a premium milk, sold in clear plastic bottles with a newly introduced double-seal cap. Kapiti started its operations 4 years ago with 17 staff, producing **[ ]** litres of milk a day. It now produces in excess of **[ ]** litres a day, and is a 24-seven operation that employs over 40 staff. About **[ ]**% of Kapiti's milk comes from contracted farmers, and the remainder is sourced from Fonterra under DIRA.

Counterfactual

8.7 As noted in the Commerce Commission's *Mergers and Acquisitions Guidelines,* establishing the appropriate counterfactual is critical to ensuring an appropriate benchmark for the subsequent competition analysis.

8.8 In the Applicant's view, the most likely counterfactual is the status quo. Kapiti and UML are not "failing firms", and there are currently no other competing bidders for the business. Foodstuffs LNI acquired Kapiti to ensure its own supply of milk. It is disposing of Kapiti and UML (and thereby exiting its vertically integrated position) in a manner that expressly preserves milk supply for its flagship *Pam's* brand, and enables it to better compete with its primary competitor, Woolworths Australia (Progressive).

8.9 Importantly, from the perspective of competing acquirers of wholesale milk, the acquisition will not change the status quo. Foodstuffs LNI is moving from a guaranteed internal milk supply to a guaranteed external supply (under a long term milk supply contract with Fonterra). Nor will the acquisition change from the perspective of suppliers (none of whom has the current option to supply Foodstuffs LNI).

8.10 Indeed, under the counterfactual the competitive position at the retail level is likely to worsen for consumers in the lower North Island, as Foodstuffs LNI increases the prevalence of its private label products. As discussed below, many Foodstuffs LNI supermarkets have reduced the level of chiller space reserved for other manufactured brands, in favour of *Kapiti, Farmgate* and *Pam's* milk. The transaction will reverse this trend.

9 The reasons for the proposal and the intentions in respect of the acquired or merged business

Overview

9.1 The *Kapiti* brand is recognised as a premium domestic cheese and ice cream brand, and is also exported in small volumes to Australia, US and parts of Asia. The acquisition of Kapiti will immediately enhance Fonterra's brand portfolio, in the segment of those markets where Fonterra's presence is currently limited. Kapiti's milk processing plant will also enable Fonterra to diversify its production risk, and reduce transport costs (including to the South Island).

9.2 Of greater importance is the international market in which Fonterra operates. Fonterra's infrastructure will accelerate the penetration of the *Kapiti* brand in key export markets. Fonterra must be able to develop and improve good products at home, before taking them global. The acquisition of Kapiti – as a premium domestic brand – will help facilitate product experimentation within domestic markets that Fonterra can then roll out globally.

9.3 Foodstuffs LNI's business strategy involves moving away from vertical integration towards securing key supply relationships with reliable suppliers. This strategy is a response to Woolworths Australia's acquisition of Progressive.

9.4 The rationale for the acquisition is discussed in more detail below.

Global demand presents opportunities

9.5 The dairy industry, and its continued growth, is vital to the New Zealand economy. Dairy now accounts for nearly 20% by value of total exports from this country, and 95% of all milk produced in New Zealand is exported. Fonterra was created with a view to enhancing the New Zealand dairy industry's competitive position in expanding and highly contested international markets.

9.6 Globally, the demand for dairy is growing. International demand for milk, cheese, yoghurt and other products is fuelled by a combination of economic growth, and changing consumer preferences, especially in populous Asian economies. For example, China's retail dairy sales are expected to expand 55% to NZ$11.31 billion by 2009. As Mark Voobergen, a dairy analyst for the Netherlands financial institution Rabobank, recently stated:

> *The traffic lights are all green — It's just a matter of whether exporters can meet growth*.[1]

9.7 New Zealand currently has a comparative advantage in milk production — it costs US$17 to produce 100kg of milk in New Zealand, compared to US$34 in the United States and US$54 in Germany. It is vital Fonterra maintains that competitive strength through continuous on-farm improvement and production efficiencies. But, low cost production alone will not ward off emerging producers around the world determined to take on Fonterra's global position. Nor will simply expanding milk supply.

9.8 Fonterra therefore has developed its "Winning Through Brands" strategy, to lift its performance of its top earning brands, increase innovation, grow its food service business and achieve supply chain efficiencies. That strategy is explained in Fonterra's *2005 Annual Report* in the following terms:

> *Wherever they are in the world, consumers shape demand in the food industry. What they want today and what they might want tomorrow occupies the minds of manufacturers, retailers and the hospitality sector.*

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[1] J Gale and D Hooper, "Global thirst for milk goes up another notch in Asia", *The New Zealand Herald*, 12 September 2005.

> *Consumers' needs are diverse. Some want good, cheap nutrition. Others want fast, convenient food. Some want to guard against specific illnesses. Others want pure indulgence.*
>
> *Dairy meets all these needs. Our returns to shareholders are influenced by how well we enable food manufacturers, retailers, the foodservice industry and consumers to make that connection and more importantly, buy our ingredients and branded dairy products. Our strategy is designed to grow these returns through strengthening our positions in the commodities, speciality products, foodservice and branded dairy products market, defending our low cost position, building valuable customer partnerships and increasing our rate of innovation.*

9.9 The Winning Through Brands strategy will require closer alignment of Fonterra's position in its home base with its operations in all other parts of the world. To meet those diverse needs of consumers, to lead innovation, and to grow global demand for dairy, Fonterra must be able to develop, and continue to invest in, those brands that properly convey the nutritional, health and convenience benefits of dairy. Within New Zealand, that alignment must be viewed against the changing dynamics of the packaged food industry as a whole.

9.10 The acquisition will enable Fonterra to enhance its brand portfolio within New Zealand with the high value *Kapiti* brand in the cheese and ice cream markets. These brands will enable Fonterra to reconfigure its retail and food service offerings within New Zealand to accord with consumer trends. The transaction will also reduce transportation costs (given the locality of Kapiti's plant) and yield significant production synergies that will allow for a scale of R&D going forward that Kapiti itself simply could not contemplate.

9.11 More importantly, it will help facilitate further experimentation within domestic markets with new products that, if they are successful, can be rolled out globally. In other words, the acquisition provides a short-cut "testing" route to effective commercialisation of innovation. Kapiti is a well recognised premium domestic brand, with international sales to Australia, US and Asia. The New Zealand dairy industry has a long history of innovation, and the acquisition of Kapiti will help provide Fonterra with the opportunity to develop premium products here, before launching them on the international market and expanding Kapiti's international reputation as a premium New Zealand dairy brand.

Changing consumer patterns

9.12 Those changing dynamics are well described in the Euromonitor Report *Packaged Food in New Zealand* of April 2005, which is attached as ***Appendix D***. The starting point for the Report is that steady economic conditions over the past five years have lead to higher household spending generally in New Zealand. However, several factors, including the rising number of single households, increasing numbers of women in the workforce, Asian and Pacific Island immigration and an ageing population, are having a significant influence on buyer behaviour in some sectors.

9.13 With food products, there is increasing demand for products addressing consumer health concerns, convenience and taste. People are turning towards easy to prepare meals and food service outlets, with the latter now accounting for almost a quarter of all money spent on food. Similarly, there is rising consumer awareness of health and well being.

9.14 The Report goes on to observe that supply is quite fragmented, with many international and local brands present. The top ten industry players only account for around 50% of total value packaged food sales between them. A number of New Zealand's iconic brands currently are held by NZDF and Goodman Fielder (soon to be combined) and Heinz Watties, as well as Fonterra.

Vigorous competition by supermarkets

9.15 The Report notes that private label brands have an increasingly important role. Generally, private label products are said to account for a 10% share of total packaged food sales in 2004. But, that share is much larger in fresh milk and bread.

9.16 A recent survey by one of the supermarket groups revealed that private label products appeal to a wide consumer base, including all income groups, and are also perceived to be as good as branded products. AC Nielsen has noted that while New Zealand shoppers consider that private label products represent extremely good value for money, they also offer the same quality as manufactured brands (see www.acnielsen.co.nz/news.asp?newsID=396). A significant increase in advertising and in-house promotions also fuelled the growth in sales of private label products. Supermarkets continue to be the leading retailers of packaged food, with recent consolidation of the two supermarket groups. Both groups have moved into other activities (for example, general merchandising) in an attempt to boost sales. Together the Foodstuffs and Progressive groups own a total of 361 supermarkets nationwide, with total supermarket turnover of about $10 billion.

9.17 Meanwhile traditional corner dairy stores have continued to decline in number as well as revenue due not only to increasing pressure from supermarkets and retailing by petrol stations, but also the advent of specialist retail chains such as the Warehouse and Mad Butcher. The mainstay of convenience retailing is fast moving consumer goods, often purchased on impulse, including ice cream.

9.18 Changes in retail distribution trends of packaged food are shown in the table below:

Retail Sales Channel	% Retail Value rsp	
	1999	**2004**
Supermarkets	63.5	70.2
Independent food stores	11.6	7.4
Convenience stores	9.8	8.4
Service stations	1.4	3.9
Internet sales	0.2	0.2
Discounters	3.3	2.7
Others	10.2	7.2
Total	100.0	100.0

Healthier and convenience options have driven recent growth

9.19 The Report further notes that while dairy products generally posted a value growth of 5% in 2004, those products with a healthy image (as well as providing convenience) benefited most. For example, fresh milk (which accounts for over 50% of retail dairy sales), has limited volume growth generally, but there have been significant developments by leading brands of healthier alternatives (such as milk enriched with calcium and vitamins, and soy).

9.20 Similarly, the value growth in cheese has been driven by the introduction of many new brands in response to emerging trends for low fat, low salt cheese, smaller pack sizes, cheese flavoured with herbs and spices, and other specialty cheeses.

9.21 With ice cream, there is a high level of market saturation, with strong signs of maturity even in the premium and super premium ice cream niches, which were previously the key drivers of increased sales. New developments here are primarily in response to growing consumer health concerns (such as Kiwi Ice Cream Company Limited's low fat, calcium enriched *Calci Lite* ice cream) and a focus on increasing food service as a distribution channel.

Lower domestic growth predicted

9.22 Looking forward, the Report predicts lower value growth overall for packaged food generally within New Zealand, with an emphasis on healthier options and continued slowing sales of traditional lines. For dairy products, the demand for convenience and portability, and rising health awareness, will continue to impact on demand. Further, the increasing penetration of private label products in both supermarkets and convenience channels will deter higher value growth in core areas, including fresh milk.

9.23 All this means that value growth in milk, cheese and ice cream now is dependent on the continued development of convenience and healthier options, and other specialised products; while the trend towards food service sales presents new opportunities. These developments, in turn, must drive off ongoing innovation by Fonterra.

9.24 That commitment by Fonterra to innovation is manifest. In July this year Fonterra announced organisational changes to enhance its innovation capabilities within New Zealand, with the former Marketing and Innovation group being strengthened and becoming Fonterra Innovation. That development was mirrored late last month by the announcement that Fonterra is to establish a $16 million dairy innovation centre in Melbourne to focus on consumer dairy products, complementing its main research facilities in Palmerston North.

9.25 Announcing that new facility, the first of its kind in Australia, Fonterra's Director of Innovation, Bob Major, explained:

> *We need to invest significantly in innovation for our brands and ingredients businesses to ensure we remain at the forefront of developing the speciality ingredients and consumer products that continue to increase our share of the growing global dairy market and our earnings from it.*
>
> *Fonterra's global research effort reflects the fact that its customer base was also global.*
>
> *It is important to have the advantage of being close to our customers and also to the many different consumer trends which drive demand for dairy.*
>
> *Our innovation and product development centres in Melbourne, New Zealand, Latin America, and Asia will ensure our ability to create market-leading products and ensure that Fonterra remain the forefront of advances in dairy research.*

9.26 The proposed acquisition, and associated commercial arrangements between Fonterra and Foodstuffs LNI (as described above), drive off the same demand for constant innovation and development of new consumer dairy products. Kapiti produces high value specialty ice cream and cheeses. These products are especially attractive to food service outlets, as well as to that part of the retail markets where there still is opportunity for growth.

Enhancing the opportunity to compete

9.27 At the same time, the parties recognise that Kapiti's milk processing facility was developed primarily to secure supply of fresh milk – especially private label – for its shareholder, Foodstuffs LNI. That security of supply will be preserved, but in a more efficient fashion. And, importantly, in a way that does not foreclose competitors beyond the term and scope of the arrangement.

