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COMMERCE COMMISSION

Decision No. 428

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

MAINLAND PRODUCTS LIMITED

and

SOUTHERN FRESH MILK COMPANY LIMITED

The Commission:	MJ Belgrave PR Rebstock PJ Taylor
Commission Staff:	
Summary of Application:	The acquisition by Mainland Products Limited, or any of its interconnected bodies corporate, of up to 100% of the shares in or assets of Southern Fresh Milk Company Limited.
Determination:	Pursuant to section 66(3)(b) of the Commerce Act 1986, The Commission declines to give clearance for the proposed acquisition.
Date of Determination:	18 May 2001

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THE PROPOSAL

1. On 17 April 2001 Mainland Products Limited (Mainland) registered a notice with the Commission seeking clearance under s66 (1) of the Commerce Act 1986 for it or any of its interconnected bodies corporate to acquire up to 100% of the shares in or assets of Southern Fresh Milk Company Limited (Southern Fresh).

THE PROCEDURES

2. Section 66(3) of the Act requires the Commission either to clear, or to decline to clear, a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave the notice agree to a longer period. An extension in time was sought by the Commission and agreed to by the applicant. Accordingly, a decision on the application was required by Friday 18 May 2001.

3. Mainland sought confidentiality for certain information contained in the Application, and a confidentiality order was made in respect of that information for a period of 20 working days from the Commission's determination of the notice. When the confidentiality order expires, the provisions of the Official Information Act 1982 will apply to the information.

4. The Commission's determination is based on an investigation conducted by its staff, and their subsequent advice to the Commission.

5. In the course of their investigation of the proposed acquisition, Commission staff have discussed the application with a number of parties. These parties included New Zealand Dairy Foods Limited (Dairy Foods), Southern Fresh Milk Co Limited (Southern Fresh), Westland Dairy Co-operative Ltd (Westland), Marlborough Milk Ltd (Marlborough); supermarket groups including Woolworths (NZ) Ltd (Woolworths), Progressive Enterprises Limited (Progressive), Foodstuffs (South Island) Ltd, and Foodstuffs (Wellington) Ltd; the South Island Milk Vendors Federation, and the major oil companies.

THE PARTIES

Mainland

6. Mainland is a private company owned 83% by Kiwi Co-operative Dairies Limited ("Kiwi") and 17% by Aorangi Laboratories Ltd. Kiwi is the second largest dairy co-operative in New Zealand. Aorangi Laboratories has no other involvement in the dairy industry.

7. Mainland's business activities include the acquisition of raw milk from Kiwi for manufacture into fresh and UHT milk, cream, yoghurt, other cultured milk products and specialty cheeses; the packing, wholesaling and marketing of certain dairy products for the domestic market; the manufacture and packaging of specialty cheeses for export; the wholesaling of processed meats and small goods; and the supply of chilled food products.

8. The major brands of dairy products owned and used by Mainland are Mainland, Valumetric, Galaxy, Ferndale, Tararua and Meadow Fresh. Of particular relevance to this

application is Mainland's involvement in the processing and wholesale supply of town milk in the South Island.

9. Mainland supplies the majority of the South Island from its Christchurch processing plant, and the Southland and Otago regions from its plant in Dunedin.

Southern Fresh

10. Southern Fresh is a processor and wholesaler of town milk. Invest South Limited, an investment company, holds 16% of Southern Fresh's shares, Southern Dairy Investments Ltd holds 8%, and the balance is held by 21 farmer suppliers through Southland Co-operative Milk Producers Ltd. Southern Fresh has a franchise agreement with New Zealand Dairy Foods Limited (Dairy Foods), under which it processes and sells milk under the "Anchor" brand in Otago and Southland. It also contract processes and packs milk under the "Anchor" brand for Dairy Foods for sale in Canterbury. It produces and supplies milk under its own "So Fresh" brand in the Otago and Southland regions and produces and supplies housebrand milk to Woolworths in Otago and Southland.

