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COMMERCE COMMISSION

Decision No. 638

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

DFS GROUP LIMITED

and

THE NUANCE GROUP

The Commission:	Paula Rebstock Peter J M Taylor Denese Bates QC
Summary of Application:	The acquisition of 100% of the shares in, or assets of, the New Zealand operations of The Nuance Group, or any interconnected body corporate of The Nuance Group by DFS Group Limited.
Determination:	Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commerce Commission determines to decline to give clearance to DFS Group Limited for the Acquisition.
Date of Determination:	28 March 2008

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EXECUTIVE SUMMARY

Introduction

E1. The Commerce Commission (Commission) received an Application from DFS Group Limited (DFS Galleria) seeking clearance to acquire 100% of the shares in, or the assets of, the New Zealand operations of The Nuance Group (Nuance), trading principally as Regency, or any interconnected body corporate of Nuance.

E2. The question the Commission considered was whether it can be satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in any market.

E3. To aid its analysis, the Commission compared two situations: one in which the acquisition proceeds (the factual), and one in which the acquisition does not proceed (the counterfactual). The impact of the acquisition on competition in a market is then viewed as the prospective difference in the extent of competition between these two situations.

Background

E4. DFS Galleria is a Hong Kong-based group of companies whose New Zealand subsidiary operates both off-airport and on-airport duty free stores in Auckland and Christchurch.

E5. Nuance is a Swiss group of companies whose New Zealand subsidiary operates general duty free stores at Auckland and Wellington International Airports, with specialty stores at Auckland, Wellington, and Christchurch International Airports.

E6. The current application involves DFS Galleria acquiring Nuance's concessions for duty free retailing at both Auckland International Airport and Wellington International Airport. DFS Galleria currently has no presence at Wellington International Airport, but it does have an ongoing concession for duty free retailing at Auckland International Airport. Therefore, the Commission has considered the competition implications of the proposed acquisition at Auckland International Airport.

E7. Although both DFS Galleria and Nuance presently retail duty free goods at Auckland International Airport, Auckland International Airport Limited (AIAL) has determined to move to a sole duty free operator from 4 August 2009. Following a tender round, the sole general duty free concession was granted to DFS Galleria. This prompted the current Application.

E8. In addition, the Commission is currently investigating whether the reduction in the number of duty free concessionaires by AIAL could breach Part 2 of the Commerce Act.

The Relevant Markets

E9. The Commission first must define the relevant markets affected by the proposed acquisition in order to assess the likely competition effects.

E10. The Commission considers the relevant market for the consideration of this Application is the market for the retail supply of duty free goods at Auckland International Airport to international air travellers. The highest volume products sold by duty free retailers are alcohol products, beauty products (cosmetics and fragrances), and tobacco products. These products are the focus of the Commission's analysis.

E11. The proposed acquisition potentially involves an upstream market, where duty free retailers compete in a bidding process to secure the rights, and retail space, to provide duty free retail services at an airport. The Commission considers that there are a number of duty free retailers, other than Nuance, that could potentially compete in such a tender round at Auckland International Airport, so competition in this market is unlikely to be significantly reduced.

E12. Therefore, the Commission has not further considered the competition effects of the proposed acquisition on this upstream market, in this particular fact scenario, except insofar as it relates to competition in the downstream retail market.

Factual and Counterfactual

E13. The factual scenario (with the acquisition) would remove Nuance as the only existing competitor in the market for the retail of duty free goods at Auckland International Airport.

E14. In the counterfactual scenario (without the acquisition), the Commission considers that it is a real and substantial prospect that Nuance would stay and continue to operate at Auckland International Airport until at least 3 August 2009. Accordingly, the Commission has adopted this outcome as the likely counterfactual scenario.

E15. In respect of Nuance's remaining New Zealand operations in Wellington and Christchurch, the Commission considers the likely counterfactual scenario to be that Nuance would sell these operations to an independent third party.

Competition Analysis

E16. In this Application, the factual would see the removal of the competition posed by Nuance. Duty free consumers would no longer have a choice of duty free retailers, and no longer have the ability to compare prices between competing retailers at Auckland International Airport. Essentially, there would no longer be competing retailers vying for the patronage of customers.

E17. In order for the combined entity to face constraint from potential competition, AIAL would need to be able to credibly threaten to create an additional duty free concession to facilitate new entry. This seems unlikely as it is contrary to AIAL's announced policy of having a sole duty free concessionaire at Auckland International Airport.

E18. The Commission has also considered the proposition put forward by DFS Galleria and Nuance that AIAL would exercise a significant constraint on the combined entity. However, the evidence suggests that AIAL would have little reason to ensure that the combined entity's duty free prices are constrained to the level likely seen in the counterfactual, or to enforce the relevant contractual obligations on pricing. It would also have little ability to influence pricing outcomes by the way in which the concession rental payments are structured, whether they are minimum annual guarantee (MAG) payments or proportional payments. In either case, the concessionaire would maximise its profits, and the impact of either rental payment would not be to lower prices, compared to a situation where no rental payments were made.