9.28 Importantly, Foodstuffs LNI will realise considerable commercial value by selling Kapiti and UML to Fonterra, providing it with the opportunity to seek a better return on capital more consistent with its long term business strategy. That strategy involves moving away from its vertically integrated position, and aligning itself with key suppliers in order to compete more effectively with Progressive.

9.29 Woolworths Limited (one of Australia's largest retailers) is currently completing its acquisition of Foodlands Associated Limited's Australian and New Zealand businesses (eg, Progressive). Woolworths is likely to replicate its Australian business practices of securing key supply relationships in New Zealand. By way of example, Woolworths stocks *Inghams* frozen chicken to the exclusion of all others. For milk supply in Australia, Woolworths has an established relationship with National Foods for the national supply of town milk. Given that relationship, Foodstuffs LNI strongly believes that National Foods is likely to establish a milk processing plant in Auckland in the near future, providing it with the ability to replicate its supply relationship with Woolworths here.

9.30 It is vital that Foodstuffs develops similar relationships here in order to compete successfully with Woolworths. Securing reliable supply chains and reducing costs are fundamental to its strategy; the milk supply contract with Fonterra provides certainty as to price, quality and quantity of supply for Foodstuffs LNI. In other words, the contract is a key component of the transaction, as it provides Foodstuffs LNI with the secure supply required in order to effectively compete with Woolworths, going forward. Expansion by Foodstuffs into banking, fuel and general merchandising are also important aspects of Foodstuffs LNI's strategy.

9.31 **[** **]**. The competitive effects of the supply agreement are considered in detail at paragraph 21.

9.32 Foodstuffs LNI is also likely to use some of the proceeds from the divestment to establish a new distribution centre in Palmerston North.

PART II: IDENTIFICATION OF MARKETS AFFECTED

10 Horizontal aggregation

10.1 The markets relevant to this application are:

(a) ***Supply/acquisition of raw (or unprocessed) milk in the North Island:*** The acquisition of Kapiti and UML will result in very minor aggregation in the raw milk market through Fonterra acquiring the supply contracts of Kapiti's independent suppliers.

(b) ***Processing and wholesale supply of town milk in New Zealand:*** The acquisition will result in Fonterra acquiring Kapiti's milk processing facility at Palmerston North. Post acquisition, Fonterra will supply **[ ]**% of town milk nationally.

(c) ***Manufacture and wholesale supply of cheese in New Zealand:*** The acquisition will result in Fonterra acquiring Kapiti's cheese processing facility at Paraparaumu. That aggregation is minor in the context of the cheese market. In addition, Kapiti's products are focused on the specialty segment; the acquisition will have no impact on the block segment.

(d) ***Manufacture and wholesale supply of take home and novelty/scoop ice cream in New Zealand:*** The acquisition will result in a slight increase to Fonterra's share of the markets for take home ice cream (that is, ice cream tubs sold primarily in supermarkets) and frozen novelty/scoop ice cream (that is, frozen novelties and bulk ice cream sold to retail and food service outlets). As with cheese, this aggregation will only occur at the premium end of these markets.

10.2 Each of these markets is considered in detail below.

11 The market for acquisition/supply of raw milk in the North Island

11.1 The acquisition of Kapiti will result in Fonterra inheriting the obligation to take milk under contract from Kapiti's suppliers (which comprise 16 owners of 18 farms based in the lower North Island). Some of these suppliers also currently supply milk to Fonterra.

No substantial lessening of competition in raw milk

11.2 The Island-wide markets for the acquisition of raw milk were considered in detail by the Commission in the MergeCo Draft Determination, 27 August 1999 *(Draft MergeCo Determination),* Decision 396 *(Mainland Products/Nelson Milk - 2000)* and Decisions 428/454 *(Mainland Products / Southern Fresh Milk – 2001/02).*

11.3 The horizontal aggregation resulting from the current acquisition will be insignificant (and amounts to less than **[ ]**% of national milk supply). As the Commission previously recognised in Decisions 396 and 428, such level of aggregation will have an inconsequential impact on competition in the North Island raw milk market.

11.4 The relative position of Kapiti as an acquirer of raw milk is much less significant, in competition terms, than the position of the Waitara plant in *AFFCO v ANZCO* (2005) 11 TCLR 278 (CA). There, the Court of Appeal held that the removal of that plant (accounting for 2% of the market for beef procurement) could not have the effect of substantially lessening competition in the market, particularly where barriers to entry are low.

11.5 On that basis, strictly speaking, this market need not be considered in any further detail (and is not considered in Parts III — V).

11.6 It is important, however, that the acquisition be seen in its proper perspective, with regard to the regulated environment in which Fonterra operates, and the current state of competition in the market (which indicates that the regulated environment is working well). It would be too easy for this acquisition to be characterised as the largest firm in New Zealand exerting market power over a few hapless farmers. The reality is quite different. Considering the dynamics of the raw milk market in detail also provides an important backdrop to the other down-stream markets relevant to the acquisition.

DIRA facilitates entry

11.7 As the Commission knows, the raw milk market is regulated by DIRA. DIRA subjects Fonterra, as a virtual monopsonist purchaser of raw milk in some areas, to an environment designed to facilitate competition in the raw milk market and other down-stream dairy markets.

11.8 Briefly, section 70 of DIRA acknowledges that the purpose of Subpart 5 of Part 2 is to promote "the efficient operation of dairy markets in New Zealand". The Subpart is designed to promote the principle that "independent processors must be able to obtain raw milk necessary for them to compete in dairy markets".[2]

11.9 DIRA achieves these objectives and facilitates market entry/exit by imposing behavioural constraints on Fonterra. Importantly, Fonterra must accept supply, it must not discriminate between suppliers, and suppliers can freely exit the co-operative at the conclusion of a season and receive fair value for their capital investment. Existing supplies can also supply up to 20% of their milk to competitors. In addition, DIRA provides for Regulations that require Fonterra to disclose and publish information on its business, thereby reducing Fonterra's ability to engage in unilateral anti-competitive conduct. As of June 2006, Fonterra will also have a number of

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[2] Section 71(a) of DIRA.

contract supply options, developed to facilitate entry into dairy farming and generate new supply.

11.10 The Primary Production Committee report on the Dairy Industry Restructuring Bill stressed that a core policy objective of DIRA is to mitigate anticompetitive concerns, stating (at page 2):

> *The cornerstone of the measures to mitigate Fonterra's dominance is the open entry and exit regime to the co-operative. For this regime to function properly it is critical that, at any given time, Fonterra charges the same price (per kilogram of milk solids) for entry to the co-operative as it pays upon exit. It also essential that all other barriers to entry and exit are removed or at least reduced to an absolute minimum.*

11.11 It is clear that the regime is working. Since its introduction in 2001, a number of new entrants have established a presence in the market. Currently, there are 28 milk processors supplied by Fonterra in New Zealand, and a variety of other processors that have independent milk supply. In the North Island alone, competing acquirers of raw milk include Open Country Cheese, Tatua, Emerald Foods, Green Valley, Fresha Valley, Top Milk, Taranaki Fresh, Ridge Processing and Gisborne Milk. There is also a proliferation of large and niche cheese processors, including Waimata, Whitestone, Open Country Cheese, Te Mata, Gibbston Valley, Kingsmead Cheese, Zany Zeus, Evansdale, Matatoki Cheese, and Mercer Cheese.

11.12 To Fonterra's knowledge, competitors took **[ ]** suppliers from Fonterra in the 2004/2005 alone, resulting in the loss of **[ ]** kilograms of milk solids. Open Country Cheese are actively seeking more suppliers, and aim to increase processing capacity to 15 million kgs milk solids per annum. In terms of their ability to compete, Open Country Cheese have stated:

> *The Open Country Cheese Company was created as the new legislation completed its passage through Parliament to be in the vanguard of the exciting new opportunities created by deregulation.*[3]

11.13 Suppliers can easily exit Fonterra by providing notification prior to the end of the application period (usually 28 February). Ease of exit is illustrated by Synlait, based in Canterbury (see www.synlait.co.nz). Synlait currently supplies Fonterra with more than 40 million litres of raw milk a year, but has stated publicly that it intends to become independent (with its own processing facility) as from the 2007/08 season. It anticipates processing over 100 million litres of milk annually — equivalent to one percent of New Zealand's total milk production. Synlait's view is that:

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[3] See www.open-country-cheese.co.nz

> *The Government's legislation [DIRA] envisaged and facilitates the emergence of entrepreneurial new players such as Synlait.*[4]

11.14 Bill Bailey, head of agribusiness at Massey University, has stated that the profitability of dairying means the emergence of further companies like Synlait is inevitable. Independent companies, that require their own milk supply, will establish themselves in heavily dairy-concentrated areas such as Waikato to enable them to "reach mass real quick":

> *There are small independent milk producers in New Zealand who are meeting their five year business goals within two years of starting out...* [5]

11.15 In other words, DIRA facilitates competition by ensuring ease of entry to the raw milk market by competing acquirers, and the ease of exit by suppliers to Fonterra. Fonterra must offer attractive returns to farmer suppliers, or face reduced volume and increased collection costs, as suppliers are cherry-picked from easily accessible regions by competitors like Synlait and Open Country Cheese.

Alternative Land Use

11.16 As an acquirer of raw milk, Fonterra also competes against the next best alternative use of land. Fonterra operates in an environment where alternative uses of land (such as cattle, wool, crop harvesting and subdivision) are becoming increasingly attractive substitutes. Dairy farmers are commercially astute, and becoming increasingly aware of alternative land use options and their potential for an increased return on investment.

11.17 Last season, **[ ]** dairy farms provided "applications to cease supply" to Fonterra, with **[ ]**% of ceasing suppliers indicating an intention to switch to beef farming in the near future. The Fonterra paper dated 22 June 2005 entitled "Future Milk Supply & Cessation Trends" attached at ***Appendix E*** illustrates the competitive tension faced by Fonterra in this regard.

11.18 Henry van der Heyden, Chairman of Fonterra, has recently noted:

> *Let me make this clear - Fonterra wants to grow milk supply. And we want to grow supply in an environment that sees us up against competing land use, up against losing suppliers who simply leave the industry without the farm going back into dairying and up against new entrants into the industry.*[6]

11.19 These comments reflect the reality that Fonterra's activities must be viewed against both domestic pressures and the global environment in which Fonterra operates.

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4 See www.synlait.co.nz

5 Collins B, "Dairy Farming is at the Crossroads", *Rural News*, 11 May 2005.

6 "Competition for Supply is a two-way Street", *Farmlink*, September 2005, p 1.

Co-operative structure

11.20 Fonterra's co-operative structure renders the economic analysis applicable to typical investor-owned firms inappropriate. A typical monopsonist seeks to lower the price paid for inputs in order to maximise shareholder wealth. However, a core principle behind Fonterra's co-operative form is to ensure it acts in the best interests of its farmer owner/suppliers. Under a co-operative structure any excess profits extracted from suppliers are ultimately returned to them (as owners) in the form of pay out or capital gain. Fonterra's constitution and the Act ensure that these interests are aligned (ie, non-discrimination), and that the interests of suppliers are protected. In other words, Fonterra has no incentive to prejudice its suppliers.

11.21 The constraining effect of the co-operative structure was recognised in *New Zealand Co-operative Dairy Company Limited & Anor v Commerce Commission* (1991) 3 NZBLC 102,259 (and cited in *Draft MergeCo Determination* at para 301):

> *In this instance such market power could only be exercised against the interests of the suppliers. The suppliers are in a position through ownership of the company to prevent or at least curtail the exercise of any such power by the merged entity, whose ability and motive to exploit suppliers would be restricted accordingly.*

11.22 Since those decisions, the protections inherent in the co-operative structure have been enshrined. The independent Shareholders Council and Milk Commissioner not only ensure transparency, but provide a coherent voice for shareholders in respect of Fonterra's activities.

12 The market for the processing and wholesale supply of town milk in the North Island

12.1 The acquisition will involve aggregation in the market for the processing and wholesale supply of town milk in the North Island. Pasteurised fresh milk sold in New Zealand is referred to as "town milk". Town milk includes the supply of a variety of types of milk (such as full cream, homogenised, reduced fat and calcium enriched varieties), fresh flavoured milks, fresh soy milks (such as *Anchor* "SoyLife", which occupies the same chiller space as regular milk) and cream.

12.2 The town milk market is mature, with little or no overall volume growth in the traditional varieties of milk (e.g. "standard" and "trim"). Growth is occurring at the margin in value-added products such as flavoured milk and enriched types, as consumers' preferences and habits change toward convenient and healthier alternatives. Approximately 370 million litres of fresh milk are consumed within New Zealand annually.

