

## Statement of Preliminary Issues

### H. J. Heinz Company (New Zealand Limited / Cerebos Pacific Limited)

14 December 2017

#### Introduction

1. On 28 November 2017, the Commerce Commission (Commission) registered an application seeking clearance from H. J. Heinz Company (New Zealand) Limited (Heinz NZ) to acquire Cerebos Pacific Limited's (Cerebos') New Zealand food and instant coffee business, by acquiring 100% of the shares in Cerebos' subsidiary Cerebos Gregg's Limited (the proposed merger).
2. The proposed merger forms part of an international transaction through which Heinz NZ's parent, the Kraft Heinz Foods Company, via local subsidiary companies, will acquire Cerebos' New Zealand, Australia, and Singapore food and instant coffee business.
3. The proposed merger is subject to Heinz NZ undertaking to sell certain assets to a third party (the proposed divestment undertaking), including:
  - 3.1 the recipes for Gregg's tomato sauce, barbecue sauce and steak sauce products supplied in New Zealand;
  - 3.2 the right to use the Gregg's brand for tomato sauce, barbecue sauce and steak sauce in New Zealand;
  - 3.3 the recipes for F. Whitlock & Sons Worcestershire sauce supplied in New Zealand;
  - 3.4 the right to use the F. Whitlock & Sons brand for Worcestershire sauce in New Zealand; and
  - 3.5 an offer to enter into co-packing agreements with any purchaser of the brands divested pursuant to the divestment undertaking, if requested.
4. The Commission will give clearance if it is satisfied that the merger will not have, or would not be likely to have, the effect of substantially lessening of competition in a market in New Zealand.
5. This statement of preliminary issues outlines the key competition issues we currently consider to be important in deciding whether or not to grant clearance.<sup>1</sup>

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<sup>1</sup> The issues set out highlighted in this statement are based on the information available at the time of publication. They are not binding on us and may change as our investigation progresses.

6. We invite interested parties to make comment on the likely competitive effects of the proposed merger. We request that parties who wish to make a submission do so by close of business on **Friday 12 January 2018**.

## The parties

### Heinz NZ

7. Heinz NZ is ultimately 100%-owned by Kraft Heinz Company, an international food and beverage company. In New Zealand, Heinz NZ manufactures and supplies a range of branded processed food products. Relevant to the application for clearance is the range of sauces that Heinz NZ manufactures and supplies to supermarkets and to the food service industry in New Zealand under the brands Wattie's, Heinz, Lea & Perrins, HP, and Gourmet.

### Cerebos

8. Cerebos is ultimately 100%-owned by Suntory Beverage & Food Pte Ltd, a large food and beverage company that operates globally, including throughout Australasia. Relevant to this application is that Cerebos produces sauces in Australia under a number of brands, mainly Cerebos, Gregg's, F. Whitlock & Sons, and Asian Home Gourmet. Cerebos then exports them to New Zealand for distribution.

## Our framework

9. Our approach to analysing the competition effects of the proposed merger is based on the principles set out in our Mergers and Acquisitions Guidelines.<sup>2</sup> As required by the Commerce Act 1986, we assess mergers using the substantial lessening of competition test.
10. We determine whether a merger is likely to substantially lessen competition in a market by comparing the likely state of competition if the merger proceeds (the scenario with the merger, often referred to as the factual), with the likely state of competition if the merger does not proceed (the scenario without the acquisition, often referred to as the counterfactual).<sup>3</sup>
11. We define markets in the way that we consider best isolates the key competition issues that arise from the merger. In many cases this may not require us to precisely define the boundaries of a market. A market is ultimately determined, in the words of the Commerce Act, as a matter of fact and commercial common sense.<sup>4</sup>
12. We compare the extent of competition in each relevant market both with and without the merger. This allows us to assess the degree by which the proposed merger might lessen competition. If the lessening is likely to be substantial, we will not give clearance to the proposed merger. When making that assessment, we consider, among other matters:

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<sup>2</sup> Commerce Commission, *Mergers and Acquisitions Guidelines*, July 2013. Available on our website at [www.comcom.govt.nz](http://www.comcom.govt.nz).

<sup>3</sup> *Commerce Commission v Woolworths Limited* (2008) 12 TCLR 194 (CA) at [63].

<sup>4</sup> Section 3(1A). See also *Brambles v Commerce Commission* (2003) 10 TCLR 868 at [81].

- 12.1 existing competition – the degree to which existing competitors compete;
  - 12.2 potential competition – the extent to which existing competitors would expand their sales or new competitors would enter and compete effectively if prices were increased; and
  - 12.3 the countervailing market power of buyers – the potential for a business to be sufficiently constrained by a purchaser’s ability to exert substantial influence on negotiations.
13. Where a proposed merger raises competition concerns, an applicant can provide an undertaking to sell certain assets or shares as a condition of clearance in order to remedy those competition concerns.<sup>5</sup> The Commission can only accept undertakings to divest assets<sup>6</sup> or shares<sup>7</sup> and it is up to an applicant to decide whether to offer a divestment undertaking.