E19. [ ]. Moreover, AIAL may have difficulties in enforcing compliance with these conditions.

E20. The Commission considers that there may be some very limited competition from duty free retailers outside the market. However, this competitive constraint would be likely to fall well short of that posed by Nuance in the counterfactual, and unlikely to be sufficient to counter an exercise of market power by the combined entity in the factual scenario.

E21. Therefore, the Commission considers that the scope for unilateral market power would be enhanced by the absence of existing competition, and would not be constrained by other competitive factors, such as potential competition, the possible countervailing power of AIAL, and duty free retailers outside of the market.

E22. Consequently, it is anticipated that duty free prices would increase post-acquisition. If the experience at Wellington International Airport were replicated at Auckland International Airport, consumers could expect to pay in the order of 10% more for duty free goods. At Auckland International Airport, such a price change could equate to consumers of duty free goods facing detriment in the order of $[ ]m, for the period until 3 August 2009.

E23. Accordingly, the Commission cannot be satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the market for the retail supply of duty free goods at Auckland International Airport to international air travellers.

THE PROPOSAL

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 21 November 2007. The notice sought clearance for the acquisition of 100% of the shares in, or the assets of, the New Zealand operations of The Nuance Group (Nuance), trading principally as Regency, or any interconnected body corporate of Nuance, by DFS Group Limited (DFS Galleria).
2. As part of the proposed acquisition, Nuance would be bound by a restraint of trade provision that would prevent it from competing for business in New Zealand for the next five years. Auckland International Airport Limited (AIAL) advised the Commission that it expects Nuance would participate in the next tender round, which is not expected to occur until at least 2013.
3. The Commission has considered this Application on the basis that:
   - the assets to be acquired are those described in paragraph 145 below; and
   - the only aggregation of market shares resulting from this acquisition occurs in respect of duty free retailing at Auckland International Airport.

PROCEDURE

4. Section 66(3) of the Act requires the Commission either to clear or to decline to clear the acquisition referred to in a s 66(1) notice within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was agreed between the Commission and the Applicant. Accordingly, a decision on the Application was required by 28 March 2008.
5. The Commission's approach to analysing the proposed acquisition is based on principles set out in the Commission's *Mergers and Acquisitions Guidelines*.[1]

STATUTORY FRAMEWORK

6. Under s 66 of the Act, the Commission is required to consider whether the proposal will have, or would be likely to have, the effect of substantially lessening competition in a market. If the Commission is satisfied that the proposal would not be likely to substantially lessen competition then it is required to grant clearance to the application. Conversely, if the Commission is not satisfied it must decline the application. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.[2]
7. The substantial lessening of competition test was considered in *Air New Zealand & Qantas v Commerce Commission*, where the Court held:

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

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[1] Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004.
[2] *Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission* (1992) 4 TCLR 713-721.

permitted if the inquiry were limited to the existence or otherwise of market power in the factual.[3]

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

9. When the impact of market power is expected to be predominantly upon price, for the lessening, or likely lessening, of competition to be regarded as substantial, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and ordinarily able to be sustained for a period of at least two years, or such other time frame as may be appropriate in any given case.

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

THE PARTIES

DFS Group Limited (DFS Galleria)

11. DFS Galleria is a Hong Kong-based group of companies whose New Zealand subsidiary (DFS New Zealand Limited) operates both off-airport and on-airport duty free stores in Auckland and Christchurch. It is not an associated company of Duty Free Stores Wellington Limited (DFSW).

The Nuance Group (Nuance)

12. Nuance is a Swiss group of companies whose New Zealand subsidiary operates a wholesale duty free business, duty free stores at Auckland and Wellington International Airports, and specialty retail shops at Auckland, Wellington, and Christchurch International Airports. Nuance does not have any off-airport duty free retail operations in New Zealand.

OTHER PARTIES

13. A complete list of relevant parties is attached as Appendix 1.

Auckland International Airport Limited (AIAL)

14. AIAL is a publicly-listed company on the New Zealand and Australian Stock Exchanges. It owns and operates Auckland International Airport. AIAL's major shareholders include Auckland City Council and Manukau City Council.

Duty Free Stores Wellington Limited (DFSW)

15. DFSW is a privately-owned company, and is not in any way connected with DFS Galleria. It operates duty free stores at Wellington International Airport, under the banner 'Duty Free Stores New Zealand'. There are also stores at

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[3] *Air New Zealand & Qantas Airways Limited v Commerce Commission* (2004) 11 TCLR 347, para 42.
[4] *Fisher & Paykel Limited v Commerce Commission* (1990) 2 NZLR 731, 758 and also *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554, 563.

Dunedin, Queenstown, and Hamilton International Airports, and an online store, which operate under this banner.

INDUSTRY BACKGROUND

Duty Free Products

16. In New Zealand, alcohol, tobacco, fragrances and cosmetics attract duties. Duty for each of these product categories varies, although typically this is approximately 60% for tobacco, 20-40% for liquor (excluding wine), and 20% for fragrances and cosmetics. The standard 12.5% Goods and Services Tax (GST) is applied on top of the duty inclusive value of these products.