12.3 Fonterra's sales of wholesale town milk are split evenly between Key Accounts (supermarkets) and route trade/foodservice (which includes dairies, petrol stations, hotels, restaurants, cafes and institutions). There is an ongoing volume switch in the order of 3% per annum from route trade to supermarkets, which has a knock-on effect at the wholesale level given the corresponding increased countervailing power of supermarkets (discussed below). At the retail level, town milk can be divided into two categories:

(a) manufactured (or "branded") milk, such as Fonterra's *Anchor* brand and NZDF's *Meadow Fresh* brand. Branded milk comprises **[ ]**% of total supermarket sales; and

(b) "private label" (or "house brand") milk, such as Foodstuff's *Pam's,* and Progressive's *Signature Range* and *Basics* brands. Private label milk comprises **[ ]**% of total supermarket sales.

Product and Functional dimensions

12.4 The relevant product market is that for town milk (which, as outlined above, includes various milk varieties, flavoured milks and creams). Milk is relatively inelastic at the retail level, although flavoured milks compete with a variety of other beverages, including smoothies, energy drinks, and fruit drinks.

12.5 The relevant functional dimension of the market is between town milk processors (including supermarkets, that participate through private label brands) and retailers (such as supermarkets, oil companies, dairies and milk vendors), for the wholesale supply of town milk.

Geographic Extent of the market

12.6 The Commission has previously identified distinct North and South Island markets for the wholesale supply of town milk *(Draft MergeCo Determination,* at para 193 and Decision 396 *(Mainland/Nelson Milk - 2000)* at para 42). This Island-wide market analysis was re-affirmed in Decision 454 *(Mainland/Southern Fresh – 2001/02).* In that decision, the Commission suggested that processed milk is only transported across the Cook Strait during exceptional market circumstances. It duly found that from a supply side perspective, it was appropriate to distinguish between North and South Island operations.

12.7 However, since Decision 454 both NZDF and Fonterra have rationalised their respective operations on a national basis. Several *Anchor* products sold nationwide now are only produced at Takanini, Auckland (for example, vitamin enriched milk such as *Vital* and flavoured *Primo* milk is manufactured and trucked from Takanini, and carried over the Cook Strait via ferry). Similarly, NZDF contract manufacture all of Fonterra's national *Supashake* requirements from their Christchurch plant, and ship product nation wide. Indeed, part of the rationale for acquiring the processing plant at Palmerston North is that supply across the Strait will become more cost effective for Fonterra. Marketing activities by NZDF and Fonterra are all firmly focussed at the national level.

12.8 On the demand side, supermarket chains and route service operations purchase town milk on a national level, with national distribution networks. In addition, there is very little difference in the wholesale price of milk between the North and South Island. In order to test the geographic extent of the market, the Applicant commissioned a report from CRA. That report includes (among other things) a study of the wholesale price for milk across both Islands, which over the last 4 years has been highly correlated. A copy of that report is attached at ***Appendix F***.

12.9 Accordingly, the Applicant believes that the relevant geographic extent for the town milk is now national. However, for the purposes of this application the Applicant has also provided North Island data to allow the Commission to investigate the proposal on a "worst case" basis. That said, the Applicant would be happy to provide more detailed information to the Commission if the geographic parameters of the market become crucial.

Parties involved in the market for the wholesale supply of town milk in the North Island

12.10 Market participants include dedicated town milk companies, the domestic operations of Fonterra and NZDF, and supermarkets (which process/market private label milk). A full list of competitors is set out in paragraph 18.1 below.

Differentiated product market

12.11 The Commission has previously noted that town milk is largely an undifferentiated product, with branding not appearing to be particularly important to consumers, as evidenced by the substantial sales of private label milk (see Decision 428, para 66). However, growth in branded milk is occurring at the margin as consumers become more aware of value-added, healthier alternatives.

12.12 This change in consumer demand at the retail level provides incentives for wholesalers to produce specialist milks (differentiating on product, not brand). It is now common for households to have a range of milk for the entire family, such as *Lite* for Dad, *Xtra* for Mum, and *Mega* for children. This differentiation is reflected in the default colour-coding system for labels/caps:

Product attribute	Colour	Anchor	Meadow Fresh	House brand
Calcium Enriched milk	Yellow	Xtra	Calci-Trim	Calci-Smart
Kids milk	Orange/Blue & Yellow	Mega	Calci-Kids	-
Reduced fat	Light Blue	Lite	Balance	Lite
Trim	Green	Trim	Trim	Slim

Product attribute	Colour	Anchor	Meadow Fresh	House brand
Non Fat	Light Green	Super Trim	Extra Trim	Ultra Lite
Omega 3 Enriched	Purple	vital	-	-
Growing up Milk	Orange	-	Junior	-
Soy Milk	Red	SoyLife	-	-

Source: Fonterra

12.13 Other milks are marketed for perceived health benefits – for example, A2 milk (containing beta casein claimed to lower the risk of cardiovascular disease), culture infused milks (said to improve the gastric tract and aid digestion), vitamin enriched milks and non-dairy substitutes such as soy (preferred by lactose intolerant consumers). In the period December 03 to September 05, **[**
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13 The market for manufacture and supply of cheese in New Zealand

13.1 Fonterra and Kapiti both produce a variety of cheese products, and there will be minor aggregation in the wholesale cheese market. As discussed at paragraph 22 below, that aggregation is limited to the premium end of the market. Kapiti does not produce any block cheeses and there will be no aggregation in respect of the block segment.

Product dimension

13.2 The relevant market is that for the manufacture and wholesale supply of cheese. In the *Draft MergeCo Determination*, the Commission identified two discernible categories within the cheese market:

(a) "block" cheese, which includes mass produced, commodity varieties such as basic cheddars, colby, mild and pre-grated cheeses, processed cheese slices and spreads (including Fonterra's *Mainland* brand, and NZDF's *Anchor* brand). Block cheese comprised approximately **[ ]** of national key account cheese sales by total value for the quarter to October 05; and

(b) "specialty" cheese, such as Fonterra's *Galaxy* and *Ferndale* brands, NZDF's *Puhoi* and *Bouton D'Or* brands, *Whitestone, Kapiti* and various other domestic and imported specialty brands. Specialty cheese comprised approximately **[ ]**% of national key account cheese sales by total value for the quarter to October 05.[7]

13.3 Since the *Draft MergeCo Determination*, there has been an increase in the popularity of specialty cheese. As the Commission considered recently in respect of wine in Decision 553 *(Pernod Ricard – 2005),* there is a "chain of

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[7] Market share data is based on Aztec market research. Because this data is derived from scanner information, it does not include retail sales from the cheese bar, or include sales made to food service outlets.

substitutability" within the cheese market, where premium cheeses compete with others in the same price level and in the immediately adjacent price levels, and so on, to the lower end of the market.

13.4 As the Commission further noted, selecting which wines should be considered as "premium" is an arbitrary process. The same is true of cheese. While the physical distinctions between block and specialty cheese may be obvious, that distinction becomes blurred when expensive block cheeses such as *Weightwatchers* are compared with lower-priced *Bouton D'Or* or *Galaxy* specialty cheese which are priced for "everyday" consumption. Accordingly, despite differences between the two categories identified above, block and specialty comprise the same market.

Functional dimension

13.5 The relevant functional dimension is between manufacturers and retailers, such as supermarkets, foodservice channels and specialty retailers. Supermarkets sell block cheese and some specialty cheese through dairy chillers, while other specialty cheeses are also sold (generally unboxed and of varying weights) through the deli/cheese bar. Block and specialty cheese is also sold direct to food service outlets (such as restaurants, speciality shops and caterers).

Geographic Market

13.6 As recognised in the *Draft MergeCo Determination,* the relevant geographic market is New Zealand, given the national purchasing regimes of the major supermarkets, and the ease with which cheese can be transported long distances. Cheese also has a long shelf-life (brie and camembert can be stored for up to 42 days, while some block cheese can be stored for up to twenty four months), which facilitates imports.

Parties involved in the market for the manufacture and supply of cheese in New Zealand

13.7 Participants in the cheese market include Fonterra and NZDF, a large variety of other domestic cheese manufacturers and importers, and supermarkets (which market private label cheese). While it is difficult to list all competitors, the main participants are set out in paragraph 22.1 below.

Differentiated product market

13.8 In the *Draft MergeCo Determination,* the Commission noted the wide variety of cheese on the market, and the large price variations across the product segments. The Commission identified the two main categories of cheese – block cheese and specialty cheese – but agreed with the applicant's view that there are few direct substitutes for cheese.

14 Ice Cream Markets

14.1 As with town milk and cheese, the wholesale ice cream markets in New Zealand are characterised by vigorous competition, with growth driven by value-added health-conscious products and super premium varieties. Fonterra's wholesale supply of ice cream is focused on the everyday "consumer" product segment, whereas Kapiti's focus is on the higher value, super premium product (with most of its sales in the food services sector).

14.2 The proposed acquisition involves slight aggregation in the wholesale markets for take home ice cream, and for frozen novelty/scoop ice cream. The effect of the acquisition on the competitive dynamics of those markets is minimal, due to the relatively small size of Kapiti's ice cream operations, its focus on a separate product segment (super premium), and the presence of Unilever S.A. (*Unilever*), Kiwi Ice Cream Company Limited (*Kiwi Ice Cream*), Emerald Foods Limited (*Emerald*), Talley's Frozen Foods Limited (*Talley's*), Deep South Limited (*Deep South*), and other minor players in the industry.

Market Definition

14.3 The Commission has previously considered markets for the manufacture and wholesale supply of ice cream products in Decision 127 (*Watties Industries/Taylor Freezer – 1985*), Decision 210A (*Goodman Fielder/Watties Industries – 1987*), Decision 216 (*New Zealand Co-operative Dairy Company/Auckland Co-operative Milk Producers – 1988*), and Decision 313 and 313A (*Tip Top Ice Cream Company/New American – 1997*).

14.4 In those decisions, the following markets for ice cream products were established:

(a) manufacture and wholesale supply of take home ice cream in New Zealand (the *take home market);*

(b) manufacture and wholesale supply of frozen novelties and scoop ice cream in New Zealand (the *novelty/scoop market);* and

(c) manufacture and wholesale supply of frozen desserts in New Zealand (the *frozen dessert market).*

14.5 The current acquisition relates only to the take home and novelty/scoop markets, as Kapiti do not produce frozen desserts.

Product and Functional Dimensions

Take home ice cream

14.6 In Decision 313, the Commission outlined the take home market (at paragraph 35) as comprising the sale of:

> *one, two and five litre containers of ice cream, which are primarily sold in supermarkets. Ice cream sold in this form is consumed by customers at home. Take home ice cream is most often served as a dessert or an accompaniment to a dessert.*

14.7 As with town milk, Fonterra and Kapiti both wholesale take home ice cream to key accounts (eg, supermarkets). Fonterra also sells to the route trade. The major supermarket chains maintain their own distribution centres to service their stores. Route trade outlets are generally higher margin, lower demand outlets such as service stations, convenience stores and corner dairies, that rely on third party distribution networks for set fee product delivery.

14.8 The take home market is divided into three segments by industry participants; the everyday segment (eg, *Tip Top* and *Basics*), the super premium segment (eg, *Mövenpick*, *Killinchy Gold*, and *Rush Munro's*), and the moderation or low-fat segment (eg, *Guilt Free*). Kapiti and Tip Top mostly focus on different segments, with Kapiti producing solely super premium products, and Tip Top primarily the everyday and moderation products, with a small quantity of super premium product.

14.9 The everyday and super premium products are distinguishable in quality, price and, more generally, pack size. In particular, super premium product is priced between approximately $5.00 and $9.00 per litre at wholesale, is manufactured using high quality ingredients, and is primarily available in packs up to one litre in size. Everyday products, in contrast, are priced from approximately $1.50 to $2.50 per litre at wholesale, use cheaper, lower quality ingredients, and are largely packaged in two litre containers. Accordingly, *Tip Top* and *Kapiti* ice cream are generally not considered substitutes by consumers in terms of product price and quality.

14.10 Like town milk, there has been a rise in value-added products in the ice cream industry in recent years. The Applicant estimates the current annual growth in the super premium segment to be approximately **[ ]**% by volume. This growth in super premium is not confined to manufactured brands, but has extended to private label products, with Progressive's recent introduction of *Signature Range* super premium ice cream. Private label ice cream products are discussed further at paragraph 26 below.