### **Market definition**

14. Heinz NZ has submitted that the relevant markets most affected by the proposed merger are the national markets for the wholesale supply of:
- 14.1 red sauce (primarily tomato sauce and ketchup);
  - 14.2 barbecue sauce;
  - 14.3 steak sauce;
  - 14.4 Worcestershire sauce;
  - 14.5 Asian sauces;
  - 14.6 condiments; and
  - 14.7 chilli sauce.
15. Heinz NZ distinguished separate markets between the wholesale supply of these products to the retail channel and the food services industry channel, which form the channels through which the products are distributed.
16. As part of our investigation, we will consider whether it is appropriate to:
- 16.1 assess the proposed merger using the narrow markets adopted in the application for each of steak and barbecue sauces; and
  - 16.2 assess whether to further segment the Asian sauces category, by considering the substitutability between Indian and non-Indian sauces.

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<sup>5</sup> Commerce Act 1986, s 69A.

<sup>6</sup> Section 2(1) of the Commerce Act 1986 states that “assets” include intangible assets.

<sup>7</sup> Under section 2(1) of the Commerce Act 1986, a “share” means “a share in the share capital of a company or body corporate, whether or not it carries the right to vote at general meetings....”

17. We will also consider the impact of the proposed merger on the manufacture/importation functional levels of the relevant product markets.

### **Without the acquisition**

18. As part of our consideration of the proposed merger, we will consider what is likely to happen if the merger does not proceed. This will include whether a different state of competition (other than the status quo) would be likely if a third party acquired Cerebos' food and instant coffee business in New Zealand.

### **Preliminary issues**

19. We will investigate whether the proposed merger is likely to substantially lessen competition in the relevant markets by looking mainly at the unilateral effects that may result from the merger. In particular, we will consider whether the merged entity would be able to raise prices above the prevailing level.
20. We will also look at whether the proposed merger is likely to result in coordinated effects. That is, whether the merged entity would be able to coordinate with rivals to raise prices.

### **Unilateral effects: would the merged entity be able to raise prices on its own?**

21. Where two suppliers compete in the same market, a merger could remove a competitor that would otherwise provide a competitive constraint, allowing the merged entity to raise prices. A merger could also reduce competition if the target was a potential or emerging competitor. In such a case, a merger could result in higher prices compared to the scenario without the merger.<sup>8</sup>

### *Existing competition in the red, barbecue, steak and Worcestershire sauces markets*

22. Heinz NZ has submitted that absent the proposed divestment undertaking, the merger would involve the aggregation of the number one and two suppliers of red, barbecue, steak and Worcestershire sauces. However, it considers that the proposed divestment of the Gregg's brand of tomato, barbecue and steak sauces and the F. Whitlock & Sons brand of Worcestershire sauce will remove almost all of the aggregation that would otherwise occur in these markets as a result of the merger.
23. As part of our investigation we will consider:
- 23.1 the level of aggregation that is likely to result from the merger in the affected markets in both the retail and food service industry channels;
  - 23.2 the closeness of competition between the merging parties and their rivals;
  - 23.3 the constraint that competitors, including private label offerings, would provide post-merger in the affected markets;

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<sup>8</sup> Commerce Commission, *Mergers and Acquisitions Guidelines* (July 2013) at [3.62-3.63].

- 23.4 entry and expansion conditions, and whether entry or expansion would be likely, timely, and sufficient in extent to prevent a substantial lessening of competition in the affected markets. This will also include an assessment of the profitability of securing entry or expansion – and the promotion and marketing costs – associated with obtaining supermarket shelf space in competition with the established brands of Heinz NZ; and
- 23.5 the extent of countervailing power of supermarket and food service industry customers, and whether this power will be sufficient to constrain the merged entity from profitably increasing prices (including, for instance, by sponsoring entry and/or expansion, or in the case of supermarkets, in expanding their offerings of private label products or reducing shelf space).

*Proposed divestment undertaking*

24. Where we consider that a merger is likely to substantially lessen competition in the relevant market(s), we consider whether the proposed divestment undertakings will remedy that likely substantial lessening of competition. For a divestment undertaking to remedy competition concerns, we must be satisfied that the divestment will result in sufficient additional competitive constraint on the merged firm so that a substantial lessening of competition is no longer likely.<sup>9</sup>
25. To make this assessment, we consider all the relevant risks associated with the divestment undertaking. We assess three kinds of risk associated with divestment undertakings:
- 25.1 Composition risk – the risk that the scope of a divestment undertaking may be too limited, or not appropriately configured, to attract a suitable purchaser or to allow a successful business to be operated in competition with the merged entity.
- 25.2 Asset risk – the risk that the competitiveness of a divested business will deteriorate prior to the completion of the divestment.
- 25.3 Purchaser risk - the risk that there may not be a purchaser that is acceptable to us and/or the risk that the applicant has an incentive to sell to a party who would not be a strong competitor.
26. Heinz NZ has submitted that there is no material composition, asset, or purchaser risk associated with the proposed divestment undertaking because:
- 26.1 Gregg's is an established brand occupying a prominent position in the supply of red and brown sauces, and F. Whitlock & Sons is a strong brand in Worcestershire sauce;

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<sup>9</sup> Commerce Commission, *Merger and Acquisitions Guidelines* (July 2013), Attachment F at [F.12].