11. Southern Fresh also manufactures ice cream for export under its own brand, and entered a supply agreement with Movenpick for sale of icecream in the Japanese market. [

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OTHER RELEVANT PARTIES

Dairy Foods

12. Dairy Foods is currently a subsidiary of New Zealand Dairy Group ("Dairy Group"). Dairy Foods is a public unlisted company with Dairy Group holding 50 percent of the shares of the company, and around 7,000 Dairy Group farmer shareholders holding the balance of shares.

13. Dairy Foods manufactures, markets and distributes chilled dairy products in the domestic and export markets. It has three divisions – Foods, Beverages and International. The Beverages division processes milk, cream and flavoured milk. Dairy Foods has a town milk processing plant in Takanini and has a 50% shareholding in Marlborough Milk Ltd, a small town milk processing company which supplies Marlborough. Dairy Foods has a franchise arrangement with Southern Fresh under which Southern Fresh processes and sells milk under the "Anchor" brand in Otago and Southland. Southern Fresh also contract processes and packs milk under the "Anchor" brand for Dairy Foods for Canterbury.

Supermarkets, Oil Companies and Milk Vendors

14. Forty percent of town milk in New Zealand is sold through supermarkets. The three supermarket chains in New Zealand are the Foodstuffs companies, Progressive and Woolworths. Supermarkets sell both the milk companies' brands, and their own brands, packed by the town milk companies ("housebrands"). The oil companies are significant

retailers of milk through their service station outlets. Milk vendors also account for significant retail sales, delivering milk to the route trade, and through home delivery, which is still common in the South Island.

BACKGROUND INFORMATION

Industry Background

15. The Commission has assessed a number of business acquisition proposals involving dairy companies recently. These include:
    - Mainland Products Limited/Nelson Milk Company, Decision 396, 7 June 2000.
    - MergeCo Draft Determination, 27 August 1999 ("*MergeCo*").
    - Kiwi Co-operative Dairies Limited/South Island Dairy Co-operative Limited (SIDCO) Decision 341, 26 February 1999.
    - Mainland Products Limited/South Island Dairy Farmers Co-operative Limited (SIDF) Decision 324, 12 May 1998.

16. As these reports, particularly *MergeCo*, provide detailed background to the dairy industry, it is not intended to provide a detailed description of the industry to date in this report.

17. The proposed Global Merger will see Kiwi Co-operative Dairies Limited, New Zealand Co-operative Dairy Company Limited (Dairy Group) and the New Zealand Dairy Board and their interconnected bodies corporate become one group. The amalgamated company's working name is Global Dairy Company. At this stage it appears that two other dairy companies – Westland and Tatua – will remain outside Global Dairy Company.

18. The proposed regulatory package provides that Global Dairy Company will be obliged to supply raw milk to all comers at a competitive wholesale price. It will also provide for fair value entry into and exit from Global Dairy Company for farmers. Dairy Foods must be divested from Global Dairy Company within one year of the amalgamation.

MARKET DEFINITION

Introduction

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

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

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

21. Relevant principles relating to market definition are set out in *Telecom Corporation of New Zealand Ltd v Commerce Commission*,[1] *Commerce Commission v Carter Holt Harvey Building Products Limited*,[2] and in the Commission's *Business Acquisition Guidelines* ("the Guidelines").[3] A brief outline of the principles follows.

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

23. A properly defined market includes products which are regarded by buyers or sellers as being not too different ('product' dimension), and not too far away ('geographical' dimension), and are therefore products over which the hypothetical monopolist would need to exercise control in order for it to be able to exert market power. A market defined in these terms is one within which a hypothetical monopolist would be in a position to impose, at the least, a "small yet significant and non-transitory increase in price" (the "ssnip" test), assuming that other terms of sale remain unchanged.

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

Relevant Markets

25. For the purposes of considering the market aggregation that would result from the proposed acquisition, the Applicant submits that the relevant markets are those for the acquisition/supply of raw milk in the South Island and for the processing and wholesale supply of town milk in the South Island.