Novelty/Scoop ice cream

14.11 The Commission also identified a novelty/scoop wholesale market in Decision 313 (1997), although the market did not present significant competition issues and was not analysed in detail by the Commission. The novelty/scoop market encompasses supply to all outlets retailing novelty and scoop products, including flavoured ice blocks (eg, Popsicles), ice cream sticks (eg, Moritz), and the bulk sale of ice cream to retailers and food service outlets in larger 10 and 16 litre containers.[8]

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[8] The Investigation Report into Tip Top's acquisition of New American (AUT/BA-T19/1, M2314, 24 September 1996) included multi-packs (i.e. frozen novelties sold in family packs at retail for take home consumption) as part of the novelty/scoop market. The Applicant considers multi-packs to form a separate market from take home and novelty/scoop ice cream and has

14.12 In recent years, the supply of bulk ice cream as an ingredient for the food service industry has increased. Specifically, the food services channel involves the supply of bulk ice cream product to hospitality outlets, such as restaurants, cafés, and catering businesses (including airlines). Ice cream is generally used by these outlets as an ingredient to which additional value is added, prior to the end sale to customers at cafés, restaurants, or as part of a catered meal. Such products are likely to be viewed more generally by the consumer as part of a wider range of after-dinner options (including sweet desserts, cakes, and savoury items such as cheese boards). Kapiti's sales of scoop ice cream are almost exclusively to food services outlets.

14.13 In comparison, Tip Top focuses its sales of novelties and scoop ice cream to retailers (comprising "impulse" outlets such as dairies, petrol stations and ice cream parlours). These outlets tend to treat novelties and scoop products as high-volume, large turnover items sold without modification (except, perhaps, the addition of a cone, chocolate dip and sprinkles/nuts) for immediate consumption. Impulse outlets also stock a range of substitutes for such products, such as other frozen novelties, potato chips, confectionery, and refrigerated drinks. Such products provide an important constraint on the price of novelties and scoop ice cream. **[**
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14.14 As noted above, Kapiti does not manufacture frozen novelties, focussing on premium scoop ice cream for trade buyers in the food service industry, with a small amount of sales to its owner-operated retail outlets. Accordingly, the competitive effects of the acquisition in parts III-V of the application focus on the premium segment of the market.

Geographic Extent of the markets

14.15 The previous Commission decisions relating to the ice cream industry, including Decision 313, identify national markets. Given the larger distribution centres operated by each of the supermarkets, and significant capacity existing in the industry, even local suppliers' products are able to gain national distribution at the retail level. In addition, with the novelty/scoop ice cream market, each manufacturer is able to use third party national distribution networks to supply clients. Accordingly, both the take home and scoop markets are national.

Parties involved in ice cream markets

14.16 Present suppliers in the take home market include the supermarkets' private label brands, Tip Top, Kiwi Ice Cream, Emerald, Talley's, Kapiti and other smaller players.

excluded multi-packs from this application. As Kapiti does not produce frozen novelties, there will be no aggregation in multi-packs resulting from the acquisition.

14.17 Suppliers of scoop ice cream include Tip Top, Kiwi Ice Cream, Kapiti, Deep South*,* Rush Munro's of New Zealand Limited *(Rush Munro's)* and Talley's. Unilever also has a significant New Zealand presence through their *Streets* label novelties.

14.18 A full list of market participants and their respective market shares for each market are set out at paragraphs 23.1 and 23.5 respectively.

Differentiated product markets

14.19 As discussed above, there is some product differentiation between everyday flavours (such as chocolate and vanilla) and super premium ice creams (which have more exotic ingredients and flavours, such as walnut, fig and honey, ginger nut and lemon sorbet).

15 Vertical Integration

15.1 The acquisition occurs at a number of functional levels of the dairy chain (including acquisition, processing, and wholesale), and the acquisition will not result in any further vertical integration. Rather, post-acquisition, Foodstuffs LNI will cease raw milk production and processing (thereby reducing the extent of its vertical integration), but will retain the *Pam's* private label brand and enter into a long-term milk supply contract with Fonterra to fulfil its private label town milk requirements. The details and competitive effect of that supply contract are discussed below at paragraph 21.

16 Previous notifications to the Commission or acquisitions

16.1 The participants have made the following business acquisitions as notified to the Commerce Commission in the last three years:

(a) Decision 454 (*Mainland Products Limited/Southern Fresh Milk Company*). Cleared and proceeded;

(b) Decision 462 (*Anchor Investments Limited/Grated Cheese Company Limited*). Cleared and proceeded;

(c) Decision 542 *(Fonterra/National Foods Limited).* Cleared, but did not proceed; and

(d) Decision 562 *(Fonterra/Rank Group Limited).* Cleared.

16.2 In addition, Fonterra is a party to the Commission's determinations under the Dairy Industry Restructuring Act 2001, copies of which are located at http://www.comcom.govt.nz/dairy/decisions.cfm.

16.3 Fonterra has not undertaken any other acquisitions in any markets material to the Commission's present investigation in the last three years.

PARTS III, IV AND V: COMPETITION ANALYSIS

17 In order to avoid a fragmented analysis of each market, the Applicant provides below consolidated information relating to Parts III, IV and V of the notice for all markets identified in Part II.

THE NATIONAL WHOLESALE SUPPLY OF TOWN MILK

18 **Existing competitors**

18.1 The current wholesale production and supply figures for town milk in New Zealand are:

Firm	Volume (litres)	Market share
Fonterra[9]	**[ ]**	**[ ]**
Rank	**[ ]**	**[ ]**
Progressive[10]	**[ ]**	**[ ]**
Foodstuffs LNI[11]	**[ ]**	**[ ]**
Foodstuffs (Auckland)[12]	**[ ]**	**[ ]**
Foodstuffs (South Island)[13]	**[ ]**	**[ ]**
Gisborne	**[ ]**	**[ ]**
Independent Milk Processors	**[ ]**	**[ ]**
Klondyke	**[ ]**	**[ ]**
Top Milk	**[ ]**	**[ ]**
Green Valley	**[ ]**	**[ ]**
Ridge (A2)	**[ ]**	**[ ]**
Marlborough Milk	**[ ]**	**[ ]**
Kapiti	**[ ]**	**[ ]**
Taranaki Fresh	**[ ]**	**[ ]**
Fresha Valley	**[ ]**	**[ ]**
Total	**[ ]**	**100%**

[9] Includes **[ ]** litres produced for Fonterra by Rank, and **[ ]** litres by Marlborough Milk, in the South Island.

[10] Includes Supervalue Freshchoice (a subsidiary of Progressive). Note that Marlborough Milk contract manufactures **[ ]** litres for Progressive in the South Island, and Rank manufacture **[ ]** litres for Fonterra's supply to Progressive in the South Island. Fresha Valley contract manufactures **[ ]** litres for Progressive in the North Island, and Fonterra contract manufactures the remainder of Progressive's requirements in the North Island.

[11] All of this volume is currently contract manufactured by Kapiti.

[12] All of this volume is currently contract manufactured by Fonterra.

[13] **[ ]** litres of this volume is contract manufactured by Rank, and **[ ]** litres by Marlborough Milk (upper South Island).

Source: AC Nielsen data to 09/05 for key accounts and Fonterra ex-factory sales estimates for route/food service.

18.2 Nationally, wholesale fresh milk supply is characterised by two large players that compete with the private labels of supermarkets, and a variety of efficient smaller producers in differing regions. Supermarkets compete aggressively through their private label town milk, and as a matter of commercial practice Fonterra (and other manufacturers) treat the supermarkets as separate competitors in the wholesale market. Importantly, supermarkets have a variety of supply options to fulfil their private label requirements, and can quickly change volumes to respond to increased demand. The countervailing power of supermarkets (both as purchasers of town milk, and through their private label brands) is discussed in more detail below. The map attached at ***Appendix G*** sets out the geographic locality of the various milk processing plants around New Zealand.

18.3 The table below provides current North Island market shares of town milk suppliers:

Firm	**Volume (litres)**	**Market Share**
Fonterra	**[ ]**	**[ ]**
Rank	**[ ]**	**[ ]**
Foodstuffs LNI	**[ ]**	**[ ]**
Progressive	**[ ]**	**[ ]**
Foodstuffs (Auckland)	**[ ]**	**[ ]**
Gisborne Milk	**[ ]**	**[ ]**
Independent Milk Processors	**[ ]**	**[ ]**
Top Milk	**[ ]**	**[ ]**
Green Valley	**[ ]**	**[ ]**
Ridge (A2)	**[ ]**	**[ ]**
Kapiti	**[ ]**	**[ ]**
Taranaki Fresh	**[ ]**	**[ ]**
Fresha Valley	**[ ]**	**[ ]**
Total	**[ ]**	**100%**

Source: AC Nielsen data to 09/05 for key accounts and Fonterra ex-factory sales estimates for route/food service.

18.4 The difference between Fonterra's national and North Island market share reflects a historical difference in the market position of the major dairy co-operatives (*Meadow Fresh* is stronger in the South Island, and *Anchor* in the North). Given the focus by both Fonterra and NZDF on national marketing, and the rapidly increasing consumption of private label milk, that historical position is quickly changing.

18.5 The above tables demonstrate that Kapiti's share of the town milk market is insignificant, and the merged entity will increases its share to **[ ]**% nationally. Even the inclusion of Kapiti's contracted supply for Foodstuffs LNI's private label results in minor aggregation, with Fonterra's share of the market at just over **[ ]**% nationally (or, on a worst case basis, **[ ]**% of the North Island). Post-acquisition, the merged entity will remain constrained by the presence of NZDF, a variety of other manufacturers, and the supermarkets (as competitors, and through their countervailing power and ability to control product distribution). Fonterra has previously provided the Commission with a paper outlining the current competition in the town milk market, and describing the ease of entry into that market. A copy of that paper is attached at ***Appendix H****.* Existing competitors are discussed in more detail below.

NZDF will remain a strong competitor

18.6 In Decision 542 *(Fonterra/National Foods)* the Commission recognised that "vigorous competition is likely to continue between the merged entity and NZDF" with respect to the market for the manufacture and wholesale supply of yoghurt and dairy food. This will also be the case in the market for wholesale town milk, post-acquisition.

18.7 NZDF is ultimately owned by Graeme Hart's Rank Group, and is a strong and commercially aggressive competitor. NZDF currently supplies town milk across both the North and South Islands. The recent brand swap has reinvigorated and incentivised competition in what was already a competitive market, and NZDF has stated that it considers the business to be well run and positioned in the market.[14] Both NZDF and Fonterra will seek to realise value in their new brands; *Meadow Fresh* and *Anchor* are joint leaders of branded milk nationally, with respective strengths in each Island (although in terms of their relative strengths, *Meadow Fresh* is stronger in the North than *Anchor* is in the South).

18.8 Hart is in the process of restructuring NZDF, with the intention that it will be incorporated into Goodman Fielder, which will be listed on both the ASX and NZSX later this year. The discipline of listing, and shareholders' demand for increased returns, will incentivise NZDF to compete even more vigorously going forward. Hart's rationalisation of NZDF has already begun, as illustrated by the recent closure of the *Meadow Fresh* yoghurt and dairy food plant in Christchurch.

18.9 DIRA and the Regulations ensure that NZDF is (and will remain) a vigorous, credible competitor, post-acquisition. In particular, DIRA provides that up

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[14] *The National Business Review*, "Fonterra, NZDF swap Anchor", 8 August 2005.

to 400 million litres of milk must be made available by Fonterra to processors at a regulated price each season. Of that total, NZDF is guaranteed a supply of 250 million litres of raw milk each season (Reg 11(4)), with the remainder divided between other competitors.

18.10 **[ ]**
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Competition by other town milk suppliers

18.11 DIRA protects other competitors as well. While Fonterra is able to agree with competitors on the price of the raw milk input, the default price is the wholesale milk price plus reasonable transport costs, and, in the case of winter milk, the reasonable additional costs of procuring or supplying that milk (Reg 8). In other words, DIRA guarantees processors the critical raw milk input at a competitive price, enabling competitive down-stream pricing of town milk and other dairy products.