- 26.2 there are a number of third party toll manufacturers available to the purchaser of the divested brands, and in any case the proposed divestment undertaking also includes the offer of a co-packing agreement for these brands, if required;
- 26.3 any asset risks are appropriately addressed by Heinz NZ's hold-separate and other conduct commitments in its proposed divestment undertaking, including that Heinz NZ will use all reasonable endeavours to operate the divestment business as a separate going concern independent from the rest of its business; and
- 26.4 there are a number of potential purchasers, including those with an existing presence in the broader sauces category, which would find the brands offered for divestment as being attractive.
27. When assessing the proposed divestment undertaking we will consider:
- 27.1 whether there are any composition risks, including whether the potential purchaser(s) of the divested brands will have the ability to either manufacture themselves or access suitable toll manufacturing facilities with sufficient scale/scope such that the divested brands would continue to be competitive;
- 27.2 whether there are any asset risks; and
- 27.3 whether any of the potential purchasers we identify have the scope and scale themselves, or through a third party, to efficiently manufacture products under the divested brands and therefore have the ability to compete effectively against the merged entity. We will also explore the likelihood of Heinz NZ offering an up-front purchaser.
28. Also of relevance in assessing the proposed divestment undertaking is that that no manufacturing assets are to be divested. Instead, should a potential purchaser not have access to its own manufacturing assets, Heinz NZ has offered co-packing (toll manufacturing) arrangements. Our concern with such arrangements is that the merged entity would still be setting the wholesale price of the divested brands.

*Existing competition in the Asian sauces, condiments, and chilli sauce markets*

29. Heinz NZ has submitted that the proposed merger would not give rise to any competition concerns in any of the other affected markets because:
- 29.1 the combined market shares of the merged entity fall inside the concentration levels that are likely to raise competition concerns for the Commission;
- 29.2 there will remain a significant constraint from other suppliers of these products;
- 29.3 barriers to entry and expansion are low, as evidenced by regular new product launches and the ease of importation; and

- 29.4 supermarkets will continue to wield a considerable degree of countervailing power, and will continue to impose a significant competitive constraint on the merged entity.
30. As part of our investigation we will consider:
- 30.1 the level of aggregation that is likely to result from the merger in the affected markets;
- 30.2 the closeness of competition between the merging parties and its rivals;
- 30.3 the constraint that competitors would provide post-merger;
- 30.4 entry and expansion conditions, and whether entry or expansion would be likely, timely, and sufficient in extent to prevent a substantial lessening of competition in the affected markets; and
- 30.5 the extent of countervailing power held by customers.

**Coordinated effects: would the merged entity be able to coordinate with rivals to raise prices?**

31. A merger can substantially lessen competition if it increases the potential for the merged entity and all or some of its remaining competitors to coordinate their behaviour and collectively exercise market power such that output reduces and/or prices increase across the market.<sup>10</sup>
32. We will assess whether any of the relevant markets are vulnerable to coordination, and whether the merger would change the conditions in the relevant market so that coordination is more likely, more complete, or more sustainable. Some of the factors we will consider are:
- 32.1 whether the characteristics of the product or service makes coordination likely. This may be the case when:
- 32.1.1 the products are homogenous;
- 32.1.2 there is little innovation and stable demand;
- 32.1.3 firms can easily observe each other's prices; and
- 32.1.4 there is repeated interaction;
- 32.2 whether the merger will leave any markets with only a few rivals or eliminate a vigorous competitor; and
- 32.3 whether the firms in the market are similar (for example, in size and cost structure) such that they will have similar incentives to coordinate.

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<sup>10</sup> Ibid at [3.84].

## Next steps

33. The Commission is currently scheduled to make a decision on whether or not to give clearance to the merger by **15 February 2018**. However, this date may change as the investigation progresses.<sup>11</sup>
34. As part of our investigation, we will identify and contact parties we consider will be able to help us to assess the preliminary issues identified above.

## Making a submission

35. If you wish to make a submission, please send it to us at [registrar@comcom.govt.nz](mailto:registrar@comcom.govt.nz) with the reference “Heinz/Cerebos” in the subject line of your email, or by mail to The Registrar, PO Box 2351, Wellington 6140. Please do so by close of business on **Friday 12 January 2018**.
36. Please clearly identify any confidential information contained in your submission and provide both a confidential and a public version. We will be publishing the public versions of all submissions on the Commission’s website.
37. All information we receive is subject to the Official Information Act 1982 (OIA), under which there is a principle of availability. We recognise, however, that there may be good reason to withhold certain information contained in a submission under the OIA. For example, if disclosure would unreasonably prejudice the supplier or subject of the information. In assessing the confidentiality of information contained in submissions for the purposes of publication on our website, we intend to apply an approach that is consistent with the OIA.

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<sup>11</sup> The Commission maintains a clearance register on our website at <http://www.comcom.govt.nz/clearances-register/> where we update any changes to our deadlines and provide relevant documents.