26. In previous decisions relating to the dairy industry the Commission has discussed, in some detail, the product, geographic and functional levels associated with these markets. It is not proposed to repeat all of that detailed discussion in this report.

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1 (1991) 4 TCLR 473.
2 HC Auckland, 18/4/00, Williams J., CL 27/95 (unreported).
3 Commerce Commission, *Business Acquisition Guidelines*, 1999, pp. 11-16.

Product Markets

27. In recent decisions the Commission has concluded that there is a market for the acquisition/supply of raw (unprocessed) milk in the South Island. It continues to hold this view.

28. Pasteurised fresh milk sold in New Zealand is referred to as "town milk". Town milk includes a variety of milk types, flavoured fresh milks and cream. Milk types include full cream and homogenised varieties, and other products such as reduced fat and calcium enriched milks.

29. Studies both in New Zealand and overseas indicate that the price elasticity of demand for town milk is very low[4] which strongly suggests that there are no close substitutes for town milk.

30. In previous decisions the Commission has determined that there is a distinct town milk product market. There is no evidence that this situation has changed. The Commission therefore concludes that for the purpose of assessing the competition implications of the proposed acquisition, the appropriate product markets are those for:

    - raw milk; and
    - town milk.

Function Markets

31. The applicant has submitted that the appropriate functional levels are the acquisition/supply of raw milk and the processing and wholesale supply of town milk. This accords with previous recent decisions of the Commission such as Decision 396 and the Commission sees no reason to move from that position.

32. The Commission therefore concludes that the appropriate functional levels for assessing the competition implications of the proposed acquisition are:

    - the acquisition/supply of raw milk; and
    - the processing, and wholesale supply of town milk.

Geographic Market

33. The Commission has, on a number of previous occasions, defined the geographic extent of the market for the acquisition/supply of raw milk and for the processing and wholesale supply of town milk as being island-wide, with separate North and South Island markets.[5]

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[4] See, for example, R J Brodie, R G Moffitt and J D Gough, "The Demand for Milk: An Econometric Analysis of the New Zealand Market", Research Report No 147, Agricultural Economics Research Unit, Lincoln University, January 1984.

[5] Refer Decisions 324 and 396 and the *MergeCo* Draft Determination.

34. The Commission noted in *MergeCo* that there is a trend on the demand side of the market towards national distribution and marketing of specific milk brands. The Commission also noted that the large retail customers of the town milk companies, in particular supermarkets and oil companies, prefer to deal with a small number of suppliers for administrative simplicity, and are encouraging a trend towards national supply contracts.

35. However, on the supply side, the market is still divided into North Island and South Island operations. Other than small amounts of flavoured milk, town milk is not currently transported across Cook Strait. Although the applicant states that in the past both Mainland and Dairy Foods have transported town milk across Cook Strait, this has only occurred on occasions when supply is short. Industry participants state that it is not economic to transport town milk between the North and South Islands on a regular basis.

36. The smaller town milk companies have tended to operate in more regionally defined areas. The main reason for the limited reach of the smaller companies is the cost and difficulty of establishing a large distribution network and a national brand. For example, Southern Fresh is currently supplying town milk to Christchurch, Otago and Southland only and Marlborough Milk only supplies the Marlborough region. However, town milk is regularly transported over large distances in the South Island. A large supplier could economically supply the whole of the South Island from a Christchurch base.

37. The Commission therefore concludes that the appropriate geographic market is the South Island.

Conclusion on Market Definition

38. The Commission concludes that the relevant markets are:

- the acquisition/supply of raw milk in the South Island; and
- the processing and wholesale supply of town milk in the South Island ("the South Island town milk market").

COMPETITION ANALYSIS

Introduction

39. The competition analysis assesses competition in the relevant markets in order to determine whether the proposed acquisition would result, or would be likely to result, in an acquisition or strengthening of **dominance**.

The Dominance Test

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

> "No person shall acquire assets of a business or shares if, as a result of the acquisition, -
> a) That person or another person would be, or would be likely to be, in a dominant position in a market; or
> b) That person's or another person's dominant position in a market would be, or would be likely to be, strengthened."