18.12 There are a variety of other existing competitors in the town milk market, which are outlined in the paper attached at ***Appendix H***. Most focus on a particular geographic locality (such as Taranaki, Auckland, or Gisborne), where they own a processing plant and have a well-established supply base, supplying a full range of products (including flavoured milks and established brands). Top Milk, based in Kaitaia, supplies from the far North to Auckland (see www.topmilk.co.nz). Gisborne Milk (with its own fleet of tankers) has its own blow moulding facility, and processes 14 million litres of raw milk each year, distributing town milk North Island wide (see www.gismilk.co.nz). While these competitors have a well established home base, they provide a strong pricing discipline across the entire market (as consumers do not tolerate geographic discrepancies in the price of "basics", such as milk).

18.13 Fresha Valley (based in Waipu, Northland) is another example of an effective competitor. As well as producing its own manufactured brand, Fresha Valley successfully tendered to supply 31 Progressive supermarkets in the upper North Island with all of their house brand requirements (except for trim). Fresha's expansion illustrates the ability of small wholesalers to win major supply contracts, and exert disproportionate downward pressure on prices (it also provides further evidence of the countervailing power of supermarkets, discussed below at para 20.22). Fresha Valley has a full range of products, including A2 milk (in conjunction with A2 Corporation).

18.14 The competitive constraint imposed by supermarkets is discussed in detail at paragraph 20.22 to 20.32.

Excess capacity

18.15 Current processors have significant excess capacity, enabling a quick response in the event that Fonterra attempted to impose a ssnip, and major acquirers sought alternative supply. The table below details the excess production capacities of the North Island participants:

Competing Processor	Excess Capacity (litre pa)
Rank	[ ]
Gisborne Milk	[ ]
Fresha Valley	[ ]
Green Valley	[ ]
Top Milk	[ ]
Ridge (A2)	[ ]
Taranaki Fresh	[ ]
Independent Milk Processors	[ ]
Total	[ ]

Source: AC Nielsen data and Fonterra estimates

19 Coordinated market power

19.1 The characteristics of the town milk market provide minimal scope for collusive (express or tacit) behaviour. These structural and behavioural characteristics include:

(a) a high degree of competition between NZDF and Fonterra, and other smaller competitors;

(b) growth is occurring in value-added products, and in this respect marketing and product differentiation are crucial;

(c) a number of smaller competitors with security of access to raw milk at a competitive price, that create a disproportionate downward effect on price;

(d) low barriers to entry and expansion;

(e) major supermarkets possess substantial countervailing power; and

(f) the asymmetry between Fonterra, NZDF and other players, in respect of capacity, business models and other interests.

20 Potential competition

20.1 The rigorous competition provided by NZDF, other suppliers and the supermarkets will be sufficient to constrain Fonterra post-acquisition. However, the merged entity will be further constrained by the possibility of new entry and expansion (as well as the countervailing power of supermarkets, discussed below).

20.2 There are a variety of potential competitors that could enter the market in a manner that satisfies the LET test:

(a) an international player (like San Miguel through National Foods), or an existing domestic competitor operating in near markets (such as Open Country Cheese, which has an existing supply base and distribution network) could establish a town milk processing facility and supply the domestic market;

(b) competing co-operatives, or dairy farmers exiting Fonterra, could vertically integrate (such as Synlait, Tatua and Green Valley Dairies); or

(c) Progressive (or Foodstuffs (Auckland)) could vertically integrate and replicate the Foodstuffs LNI/Kapiti model.

Entry by San Miguel (National Foods)

20.3 New Zealand has a comparative advantage in the production of raw milk which makes entry attractive to international competitors. The Commission recognised in the *Draft MergeCo Determination* the possibility of an international near entrant implementing a "cherry-picking" strategy as a means to efficiently increase milk supply. Current international demand for dairy products provides a strong incentive to enter the New Zealand market. DIRA facilitates that entry for an international competitor.

20.4 San Miguel, in particular, has recently implemented an aggressive strategy of global expansion, acquiring significant assets in South America and Australia over the last 5 years (exemplified by outbidding Fonterra to purchase National Foods). It plans to be one of Asia's top 10 food and beverage companies. San Miguel has an existing presence in New Zealand through National Foods, which owns a yoghurt manufacturing plant in Palmerston North. Given its size, financial position and interests in Australasian expansion, its entry is likely, timely and sustainable. It has recently taken the first step toward town milk supply by launching *Big M* flavoured UHT milk in New Zealand, with listings in both Progressive and Foodstuffs supermarkets. *Big M* is the market-leading flavoured milk in Australia.

20.5 Expansion into town milk would yield significant synergies for National Foods – particularly given that it holds the contract for all Australian-based Woolworth's house-brand dairy products. Given Woolworth's acquisition of Progressive, expansion by National Foods into town milk in New Zealand would enable an Australasian supply alignment between those firms. Foodstuffs LNI considers National Foods' entry into town milk here imminent, probably through establishing a processing plant in Auckland. As discussed above, the sale of Kapiti is a key aspect of Foodstuffs LNI's strategy to compete with Woolworths and National Foods.

Entry by other near competitors

20.6 There are a number of small, independent cheese processors that could easily direct their raw milk supply to the production of town milk. The Applicant estimates the cost of conversion at about $10 million. Fresha Valley, in particular, demonstrates that small competitors can successfully establish a presence in the market and secure key supply contracts.

Exit and vertical integration by suppliers

20.7 The ability of farmers to exit Fonterra (or new farmers entering the market) to establish competing co-operatives is discussed at paragraphs 11.7 to 11.15 above. Synlait and Open Country Cheese illustrate the ease with which competing co-operatives can be established in the DIRA environment. Similarly, Green Valley is associated with Marphona Farms Limited, which ensures it has dedicated supply of raw milk.

20.8 Differentiation at the value-add end of the town milk market also enables competitors to establish a foothold before testing expansion. For example, Tatua Co-operative currently produces a limited range of flavoured town milk for Cadbury, concentrating its production on UHT sterilised liquid food products and food ingredients. It would be relatively easy for Tatua to switch to town milk production, and distribute product by expanding its existing supply chain.

Vertical integration by supermarkets

20.9 Foodstuffs LNI has demonstrated that supermarkets themselves can effectively vertically integrate into wholesale town milk. If Fonterra imposed a ssnip, one possible response for Progressive and the other Foodstuffs co-operatives is to replicate the Foodstuffs LNI model.

Barriers to entry / expansion

Access to raw milk

20.10 Raw milk is the major input cost for any processing plant. DIRA ensures that sufficient raw milk to service domestic needs is available to competitors at a regulated price, until such time as the 400 million litre statutory limit is met (eg, "dial a tanker"). In other words, Fonterra is constantly subject to the disciplines of either existing, or potential, competition.

20.11 Further, raw milk currently taken by Kapiti pursuant to DIRA will become available to a new competitor post-acquisition, and some of NZDF's take has also been freed up. This effectively means that either existing competitors can expand supply to take up the available excess, or that a new entrant will have access to raw milk at wholesale prices.

20.12 DIRA also facilitates the establishment of competing co-operatives, enabling new entrants and existing competitors to secure supply outside the ambit of the 400 million litre limit. Section 97 guarantees that any farmer can exit Fonterra at fair value, and section 108 provides that a farmer can supply up to 20% of their milk to a new venture – providing the farmer with time to evaluate a new entrant without committing their entire milk supply. Fonterra is also required to ensure that, within a 160km radius of any point in New Zealand, at least 33% of the milk solids produced are supplied either under contracts with an independent processor, or under contracts that expire (or may be terminated without penalty) at the end of the current season.

20.13 In other words, acquiring independent supply is not likely to be an issue even after Fonterra fulfils its statutory supply obligation. Both Foodstuffs and Kapiti executives have stated that access to independent supply is not problematic, particularly given that contract rates are typically higher than Fonterra's payout rate. Suppliers to such processors also avoid purchasing "expensive" shares. The October 2005 edition of the Rural Delivery Publication notes Alan Walters, CEO of Open Country Cheese observing the advantages of supplying OCC:

> *there are some distinct advantages for new suppliers not the least of which is that no shares are required to supply Open Country Cheese so there is reduced initial outlay for new property purchases. Capital released from the sale of co-operative shares can be used to reduce debt, increase cash flow, purchase additional property, invest elsewhere and improve lifestyle. Suppliers will receive a competitive milk price.*

20.14 Independent processors are very good at attracting independent supply. Wyatt Creech (director of Open Country Cheese) has stated that:

> *It's a competitive market and everyone can go directly to farmers to buy milk. Clearly Fonterra sees us as a competitor even though we are adding diversity to the dairy industry.*[15]
>
> And:
>
> *…and despite their best efforts, Fonterra's suits have been unable to prevent Open Country from securing more farmer suppliers (ex-Fonterra) than they need – and those farmers came knocking at Creech's door, not the other way around.*[16]

20.15 Greig Shearer (chief executive of Kapiti) has also noted that farmers are not happy supplying a commodity producer and prefer niche end-to-end processors:

> *That's the message coming back to me, and [farmers] are proud to be able to walk into a supermarket and point to a cheese, ice-cream or milk and say "that's my milk". It's something they can't do if they are supplying a commodity producer like Fonterra.*[17]

Plant

20.16 The cost of establishing a greenfields milk processing plant is estimated at around $10 million, and a blow moulding plant at $3 million. Neither of these requirements are significant. Plastic bottles are also available from a number of suppliers around New Zealand. In the *Draft MergeCo*

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[15] *Rural News*, "Shaking up the establishment", 16 September 2005.

[16] *Dairying Today,* September 2005

[17] *Dominion Post*, "Following the cream to the top", 27 April 2005 (p 9).

Determination and Decision 428 (para 86) the Commission recognised that capital outlay and construction time of a processing facility do not constitute a barrier to entry.

Establishing product recognition

20.17 The variety of successful town milk producers throughout the North Island indicates that establishing product recognition is relatively easy. The system of "colour-coding" caps results in consumers immediately recognising different milk types (e.g. blue full fat, light blue lite, green trim, yellow calci trim etc). In addition, cost-conscious consumers of commodity milk are not "brand conscious". Rather, they are driven by price or value-added characteristics.

Establishing a distribution network

20.18 In Decision 428, the Commission observed that the major barrier to entry to town milk is the requirement for a distribution network and gaining critical mass:

> *The major economic issue is the need for a distribution network and the critical mass required to make entry economic. To be able to gain significant market share requires the ability to supply major retail chains seven days a week, sometimes several times a day. For supermarkets, it can be necessary to "merchandise", that is deliver to, organise and maintain stock in the shop chiller. While some supermarkets do have regional arrangements, there is a strong preference for companies that can supply most if not all stores — island wide or nationwide if possible.*

20.19 Since that decision, both supermarket chains have developed central warehousing facilities. Distribution can also be achieved through specialised distributors, such as Toops. In addition, small niche producers focused on particular geographic regions can easily supply a range of local stores, so long as their product meets quality standards and supply is consistent. In particular, establishing a presence in the route trade is readily achievable and provides a good entry mechanism toward supplying key accounts. Top Milk (with listings in Whangarei's Progressive stores), Gisborne Milk (with listings in both Progressive and Foodstuffs stores in Gisborne and the Hawkes Bay), Fresha Valley and other competitors have successfully entered the market this way. Taranaki Fresh have also just secured a listing of its branded town milk in Progressive's Taranaki stores.

20.20 Kapiti's own success and quick expansion illustrates the ease of entry and expansion in this market. While Kapiti's initial entry was limited, it subsequently up-graded its milk processing operations at Palmerston North, and increased output from 35,000 litres per day to 100,000 litres per day in 4 years.

20.21 Similarly, as outlined above, Progressive or the other Foodstuffs co-operatives could vertically integrate supply in a manner similar to

Foodstuffs LNI, in order to supply their retail town milk requirements. Progressive has existing regional distribution centres and meat-packing refrigeration facilities, and could easily integrate town milk supply into its operations.

Countervailing Power of Purchasers

20.22 In the *Draft MergeCo Determination*, the Commission recognised that supermarkets have very real countervailing power (para 368). That countervailing power is expressed in two key ways:

(a) supermarkets are the major purchasers of town milk, and can (and do) switch between suppliers; and

(b) supermarkets have their own house brands, which directly compete with manufactured brands.

20.23 These constraints are discussed separately below.

Major purchasers of milk

20.24 Since the *Draft MergeCo Determination,* supermarkets have steadily increased their market share of retail town milk. AC Nielsen estimates that supermarket sales now account for 52% of total fresh milk sold to consumers. In Decision 428 (para 106), the supermarkets noted that in order to exert countervailing power, two established suppliers of town milk are required, with the Commission stating in the *Draft MergeCo Determination* (para 365):

> *While major retailers do appear to have countervailing power, to exercise such power does require at least one credible alternative source of supply.*

20.25 That is exactly what the situation will continue to be, post-acquisition. There will be two key alternative sources of national supply, with a variety of established local producers (including Fresha Valley, which successfully supplies Progressive and other strong suppliers with expanding distribution networks). Any attempt by Fonterra to impose a ssnip in respect of town milk on Progressive or the Foodstuffs co-operatives will be met by:

(a) a switch to NZDF's *Meadow Fresh* as preferred manufactured brand (or, for that matter, to other competing brands). Of course, delisting is possible across the entire range of dairy products manufactured by Fonterra; and/or

(b) a switch to a competing contract supplier of house brand milk (eg, to NZDF, Fresha Valley or other producer), which is easily achievable because consumers are unaware of the "identity" of the supplier of private label town milk.

20.26 In addition, the supermarkets would have the option of increasing house brand output (which we discuss in more detail below). Importantly, supermarkets demonstrate no loyalty to a particular manufactured brand, and will switch between them based on levels of sales to consumers. Nor does the contracted supply of milk for house brand requirements limit a supermarkets' choice of the manufactured brand(s) it lists.

House brands

20.27 Fonterra will also continue to face considerable competition from the supermarkets' own private labels ("house brands"). House branding is a common "cross fertilisation" mechanism used by retailers to promote a variety of products to end consumers through brand awareness, and perceived discount prices. House branded milk in the North Island accounts for **[ ]**% of total supermarket milk sales. Foodstuffs sell the *Pam's* range in New World and Pak'n'Save supermarkets, while Progressive sells the *Signature Range* and *Basics* products in its Woolworths and Countdown supermarkets.

20.28 House brand milk supply is generally awarded through competitive tender. The right to supply generally lasts for twenty four months, and is largely driven by price (for example, the Progressive contract for part of the upper North Island was won and retained by Fresha Valley because of its ability to be competitive on price).

20.29 Supermarkets retain ownership of the house brand, and remain free to price at the retail level as they see fit. House brands such as *Pam's* and *Basics* are generally priced below the average manufactured brand price, providing constraint on the retail price of competing manufactured brands. Nor is there a corresponding consumer perception of a loss in quality of house brand milk (see www.acnielsen.co.nz/news.asp?newsID=396). This has up-stream implications, as manufacturers must competitively price wholesale town milk to ensure their manufactured brands compete with house brands at the retail level.

20.30 Supermarkets have the option of aggressively promoting their brands. For example, Foodstuffs LNI has virtually eliminated manufactured milk brands from its chillers. Currently, over 90% of the all chiller space in the average Foodstuffs LNI supermarket comprises *Pam's, Kapiti,* and *Farmgate* brands. The ability to switch from manufactured brands to house brands illustrates the countervailing power held by supermarkets over their suppliers.

20.31 Tony McNeil (managing director of Foodstuffs LNI) has observed the effectiveness of this strategy:

> *We haven't taken Mainland or Anchor out of the stores. But I've certainly suggested to our retailers that it is dumb stocking competing products when we have got our own factory. It's also more profitable for them to take our own products, but I believe Meadow Fresh is still in 99% of the stores. Anchor has*

> *virtually disappeared. Our sales of Farmgate have risen from 6,000 litres a day to 14,000 litres a day in the past two months.*[18]

20.32 This demonstrates that consumers are not "brand loyal", and that supermarkets have the incentive and ability to increase house brand sales. Even though Foodstuffs LNI will divest its processing plant to Fonterra, it will still have an incentive to promote its own branded product in competition with manufactured brands.

Route trade

20.33 Small retailers also constrain the pricing of wholesale town milk by selling milk at the retail level as a loss leader. For example, convenience stores and petrol stations (particularly BP) often promote 2 litre milk at 2 for $5. Such promotions result in a significant spike in sales of milk and other products, which has been noted by competing supermarkets.

21 Long Term Supply Contract

21.1 An integral part of Foodstuffs LNI's divestment of Kapiti is both parties entering into a long term milk supply contract (Supply Contract). The key terms of the Supply Contract are detailed in the Heads of Agreement (attached at ***Appendix A***).

21.2 Under the Supply Contract, Fonterra has an obligation to supply *Pam's* milk to Foodstuffs LNI **[ ]**. Foodstuffs LNI will remain the owner and retailer of the *Pam's* brand, with the corresponding ability to price *Pam's* milk (and other products) as it sees fit.

21.3 The Supply Contract will have a pro-competitive effect on the dynamics of the wholesale town milk market. It obliges Fonterra to commit a chunk of its wholesale processing capacity to fulfil the private label requirements of Foodstuffs LNI. The Supply Contract will be on terms that are commercially acceptable to both parties, and ensures the continued and secure supply of *Pam's* house brand milk. In this respect (and as discussed in paragraph 9.30 above), the Supply Contract is an essential component of the commercial transaction for Foodstuffs LNI, because it will protect its current competitiveness in the retail market for the term of the contract. Security of supply for Foodstuffs LNI will be paramount given Woolworths Australia's recent acquisition of Progressive and established relationship with National Foods in Australia.

21.4 It is also important to note that there is no foreclosure issue, because currently there is no tender process for the sale of milk to Foodstuffs LNI. Foodstuffs LNI sources its private label milk requirements from its own subsidiary, Kapiti. From the perspective of a competing supplier, Foodstuffs LNI is not a contestable customer today (because it has a dedicated supply

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[18] "Processing Kapiti's North/South Expansion", *NZ Dairy Exporter*, 1 September 2005.

of town milk from Kapiti). That supply will simply change to Fonterra post-acquisition, and will not have any detrimental impact on competition compared to the counterfactual. Similarly, the Supply Contract does not change anything from the perspective of other acquirers of town milk (as Kapiti do not currently supply any other acquirers).

21.5 Indeed, compared to the counterfactual, the Supply Contract will have a pro-competitive effect on the retail town milk market. As discussed above, Foodstuffs LNI has strongly encouraged its members to list milk manufactured from Kapiti's factory (eg, *Farmgate, Pam's, Calci Smart, Kapiti* and *SUP*). But, the Supply Contract will ensure that there are at least two competing brands in Foodstuff LNI supermarkets (namely *Pam's* and *Anchor*). This will ensure a price tension remains between competing milk brands, promoting contestability at the retail level of the market. These pro-competitive effects in the down-stream retail market will provide real benefits for New Zealand end consumers (consistent with section 1A of the Commerce Act 1986).

21.6 In addition, the negotiated price at which Fonterra provides *Pam's* milk will constrain its own sales of *Anchor* to Foodstuffs. Of course, Foodstuffs LNI will remain free to stock any other manufactured brands (including *Meadow Fresh),* as it sees fit.

MARKET FOR MANUFACTURE AND WHOLESALE SUPPLY OF CHEESE IN NEW ZEALAND

22 Existing competition

22.1 The following table sets out the market shares of competitors in the wholesale cheese market:

Firm	Brands	Value ($)	Market share (by value)
Fonterra[19]	*Block: Mainland, Valumetric, Weightwatchers* *Specialty: Ferndale, Galaxy, Mainland, Perfect*	**[ ]**	**[ ]**
NZDF	*Block: Anchor, Chesdale* *Specialty: Anchor, Bouton D'Or, Ornelle, Puhoi, Aakronia, Royal Tasman*	**[ ]**	**[ ]**
Private Label	*Block: Pam's, Budget, Signature Range, Basics* *Speciality: Signature Range*	**[ ]**	**[ ]**
Others[20]		**[ ]**	**[ ]**
Kapiti	*Specialty: Kapiti*	**[ ]**	**[ ]**
Kraft Foods New Zealand	*Block: Kraft*	**[ ]**	**[ ]**
Total		**[ ]**	**100**

Source: Aztec data and Fonterra estimates, YE 10/05[21]

22.2 To reiterate, Kapiti does not manufacture block cheese and its share of the total cheese market is small. Given the existing level of competition, the minor aggregation resulting from the acquisition will have no impact on the competitive dynamics of the cheese market. However, while the Commission has analysed previous transactions using a broad cheese market (with which the Applicant agrees), Kapiti's focus on specialty cheese necessitates an analysis of that segment to demonstrate no concerns exist there either.

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[19] Note that data provided for Fonterra includes Bonlac NZ's market share of **[ ]**%.

[20] The "Others" category includes a number of manufacturers (large and small, and block and specialty manufacturers), including National Foods, Universal Foods, and Alpine Cheese.

[21] This information is derived from Aztec data for key accounts, and Fonterra's estimate for cheese bar sales and sales to food services outlets. For example, Kapiti has less than **[ ]**% of total key account sales, but is stronger in cheese bars, sales from which are difficult to quantify.

22.3 The following table contains segment shares (by value) of firms competing within the specialty segment:

Firm	Brands	Value ($)	Market Share (by value)
Fonterra	*Ferndale* *Galaxy* *Mainland* *Perfect*	**[ ]**	**[ ]**
NZDF	*Anchor* *Bouton D'Or* *Ornelle* *Puhoi* *Aakronia* *Royal Tasman*	**[ ]**	**[ ]**
Kapiti	*Kapiti*	**[ ]**	**[ ]**
Others	*Various*	**[ ]**	**[ ]**
Waimata	*Waimata*	**[ ]**	**[ ]**
Imports	*Various*	**[ ]**	**[ ]**
Delmaine	*Delmaine*	**[ ]**	**[ ]**
Whitestone	*Whitestone*	**[ ]**	**[ ]**
Barry's Bay	*Barry's Bay*	**[ ]**	**[ ]**
Total		**[ ]**	**100%**

Source: Aztec data for key accounts sale figures 2003 (which is the most recent data available for speciality cheese) and Fonterra estimates for sales through cheese bar and to food service outlets.

22.4 The acquisition of Kapiti will see the merged entity constrained by NZDF (with over **[ ]**% market share) and a huge variety of effective niche producers, as well as imports. Domestic manufacturers include over 40 producers including Whitestone, Waimata, Te Mata, Gibbston Valley, Kingsmead Cheese, Zany Zeus, Evansdale, Matatoki Cheese, Barry's Bay Cheese and Mercer Cheese. Importers include Fruit Cheese Producers, Premier Distributors, Tholstrup, Lemnos Foods, Jaycroix Cheese, Glanbia Foods, Rasmus Hansen, BEL International, Rutherford & Meyer, Fromageries BEL, Boursin, Grunland, Arla, Imported Cheese Manufacturers and Karikaas.

22.5 In addition, the above value data only tells part of the story, as Fonterra's brands (other than *Ferndale*) tend to occupy a different product space from those of Kapiti.

NZDF will remain as a strong competitor

22.6 Fonterra will remain significantly constrained by NZDF, post-acquisition. NZDF is very strong in specialty cheese, with leading brands such as *Puhoi* and *Ornelle*. NZDF has also indicated that it intends to increase its production of *Puhoi* within the year. In addition, NZDF will continue to sell *Anchor* branded block cheese (among the leading block cheese brands) **[ ]**.

Competition from other cheese manufacturers

22.7 In the supermarkets alone, there are at least thirty specialty cheeses available by competing manufacturers, and over 40 manufacturers enter the annual cheese awards. As noted in the CRA report attached at ***Appendix F***, the specialty cheese category has shown dramatic growth in recent years, facilitating new entry and expansion by small producers, by allowing entrants to focus on a discrete segment of the market (evidenced by the proliferation of small specialist cheese makers). That growth is driven by consumer demand. Success depends on flavour and brand identity, rather than price (as with block).

22.8 Whitestone Cheese is a good example of a successful specialty manufacturer (see www.whitestonecheese.co.nz). Whitestone, which is a Central South Island organic cheese manufacturer, has recently been awarded the contract to supply specialty house brand cheese to Progressive. Whitestone expanded its operation to produce blue vein cheese last year, which is regarded by the industry as a difficult product to manufacture. Whitestone's winning streak was capped this year when one of their cheese makers was awarded Champion Cheese maker at the New Zealand Champions of Cheese Awards.