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

> "For the purposes of sections 47 and 48 of this Act, a person has … a dominant position in a market if that person as a supplier … of goods and services, is or are in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market and for the purposes of determining whether a person is … in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in a market regard shall be had to-
>
> (a) The share of the market, the technical knowledge, the access to materials or capital of that person or those persons:
>
> (b) The extent to which that person is … constrained by the conduct of competitors or potential competitors in that market:
>
> (c) The extent to which that person is … constrained by the conduct of suppliers or acquirers of goods or services in that market."

42. The test for dominance has been considered by the High Court. McGechan J stated:[6]

> "The test for 'dominance' is not a matter of prevailing economic theory, to be identified outside the statute."
>
> …
>
> "Dominance includes a qualitative assessment of market power. It involves more than 'high' market power; more than mere ability to behave 'largely' independently of competitors; and more than power to effect 'appreciable' changes in terms of trading. It involves a *high degree of market control*."

43. Both McGechan J and the Court of Appeal, which approved this test,[7] stated that a lower standard than "a high degree of market control" was unacceptable.[8] The Commission has acknowledged this test:[9]

> "A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint by competitor or customer reaction.
>
> "A person in a dominant position will be able to initiate and maintain an appreciable increase in price or reduction in supply, quality or degree of innovation, without suffering an adverse impact on profitability in the short term or long term. The Commission notes that it is not necessary to believe that a person will act in such a manner to establish that it is in a dominant position, it is sufficient for it to have that ability."

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

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[6] Commerce Commission v Port Nelson Ltd (1995) 6 TCLR 406, 441.

[7] Commerce Commission v Port Nelson Ltd [ ] 3 NZLR 554, 573.

[8] *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406,440.

[9] Business Acquisition Guidelines, Section 7, p. 21.

The Market for the Acquisition / Supply of Raw Milk

45. The Applicant submits that the proposed acquisition will have no effect on competition in the acquisition / supply of raw milk. The quantity of raw milk purchased by Mainland from Kiwi, and the quantity of raw milk purchased by Southern Fresh from its farmers, represents a tiny percentage of the total quantity of raw milk sold in the South Island. As such, there will be minimal aggregation resulting from the proposed acquisition.

46. The effect of this proposal will be that the 21 farmers currently supplying milk to their own company, Southern Fresh, will now supply this milk to Mainland.

47. The Commission is satisfied that there will be little change in the market for the acquisition/supply of raw milk in the South Island as a result of the acquisition. Consequently, it is not proposed to analyse this market in any further detail.

The Market for the Processing and Wholesale Supply of Town Milk in the South Island

Market Concentration

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

49. The *Business Acquisitions Guidelines* specify certain market share "safe harbours" which can be used to screen out those acquisitions that are unlikely to breach the dominance thresholds in terms of s 47 of the Act –

> "In the Commission's view, a dominant position in a market is generally unlikely to be created or strengthened where, after the proposed acquisition, either of the following situations exist:
>
> - the merged entity (including any interconnected or associated persons) has less than in the order of a 40% share of the relevant market;
> - the merged entity (including any interconnected or associated persons) has less than in the order of a 60% share of the relevant market and faces competition from at least one other market participant having no less than in the order of a 15% market share." (p 17)

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

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

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

52. Market share information has been provided by the Applicant, Southern Fresh, Dairy Foods and other interested parties to this application. Estimated current market shares are shown in Table 1.

Table 1: Market Share in the South Island Town Milk Market

Supplier	**Brand Share**[10]		**Production Share**	
	Litres	**Shares**	**Litres**	**Shares**
Mainland	[ ]	[ ]	[ ]	[ ]
Dairy Foods	[ ]	[ ]	[ ]	[ ]
Southern Fresh	[ ]	[ ]	[ ]	[ ]
Total	**86 million**	**100%**	**86 million**	**100%**

53. Southern Fresh's production is made up as follows:

- 50% - sold under Southern Fresh's "So Fresh" label;
- 25% - sold under the "Anchor" label in Southland/Otago under a franchise agreement with Dairy Foods; and
- 25% - contract packed for Dairy Foods and sold by Dairy Foods under the "Anchor" label in Canterbury.

54. If the acquisition were to proceed, and if the current franchise and contract packing arrangements were discontinued, then both brand and production market shares would reflect the volumes of processed milk currently available to the merged entity and Dairy Foods respectively. The merged entity would have a brand and production market share of [ ] and Dairy Foods would have a brand and production market share of [ ]. These levels of market share are outside the Commission's safe harbour Guidelines. The Commission has sought to establish what the likelihood is of the franchising and contract packing arrangements remaining in place, or being replaced by similar arrangements.

55. Mainland has advised that, should the acquisition proceed, [

]

56. [

]

57. [

10 Includes supply of supermarket housebrands. These make up 18.4% of the South Island town milk market.

]

58. [

]

59. Given the uncertainty surrounding the future of the current arrangements for the supply of processed milk to Dairy Foods, and the difficulties associated with expanding Marlborough Milk production, the Commission considers that Dairy Foods brand market share is more likely to be 8% were the proposed acquisition to proceed, but could be as high as 16%. Its production market share will be 8%.

Reasons for the Acquisition

60. Mainland does not need the additional capacity of Southern Fresh's milk plant in Invercargill, as it already has excess capacity in its Christchurch and Dunedin plants. Mainland has stated that the acquisition would address the problem of oversupply of town milk in Otago and Southland, and give Mainland the opportunity to reduce inefficiencies associated with the duplication of town milk supplies and costs. Nonetheless, Mainland has said that [ ].

61. [

]

Existing Competition

62. The Commission considers that the effectiveness of Dairy Foods as an existing competitor will depend to a significant extent on access to an adequate and secure supply of processed milk. As noted above, it is uncertain whether this will be the case following the acquisition.

63. The applicant submits that Dairy Foods would be able to expand its presence in the South Island and compete effectively in that market by transporting milk from Marlborough Milk to Christchurch and Southland. It claims that the freight cost would not be sufficient to deter them. [

] the transport costs would make supplying the restof the South Island from Marlborough uneconomic. Dairy Foods states that it does not intend to follow this path.

64. The Commission does not consider that transporting town milk from Marlborough to Canterbury and Otago/Southland is a sustainable strategy in the medium term.

65. Dairy Foods has stated that it is investigating the feasibility of building a town milk processing plant in Christchurch. The plant would cost [ ] and [ ] of the South Island market.

66. Information provided by industry participants indicates that Dairy Foods should not have any difficulty expanding its presence in the market once its plant is operational. The supermarkets and oil companies have expressed a preference for dealing with a minimum of two major suppliers in the market. They advised that price and service are the key factors they consider when selecting a supplier and that they like the option of being able to switch supplier at any time. Branding does not appear to be particularly important in town milk, as evidenced by the substantial sales of housebrand milk.

67. In building its proposed new Christchurch plant, Dairy Foods would need to have access to a substantial supply of raw milk. It states that if the Global merger proceeds, Global Company would be obliged to supply raw milk to Dairy Foods at a competitive price under the terms of the regulatory package agreed with the Government Under that package, farmers would be free to supply up to 20% of their production to third parties. Furthermore, under the fair entry and exit regulations, it is intended that there would be more access to independent farmers. In the long term, Dairy Foods intends to develop an independent supply of raw milk.

68. Dairy Foods has advised that if the Global merger does not go ahead, Dairy Foods will be able to source raw milk from Dairy Group.

69. [ ]

70. Even if the Christchurch plant were approved, it may not be built within two years because of the following delays:

- a delay until the fate of the Global merger proposal is decided later this year (delay of some months);
- a further delay until Dairy Foods is divested (delay of up to a year);
- a further delay until the new owner has had time to assess the situation (delay of some months); and
- if, finally, the project is accepted, the plant would take some time to build (delay of one year).