22.9 Another example of successful entry is Te Mata Cheese, based in Havelock North. Te Mata Cheese recently started full scale production, and already produces specialty cheeses such as brie, feta and cheddar – all of which are available in supermarkets, gourmet food stores and vineyards throughout the North Island. Like Kapiti, Te Mata's products are aimed at the super premium end of the specialty segment, and despite its recent entry already competes with Kapiti in the Auckland region. As the company's website (see www.tematacheese.co.nz) states:

> *the next stage is to experiment, extend and expand. In years to come the current range of cows, sheep and goats milk cheeses will be joined by other gourmet products. And before too long, Te Mata Cheese will be heading offshore...*

Imports

22.10 Imports are a key feature of the cheese market (particularly in the specialty segment), and will continue to constrain the merged entity post-acquisition. Cheese from Europe and Australia can be imported into New Zealand and supplied through supermarket and foodservice channels often at a much lower price than domestically manufactured cheese. Currently, Kapiti and Delmaine import European cheeses and re-brand them for the domestic market. Restaurateurs, such as Simon Gault, import French and Italian cheeses directly, as do specialty stores and outlets such as Moore Wilson's. Tholstrup (Denmark) also import a significant amount of blue and white costello. These examples illustrate the ease and economic viability of importing cheese into New Zealand.

Product Differentiation

22.11 In marketing terms, Fonterra's main brands, *Mainland* and *Galaxy*, are "indulgence" brands, whereas *Kapiti*, *Ferndale*, *Puhoi*, *Whitestone* and *Te Mata* are more naturally "discernment" brands. "Indulgence" brands are marketed toward mainstream consumers; "discernment" brands toward the refined, knowledgeable consumer. Manufacturers and retailers are aware of this, and supply quantity and make placement decisions accordingly. The chart attached at ***Appendix I*** diagrammatically illustrates the differing product spaces, and substitutability between various market segments.

22.12 Product placement in supermarket cheese bars highlights the difference between Fonterra and Kapiti specialty cheeses. Fonterra's cheeses, *Mainland* and *Galaxy* are usually not placed directly alongside *Kapiti* (although Fonterra's *Ferndale* might be). On the other hand, *Puhoi, Whitestone*, *Te Mata* and other super-premium cheeses occupy immediately adjacent positions to *Kapiti* cheese. Further, *Mainland* and *Galaxy* cheese are not sold to premium foodservice outlets (as those brands are not considered appropriate for cheeseboards, tapas etc). In contrast, *Kapiti* is favoured by such outlets, and is often served as a "cheeseboard" cheese in restaurants, on airlines and in specialty cheese shops.

Coordinated market power

22.13 A range of factors indicate that there is minimal scope for collusion in the cheese market:

(a) low seller concentration and sellers of varying sizes;

(b) large variety of different cheese types;

(c) ease and speed of new entry; and

(d) countervailing power of supermarkets as the major purchasers of cheese.

Potential competition and barriers to entry

22.14 Rigorous competition from manufacturers such as NZDF, Whitestone, Waimata, Te Mata and other suppliers will be sufficient to alleviate any competition concern arising from the acquisition. However, as in the case of town milk, the threat of new entry and expansion by existing manufacturers (and again, the countervailing power of supermarkets as the major retailers of cheese) is also ever present.

22.15 In particular, there are a variety of other potential competitors which are likely to enter the specialty segment in a timely and sustainable manner, including international manufacturers from Australia and Europe, a new specialty cheese operator, entry into the specialty category by supermarkets, and entry by a variety of near competitors.

22.16 As discussed above, importers are already a significant feature of the segment, and there are no barriers to importing pasteurised cheese. In addition, the New Zealand Food Safety Authority is currently considering whether to allow imports of unpasteurised European cheese into New Zealand, and has indicated that a wide range of raw milk cheese may be allowed in to the country within two years. The demand for unpasteurised cheese is being driven by consumers who have enjoyed these cheeses overseas, but are currently unable to buy them in New Zealand. This would open up an entirely new field of import competition.

Expansion by manufacturers

22.17 The successful entry and expansion of Whitestone and Te Mata is discussed above at paragraphs 22.8 and 22.9, and there are a number of other near entrants that would be in a position to quickly enter the market.

22.18 Open Country Cheese, an independent manufacturer which commenced production in September 2004, is indicative of successful entry and expansion. In its first year, Open Country Cheese produced over 6,000 tonnes of cheese, valued at $24m. It currently exports most of its production cheese but supplies a small amount of cheese to the domestic market, which it could easily increase in the event of a ssnip. As Open Country's website (see www.opencountry.co.nz) states:

> *We are a growing company that plan to greatly increase production in both cheese and whey over the coming years.*

Entry by supermarkets

22.19 Although key players in block cheese, supermarkets currently market limited amounts of private label specialty cheese. Supermarkets in Australia are increasingly competitive in specialty cheese, and it can be expected that this trend will occur in New Zealand. By way of example, Progressive currently have a limited range of private label specialty cheese, and have recently indicated that they intend extending that range.

Entry by a near competitor

22.20 As with the town milk market, there is scope for a milk processor in a near market, such as town milk or ice cream, to quickly enter the cheese market and manufacture cheese (as alternative processors already have the requisite scale, brand loyalty, and distribution networks). The key component required for cheese manufacturing is a front-end pasteurisation system. An existing manufacturer with this equipment already established would face little or no barriers to entry.

De novo entry

22.21 Requirements for greenfields entry into the market include cheese vats, cheese manufacturing expertise, food safety compliance certification, distribution, and plant. Entry at the boutique level is estimated at approximately $2.5–$5m (and significantly less for a small operation). Entry on a medium to large scale would cost approximately $15 - $20m.

Countervailing power of supermarkets

22.22 Supermarkets are the major purchasers of cheese (both block and specialty) and exert a strong constraint over manufacturers. As with town milk, the ability to contract manufacture private label cheese provides leverage over manufacturers such as Fonterra and NZDF.

22.23 Supermarkets will continue to enjoy significant countervailing power post acquisition, and the position of supermarkets is strengthened by the fact that NZDF provides a reliable and credible alternative source of supply. In addition, there are over thirty manufacturers in the specialty category, all vying for supermarket shelf space (with NZDF being the largest).

22.24 Supermarkets exert a particularly strong constraint over manufacturers of block cheese, as they often tend to favour new "boutique" manufacturers of speciality cheese by granting them a disproportionate amount of shelf space (as a way of adding interest to the various products available) in an already limited area.

MANUFACTURE AND WHOLESALE SUPPLY OF TAKE HOME ICE CREAM IN NEW ZEALAND AND NOVELTY/SCOOP ICE CREAM IN NEW ZEALAND

23 **Existing competition**

Take home market

23.1 The Applicant estimates the current market shares (by value) for the take home market (including supply for private label requirements) as follows:

Firm	Value ($m)	Market Share (%)
Tip Top	**[ ]**	**[ ]**
Private label	**[ ]**	**[ ]**
Kiwi Ice Cream*	**[ ]**	**[ ]**
Emerald	**[ ]**	**[ ]**
Talley's	**[ ]**	**[ ]**
Deep South	**[ ]**	**[ ]**
Kapiti	**[ ]**	**[ ]**
Others	**[ ]**	**[ ]**
Total	**[ ]**	**100**

**includes the New Zealand Ice Cream Company. Source: Tip Top data to YE 10/05*

23.2 The aggregation resulting from the proposed acquisition will be insignificant, and simply extends Fonterra's ice cream range into the super premium segment. Given Kapiti's focus on that segment, the Applicant also provides the following market share data for both the everyday (including moderation) and super premium segments:

Firm	Everyday / Moderation		Super Premium		Total Take Home	
	Value ($m)	Market Share	Value ($m)	Market Share	Value ($m)	Market Share
Tip Top	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Private Label	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Kiwi Ice Cream*	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Emerald	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Talley's	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Deep South	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Kapiti	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Rush Munro's	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
The Gourmet Ice Cream Co	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Unilever	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Others	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Total	[ ]	**100**	[ ]	**100**	[ ]	**100**

***** *includes the New Zealand Ice Cream Company. Source: Tip Top data to YE to 10/05.*

23.3 In brief, the acquisition represents an increase in Tip Top's share of the super premium segment from **[ ]**% to **[ ]**% (as noted above, Kapiti do not manufacture "everyday" ice cream), and across the total take home market from **[ ]**% to **[ ]**%. While the merged entity will have a broader range of take home product, there will be minimal effect on the overall competitive dynamics of this market.

23.4 In particular, the merged entity will continue to be constrained by competition across the market, with competitive pressure from domestic producers such as Talley's and Emerald, both of whom supply branded and private label product to retailers. Again, the supermarkets themselves will also provide constraint through consistently changing suppliers for their private label contracts, as discussed below at paragraph 26. Emerald will continue to enjoy significant market share in the super premium segment, with **[ ]**% of sales through its *Killinchy Gold* and *Mövenpick* brands.

Novelty/scoop market

23.5 The Applicant estimates the current market shares (by value) for the novelty/scoop market as follows:

Firm	Value ($m)	Market Share (%)
Tip Top	**[ ]**	**[ ]**
Unilever	**[ ]**	**[ ]**
Kiwi Ice cream*	**[ ]**	**[ ]**
Emerald	**[ ]**	**[ ]**
Kapiti	**[ ]**	**[ ]**
Others	**[ ]**	**[ ]**
Total	**[ ]**	**100**

**includes the New Zealand Ice Cream Company. Source: Tip Top data to YE 10/05*

23.6 The market shares above indicate the merged entity will have **[ ]**% of the novelty/scoop market, post merger. Market share aggregation is an insignificant **[ ]**%, and will have no impact on the competitive dynamics of the market.

23.7 In addition, Fonterra and Kapiti manufacture different products for different areas of the market. Of Tip Top's supply, approximately **[ ]**% is to impulse outlets, and the remaining **[ ]**% to food service outlets. The distinction between novelty and scoop is split approximately **[ ]**% novelties and **[ ]**% scoop ice cream. Kapiti, by comparison, comprises **[ ]**% of the novelty/scoop market, and all of its supply is scoop ice cream is to food service outlets and its owner-operated retail outlets.

23.8 This distinction in supply between the participants indicates that the proposed merger will not result in any change to the competitive environment. Like the take home market, the acquisition simply represents an extension in Tip Top's food service product range (currently different to that of Kapiti) to include the super premium niche. Demand for super premium ice cream is driven by new and novel flavours, rather than price. This drive to continuously produce new flavours results in a large number of competing products in the market, and the merged entity will continue to face considerable constraint from a range of competitors.

23.9 Emerald's *Mövenpick* range demonstrates this emphasis on innovation. While *Mövenpick* is produced by Emerald in New Zealand, it is also imported directly from Switzerland on a seasonal basis to provide new flavours for the New Zealand market. Such innovation, however, is not confined to large operators. The Gourmet Ice Cream Company Limited established itself in the super premium niche with a focus on supplying food service outlets through innovative products such as *Speight's Old Dark* and *L&P* ice cream, and it now has over 500 flavours for supply.

23.10 The ease with which ice cream products can be substituted on the supply side indicates that producers can switch channels for supply towards food service outlets and thereby constrain the merged entity. For example Emerald supplies take home ice cream for supermarket private labels, but also supply food service outlets through their everyday and super premium ranges. Other producers of ice cream in the take home and novelty/scoop markets such as Talley's and Deep South are equally capable of manufacturing and supplying product to food service outlets.

Imports by Australian manufacturers

23.11 Nearly 20% of the ice cream supplied at wholesale in New Zealand is produced in Australia. Australian imports represent approximately 91% of total imports of ice cream, and the rest of the product is sourced mainly from China, Switzerland, Japan and Korea.[22] The majority of the products imported are frozen novelty or super premium take home goods.

23.12 The New Zealand ice cream market has become increasingly open to Australian manufacturers through a lack of tariffs and import licences, limited quarantine obligations, developing central distribution facilities of retailers in New Zealand providing nationwide services, and the imposition of joint food labelling standards and requirements.

24 Potential competition

Barriers to new entry / expansion

24.1 There are a wide range of commercially viable entry or expansion options for domestic and overseas ice cream suppliers. All participants in the ice cream industry retain the ability and capacity to expand their supply in the market in accordance with demand, through increasing production or importing products. This is evidenced by the number of new entrants in the industry over the last 5 years, including Emerald, Ginelli & Sons Limited and the Gourmet Ice Cream Company.

Establishing a distribution network

24.2 All participants in the ice cream industry have established distribution networks that can be used to bring to the markets increased volumes or product ranges. The need for a distribution network is not an impediment to a new entrant (as Kapiti has demonstrated), in particular because of the evolution of central distribution systems by the supermarkets (to whom manufacturers and importers may deliver direct) and independent food service distributors such as Creans and ARFD.

24.3 Each of the major Australian manufacturers operating in New Zealand has existing distribution relationships with the supermarkets which they could expand by the addition of new products or the expansion of existing products.