71. It appears, therefore, likely that the new plant would not be in operation for well over two years. On a worst case scenario, it might not be built at all.

72. The Global merger is anticipated to occur at the end of September 2001. The divestment of Dairy Foods must occur within 12 months of the merger. The applicant claims that as

a 50% shareholder in Dairy Foods, Dairy Group (and its director appointees) still need to act in the financial interests of Dairy Foods during this transitional period and accordingly would not obstruct Dairy Foods' move to obtain external funding for a town milk processing plant.

73. The applicant claims that even if the divestment of Dairy Foods were not to take place until the end of the transitional period, this is still a very short timeframe. Given the delays identified above, the Commission does not agree with this contention. The applicant argues that it cannot be assumed that the acquisition of Southern Fresh by Mainland would occur at the beginning of the period, while the divestment of Dairy Foods would occur at the end of that same period. Equally the Commission cannot assume that the acquisition of Southern Fresh would occur late, and the divestment would take place early. The Commission considers that the time delays identified above are not unrealistic.

74. The applicant claims that in any event, to focus on such a short transitional period distorts the competition analysis of the market, as it is only a link between the market before and after Global Merger. It says that the analysis should more properly focus on the state of the market *after* the transitional period and that the transitional period should be viewed in the same way as the period between the implementation of an acquisition that is subject to a Commission clearance asset divestment undertaking and the occurrence of that divestment.

75. The Commission does not agree with this view. The Commission has the opportunity to agree to clear an application on the basis of a divestment undertaking, and ensure its concerns are taken account of before accepting such an undertaking. It has remedies if divestment is not undertaken within the necessary time frame. The Commission does not control the time frame for the implementation of the Global Merger, and it may be subject to delays. The Commission considers that it is appropriate to consider the impact of the likely timing of the implementation of the regulatory and institutional arrangements on the timing of expansion or entry.

76. It should also be noted that at the time of the Commission's investigation of Mainland's application for clearance to purchase the Nelson Milk Company (Decision 396, 7 June 2000), Dairy Foods advised the Commission that it would be building a plant in Christchurch which would operational within a year or possibly sooner. However, almost a year later [ ] to build the plant.

77. The applicant states that in the event that during the transitional period Dairy Foods does not decide to build a new processing plant or to increase its expansion in the South Island market through other means, the real likelihood of this occurring once it is divested to a new investor will be a constant threat to the merged entity, thereby imposing significant competitive constraints on it.

78. To effectively constrain the exercise of market power to the extent necessary to alleviate concerns about market dominance, entry or expansion must be likely to occur before consumers or users in the relevant market are detrimentally affected to a significant extent. In this case the Commission believes that it is reasonable to use a two year timeframe to assess the potential for detriment to consumers.

79. The Commission considers that, taking into account all the relevant factors, Dairy Foods may undertake the expansion it is currently considering in the South Island at some point in the future. However, the timing of such expansion, given recent history, and the uncertainty surrounding when the significant structural changes to the dairy industry will take place, remains very uncertain. In these circumstances the merged entity would run few additional risks of prompting that expansion by seeking to exercise market power in the meantime. It may seek to obtain such rents as it can, conscious that new entry may occur in any event at some point, whether it exercises restraint or not.

80. It is therefore the Commission's view that expansion by Dairy Foods is unlikely to occur within a timeframe that would prevent the merged entity from exercising considerable market power for a significant period of time, most likely in excess of two years.

<u>Conclusion on Existing Competition</u>

81. [ ] Furthermore, Dairy Foods, despite advising the Commission at the time of Decision 396 that it intended to build a plant in Christchurch that would be operational within a year, has yet [ ] to build the plant. These factors, together with the timing uncertainty of the regulatory climate and industry structure resulting from the plan to form Global Co, raise significant doubts as to the timeliness of expansion by Dairy Foods.

82. Taking all the factors together, the Commission is not satisfied that Dairy Foods' Christchurch plant would be operational within a timeframe that would prevent the merged entity from exercising market power for a significant period of time.