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[22] New Zealand Ice Cream Manufacturers' Association Industry Statistics, 2004.

Access for supply

24.4 Raw materials and ingredients are freely available for the production of ice cream, and there are no technical knowledge barriers to entry by new participants, or expansion by existing participants. Access to raw milk is discussed at paragraph 20.10 above.

Plant

24.5 Machinery used in the manufacture of ice cream is readily available, either domestically or imported. The Applicant estimates the base capital expenditure requirements for setting up an operation of medium scale to be approximately $10–15 million.

Innovation

24.6 A key feature of the ice cream industry is new product innovation. Fonterra turns over approximately 25% of its range of ice cream products each year to enable it to compete against alternative dessert options such as frozen yoghurts. Smaller competitors do the same; as demonstrated through the introduction of new products such as *Pistachio* by Emerald, *Saffron, Honey & Almond* by Rush Munro's, *Grapefruit Orange* by Mövenpick and *Fig and Honey* ice cream by Kapiti, new entrants can compete and succeed at the innovation game. The number of smaller players in the niche super premium ice cream market is testament to the reliance on new product innovation.

Excess capacity

24.7 In Decision 313 the Commission recognised (at paragraph 73) the relevance of unused manufacturing capacity allowing "competitors to increase production, acquire additional market share in the take home ice cream market and thereby constrain the combined entity". Such excess capacity for the manufacture of ice cream is present across the industry. The Applicant estimates current spare capacity at approximately **[ ]**% of total capacity in the industry, allowing competitors to increase production in the manner the Commission envisaged in Decision 313.

Diversion of exports

24.8 In addition to the large amount of domestic capacity across the industry, the merged entity would be constrained by the ability of competitors to divert export production back into domestic supply. Approximately $35 million of ice cream products produced in New Zealand are exported per annum, primarily to Japan and Korea (50%) and Australia (36%).[23] Competitors that currently export product include Emerald (Asia Pacific), Kiwi Ice Cream (Russia, China and the Asia Pacific), and Deep South (Australia).

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[23] New Zealand Ice Cream Manufacturer's Association Industry Statistics, 2004.

Import competition

24.9 The acquisition of Progressive by Woolworths Australia is likely to further intensify the opportunities for trans-Tasman competition. This includes an increased likelihood that private label contracts for supply to New Zealand retailers will go to tender across Australasia, rather than being confined to domestic producers.

24.10 Australian ice cream manufacturers have significant production capacity, and exports to New Zealand represent only a small proportion of that capacity. The Australian industry's wholesale supply of ice cream to supermarkets is worth approximately five to six times that of New Zealand, and has grown approximately 20% by value since 2002. There is considerable excess capacity available in the Australian industry[24] that could be used to manufacture ice cream products for the New Zealand market.

24.11 The following Australian ice cream manufacturers may constrain the merged entity via direct imports into the New Zealand ice cream market through expansion or new entry:

(a) Unilever, which currently imports ice cream products (predominantly frozen novelty items) under the *Streets* brand and may expand its operations;

(b) Societe des Produits Nestlé S.A. *(Nestlé),* which is the largest ice cream producer in Australia, operating under the *Nestlé Peters* brand.[25] Although Nestlé does not currently import ice cream products into New Zealand, the Applicant considers its entry into the industry is imminent; and

(c) Regal Cream Products Pty Limited *(Regal Cream),* which owns the *Bulla* brand in Australia, currently imports *Bulla* frozen novelty products into New Zealand, and may expand its operations.

24.12 Australian producers have significant financial resources, with the two largest ice cream producers in the world – Unilever and Nestlé – operating manufacturing facilities in New South Wales and Victoria and retaining substantial market share in the Australian ice cream markets. They maintain global turnover of almost €43 billion (NZ$74 billion)[26] and CHF87 billion (NZ$96 billion)[27] respectively.

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[24] Norco Co-operative Limited 2004 Annual Report, p.4.

[25] *Nestlé Peters is* a trade mark owned outside Western Australia by Nestlé. *Peters* is a trade mark owned in Western Australia by the Peters & Brownes Group (a wholly-owned subsidiary of Fonterra). There is no connection between Nestlé and Peters & Brownes.

[26] See www.unilever.com/ourcompany/aboutunilever/introducingunilever/

[27] *Nestlé S.A.* Management Report 2004, p.11. See www.nestle.com

24.13 Both of these producers already has significant presence in New Zealand – in 2004, Nestlé had the highest growth in FMCG in New Zealand and Unilever was one of the top 10 advertising spenders[28]. They both retain ice cream production facilities and capacity in Australia, and established distribution networks in New Zealand, to supply product in any of New Zealand's ice cream markets.

24.14 In discussing Unilever's global brands recently, Unilever Australasia's Corporate Relations and Communications Director, Nick Goddard, stated:[29]

> *The fundamental consumer need is pretty much the same across the world, particularly across Australia and New Zealand, where there is not a lot of difference.*
>
> And, later:
>
> *…the desire to eat Magnum ice cream is pretty much universal across the globe ... and the majority of [Unilever] brands are global brands working to global positionings and global formulations.*
>
> *…there is no need to discriminate, from a marketing perspective, between Australia and New Zealand and indeed in many other countries… we have a very strong presence on the ground in New Zealand, from a sales and activation perspective ... [which is what gives Unilever] the ability to influence sales at point of purchase.*

24.15 Regal Cream only imports *Bulla* frozen novelties into New Zealand at present, but manufactures both take home and scoop ice cream for retail and food service supply in Australia. It also retains the ability to expand its production and supply to the New Zealand take home and novelty/scoop markets.

25 Coordinated market power

25.1 The proposed acquisition will not increase collusive behaviour in the market. The reasons given with respect to the town milk market (paragraph 19 above) similarly apply to the ice cream markets. In particular, the industry is characterised by asymmetry of product, market share and business model. The import of goods by Unilever and the supermarkets constitute a significant proportion of demand in the market.

26 Countervailing power of supermarkets

26.1 As with town milk and cheese, the countervailing power of supermarkets will significantly constrain the merged entity post-merger. Approximately 90% of sales of take home ice cream in New Zealand are made through

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28 "Surviving Globalisation*", New Zealand Marketing,* 1 October 2005, p 8.

29 Ibid.

supermarkets, with approximately **[ ]**% of those sales being house brand products. This figure is expected to grow, and a rationalisation of brands across the board by supermarkets likely to result.

26.2 Take home house brands have grown 63% in dollar value over the previous five years. Across the industry, house brand contracts tend to last up to 2 years and there is a history of supermarkets changing suppliers. Tip Top's current house brand production in New Zealand is confined to Progressive's *Signature Range* everyday ice cream range, for which the contract is due to expire in April 2007. Tip Top expects this contract to be tendered on an Australasian basis, given Woolworths Australia's acquisition of Progressive.

26.3 The *Pam's* contracts for ice cream are held by Emerald for the Foodstuffs co-operatives. Foodstuffs' current contracts for private label supply are open-ended, leaving the preferred supplier and period for supply at its discretion. Any house brand contracts can go to any supplier at any time. By way of example, Emerald has also recently secured supply of Progressive's *Signature Range* super premium ice cream, despite Tip Top holding the *Signature Range* everyday contract at present. In addition, Foodstuffs LNI is currently commissioning its own ice cream plant, which it will use to manufacture its supply of *Pam's*. This demonstrates the ability of supermarkets to vertically integrate, not only in respect of town milk, but in other products including ice cream.

26.4 Like town milk and cheese, supermarkets are able to promote their own private label ice cream brands. As noted above at paragraph 14.10, these brands now include super premium ice cream.

Central distribution facilities

26.5 In Decision 313, the Commission stated, at paragraph 119:

> *a move to central distribution facilities by supermarket chains would enable supermarkets to constrain Tip Top by supporting smaller wholesalers without extensive distribution networks.*

26.6 Only the Woolworths chain had central distribution facilities when Decision 313 was released. Since then, all of the Progressive and Foodstuffs regional centres have installed central distribution systems that include capability for frozen goods such as ice cream products. This has allowed not only smaller manufacturers to spread their products, but also direct imports to be spread throughout New Zealand.

Fonterra Co-operative Group Limited makes this application.

I, David Matthews, am authorised to make this application on Fonterra Co-operative Group Limited's behalf.

I hereby confirm that:

- All information specified by the Commission has been supplied;
- All information known to the Applicant which is relevant to the consideration and determination of this application has been supplied; and
- All information supplied is correct as at the date of this application.

I undertake to immediately advise the Commission of any material change in circumstances to the application.

Dated this 17th day of November 2005.

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David Matthews
I am General Counsel, Fonterra Co-operative Group Limited and am duly authorised to make this application.

APPENDIX A – HEADS OF AGREEMENT

[ ]

APPENDIX B – FONTERRA BRANDS CORPORATE STRUCTURE

[ ]

APPENDIX C – FOODSTUFFS LNI CORPORATE STRUCTURE

[ ]

APPENDIX D – EUROMONITOR REPORT *PACKAGED FOOD IN NEW ZEALAND*

[ ]

PUBLIC VERSION

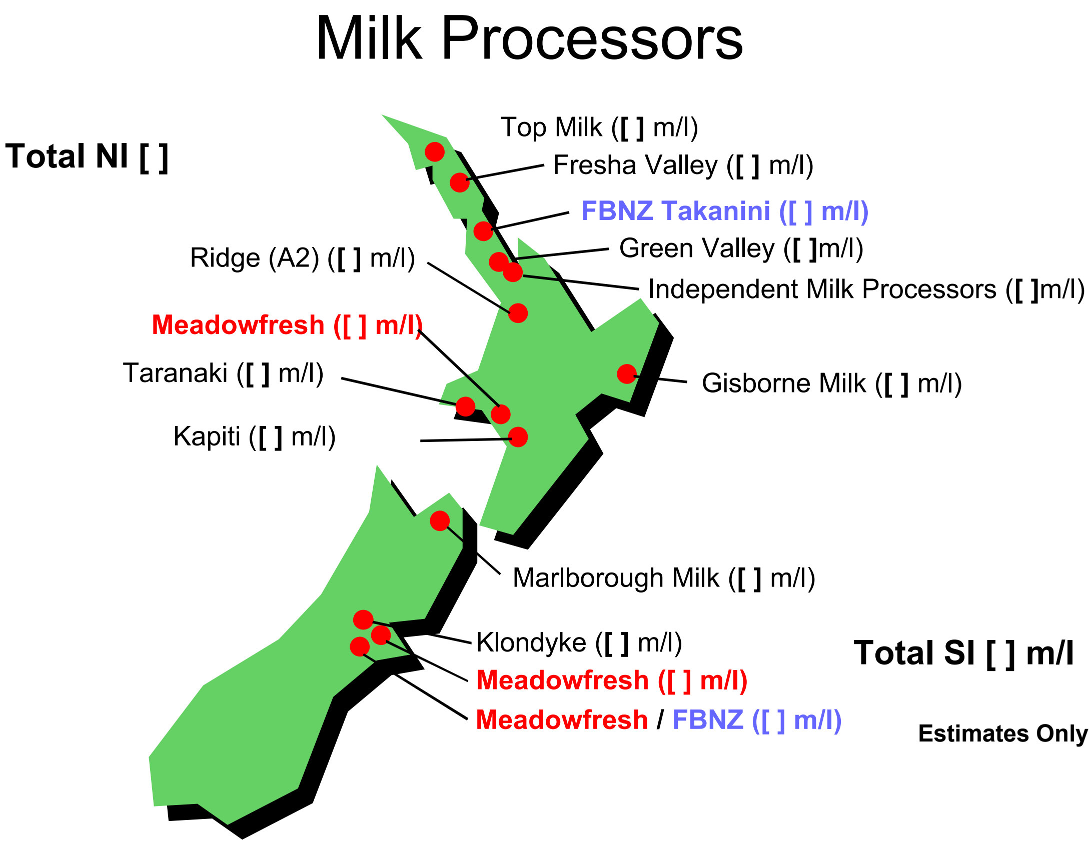
APPENDIX E – FONTERRA PAPER
"FUTURE MILK SUPPLY AND CESSATION TRENDS"

[ ]

APPENDIX F – CRA INTERNATIONAL REPORT

[ ]

APPENDIX G – MILK PROCESSORS IN NEW ZEALAND



APPENDIX H – TOWN MILK SUBMISSION

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APPENDIX I – VARIOUS BRANDS PRODUCT SPACE WITHIN SPECIALTY SEGMENT

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