83. It is therefore the Commission's view that the merged entity would not be constrained by existing competition.

Potential Competition

84. A business acquisition is unlikely to result in the acquisition or strengthening of dominance if there is a credible threat of market entry. Potential competition can act as a constraint on market power, and so an examination of the nature and extent of this constraint is part of the Commission's assessment of competition.

85. Entry conditions, including the nature and height of any entry barriers, must be considered before the threat of new entry, which might constrain the conduct of a merged entity, can be evaluated.

86. The Commission has previously looked at the conditions and barriers to entry into this market in *MergeCo and Decision 396*. In *MergeCo* the Commission observed that the major barriers to entry relate to the need for a distribution network and the critical mass required to make entry economic. The Commission stated: [11]

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[11] *MergeCo* Draft Determination, 27 August 1999, paragraph 339

> "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."

87. In *MergeCo* the Commission concluded that the importance of distribution is one of the prime reasons why Mainland and Dairy Foods have such a strong position in terms of national town milk sales, and why small companies, while important in some areas, lack the critical mass to supply large customers, and are therefore unable to compete directly with Dairy Foods and Mainland for major customers.[12]

88. The applicant agreed with both these conclusions and stated that for a market participant to be a significant competitor, it would have to match the distribution infrastructure of Mainland and Dairy Foods. Dairy Foods has assessed the cost of setting up such an infrastructure as being approximately [ ]. Mainland claims that the cost of a distribution infrastructure need not be substantial if distribution is contracted out to other parties.

89. Some industry participants have estimated that a company must be able to produce at least 10 million litres, equivalent to 15% of the market, to be viable. Some others have placed that figure at between 15 million and 18 million litres.

90. Industry estimates of the processing plant that a new entrant would need to build vary from [ ] for a plant able to produce 15 million litres a year, operating a single shift, and 30 million litres a year, operating two shifts a day. Foodstuffs (Wellington) advised that it cost [ ].

91. A new entrant of this scale would also need a substantial supply of raw milk. As already discussed with respect to Dairy Foods' intended operation in Christchurch, such supply should be available if the Global merger were to occur. However, supply of raw milk could be a problem for a new entrant if the Global merger did not occur.

92. The applicant pointed out that Foodstuffs (Wellington) has entered into a joint venture with North Island Dairy Company and has incorporated United Milk Ltd which processes all town milk required by Foodstuffs (Wellington). The applicant submits that this joint venture could easily be replicated in the South Island by Foodstuffs or another supermarket chain. Foodstuffs (Wellington) advised that it had set up the joint venture as a result of their [ ].

93. Progressive stated that [ ] It also referred to the fact that Foodstuffs have

[12] *MergeCo* Draft Determination, 27 August 1999, paragraphs 340, 342.

quite a lot of involvement in manufacturing whereas Progressive's expertise is only in supermarketing.

94. Foodstuffs (South Island) advised that it is [ ]. It pointed out that the cost of distribution is substantially more in the South Island. Woolworths advised that it [ ].

95. The applicant submitted that Westland is a potential entrant to the market. Westland advised that [ ]

96. The applicant submits that three forms of de novo entry into the town milk market are possible – entry by a manufacturing co-operative that produces a number of products; entry by a town milk company on a scale comparable with Mainland and Dairy Foods; and entry by a town milk company aiming at a geographic or product niche.

97. The applicant acknowledges that a new entrant looking to compete "head on" with Dairy Foods and Mainland is not likely in the South Island. In fact it is unlikely that any company, whether manufacturing or niche, would enter a small market such as the South Island market in competition with both Mainland and Dairy Foods. Furthermore, none of the industry participants considered that such an entry was likely, or had heard of any such possible entrant.

98. The theoretical possibility of entry is an insufficient constraint on the exercise of market power to alleviate concerns about market dominance. In order to constrain market participants, entry must be likely and sustainable in commercial terms. In the Commission's view, an economically rational business would be unlikely to enter a market unless it has a reasonable prospect of achieving a lasting and satisfactory return on its investment.[13]

99. The threat of market entry must also be at a level that is likely to cause market participants to react in a significant manner if it is to constrain market participants. The Commission does not consider entry which might occur only at relatively low volumes or in localised areas, to represent a sufficient constraint to alleviate concerns about market dominance.[14]

100. To effectively constrain the exercise of market power to the extent necessary to alleviate concerns about market dominance, entry must be likely to occur before consumers or users in the relevant market are detrimentally affected to a significant extent. As a guide, the Commission considers that, for most markets, entry which cannot be achieved within two years from initial planning is unlikely to satisfy the timeliness requirement of the *lets* test. The Commission has noted, however, that the relevant time period has to be considered on a case-by-case basis.[15]

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[13] *Business Acquisition Guidelines 1999*, Sections 5.1 and 5.4, p 19-20
[14] *Business Acquisition Guidelines 1999*, Section 5.2, p 19-20
[15] *Business Acquisition Guidelines 1999*, Section 5.3, p 20

101. The only likely new entries into the South Island town milk market at a sustainable level would appear to be in the form of joint ventures either entered into by a supermarket with a milk company, or by [ ]. However, there is no evidence of this being likely to occur within two years of the proposed acquisition.

102. It is therefore the Commission's view that the merged entity would not face effective competition from potential competitors.

Countervailing Power of Buyers

103. A firm may be constrained by any countervailing power possessed by its customers. Buyer power is likely to be high when there is a concentration of buyers and the volume purchases of the buyers are high.

104. The supermarket chains, oil companies and milk vendor groups are the major acquirers of town milk in the South Island. Supermarkets account for 40% of total town milk sales. Milk vendors service the other 60% of the market, split between the route trade with 40% and home delivery with 20%. Of the route trade, oil companies are approximately 25%. Although the oil companies negotiate directly with the town milk companies about supply and price, the milk is delivered to them by milk vendors.

105. The applicant claimed that the supermarkets in particular would exercise a constraining power over the merged entity. It pointed to the fact that not only do the supermarkets purchase a considerable percentage of its production, but that they also purchase a range of products other than town milk. If the merged entity attempted to exploit market power, it would be "punished" in those other products where it faces competition.

106. The supermarkets and oil companies have advised that they do not currently have countervailing power in the town milk market. They said that it is important that there are two suppliers of town milk in the South Island that are able to supply sufficient milk for their stores throughout the Island. They point out that if the proposed acquisition went ahead there would be only one such supplier, the merged entity, and that they would therefore have no countervailing power at all as they would be forced to deal with that supplier.

107. The South Island Milk Vendors Association purchases only Mainland town milk and [ ]. They believe that they have no power to negotiate terms of supply from Mainland. They are obliged to accept whatever prices are determined by Mainland. However, the Association has said that it would consider changing its source of supply following entry by Dairy Foods.

108. It is the Commission's view that the merged entity would not be constrained by the countervailing power of supermarkets, oil companies or milk vendors.

Conclusion on the South Island Town Milk Market

109. The proposed acquisition would result in the merged entity obtaining a [ ] brand and production market share which falls well outside the Commission's safe harbour guidelines. The merged entity would be not be constrained by any competitor within a two year timeframe which the Commission considers in this case to be relevant in assessing the ability of the merged entity to exercise market power which would detrimentally affect consumers to a significant extent.

110. The Commission is therefore not satisfied that the merged entity would not acquire or strengthen dominance in the South Island town milk market.

OVERALL CONCLUSION

111. The Commission has considered the impact of the proposed acquisition in the following markets:

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

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

DETERMINATION ON NOTICE OF CLEARANCE

113. Accordingly, pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission declines to give clearance for the acquisition by Mainland Products Limited, or any of its interconnected bodies corporate, of up to 100% of the shares in or assets of Southern Fresh Milk Company Limited

Dated this day of May 2001

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M J Belgrave
Chair