17. Because of the relatively high rate of duties on these products, when duty (and GST) free sale is permitted they become very attractive to purchasers. For this reason, these are the highest volume products sold at airport duty free stores. Liquor and tobacco products comprise 75-85%, and cosmetics and fragrances 5-10%, of duty free sales. The balance of sales consists of tax free goods, mainly electronics, for which the price discount is much smaller.

18. The Chief Executive of DFSW advised the Commission that, in general, retail duty free prices are struck at the supplier's recommended retail price less GST and the appropriate rate of duty for the product.

19. Duty free operators run regular promotions, some of which are developed in consultation with major suppliers. Supplier promotions are partially funded by suppliers by way of a rebate. In the past, suppliers of the four relevant lines of duty free products have usually offered simultaneous promotions to DFS Galleria and Nuance at Auckland International Airport.

20. Travellers can purchase items duty free and tax free on departure from and arrival into New Zealand. Duty free imports are limited by law to a per-person maximum of:

    - 3 bottles of spirits;
    - 4.5 litres of wine, port, sherry, champagne or beer;
    - 200 cigarettes, or 250g of tobacco, or 50 cigars ; and
    - NZ$700 of other goods.

21. Nuance and DFSW advised the Commission that the departures portion of their businesses has been static, or even declining, in recent years. They consider that it is likely that the departures business has been affected by the increased security measures in respect of the limited amount of liquids, aerosols and gels permitted in carry-on luggage on international flights. Industry participants advised the Commission that the uncertainty around security requirements at destination airports from New Zealand also deters some passengers from making duty free purchases on departure.

22. However, there are no security restrictions on purchasing or collecting duty free goods on arrival in New Zealand. Industry participants advised that arrival sales have increased and are expected to become an increasingly important proportion of duty free sales in New Zealand.

Duty Free Retailers

On-Airport Duty Free Retailers

23. In New Zealand, the majority of duty free products sold are by on-airport duty free retailers. Table 1 shows the duty free providers currently operating at various New Zealand international airports.

Table 1. Duty Free Retailers at New Zealand International Airports

Airport	Duty Free Provider(s)	Number of International Passengers (Arriving and Departing) in 2006 (millions)	Proportion of All Passengers
Auckland	DFS Galleria, Nuance	6.2	72.0%
Christchurch	DFS Galleria	1.5	17.7%
Wellington	DFSW, Nuance	0.6	6.6%
Hamilton	DFSW	0.1	1.3%
Dunedin	DFSW	0.08	1.0%
Palmerston North	Skywards Duty Free	0.08	0.9%
Queenstown	DFSW	0.05	0.6%
Total		**8.61**	**100%**

Source: Airports' websites, www.stats.govt.nz.

24. In order to retail duty free products at an airport, an operator requires a Customs Controlled Area Licence and a concession.

25. A Customs Controlled Area Licence can be obtained from the New Zealand Customs Service.

26. Typically, airports let their concessions through a tender process. The airport company determines the structure of the tender: the number of duty free concessions; the duration of the concession; whether the concession is a general concession or specific to certain product categories; the criteria for participation in the tender process; and the provisions of the duty free concession licence agreement.

27. When tendering for a duty free concession, duty free operators submit bids for the value of rent (i.e., concession fees) they are willing to pay to the airport. Generally, the highest bid is awarded the concession. Duty free operators interviewed by the Commission advised that they take into account a number of factors when submitting these bids, including forecast future revenue and volume of international passengers.

28. At Auckland International Airport, rent is paid monthly, and can take the form of either:

- a minimum annual guaranteed sum (MAG payment); or
- a set proportion of revenue (proportional payment).

29. Bidders submit values for both MAG payments and proportional payments during the tender round. The actual rent paid to AIAL by its duty free concessionaires is the higher of these two amounts.

30. In the past, on-airport duty free retailers, such as DFS Galleria, Nuance, and DFSW, were required to operate a high street duty free store as part of their licence agreement with the airport. In recent years, Nuance and DFSW have closed their high street duty free stores, although DFS Galleria still operates a duty free store in the Auckland CBD.

Off-Airport Duty Free Retailers

31. Off-airport duty free retailers include internet retailers, duty free retailers located in high street shopping precincts, providers of in-flight duty free offerings, and specialist duty free retailers (i.e., those which specialise in a particular product category, such as cigars). Most mainstream retailers also offer goods at tax free prices for travellers.

32. [ ], advised the Commission that off-airport duty free retailers are less prevalent, and account for a lesser proportion of total duty free sales in New Zealand than in Australia. It considers that part of the reason for this is the security procedures that surround off-airport duty free purchases in New Zealand.

33. In New Zealand, duty free items purchased off-airport are paid for by the customer in-store or online, and then transported by the retailer to an international airport specified by the customer. The customer presents his or her receipt at a collection point to pick up their purchases after passing through security when arriving into, or departing from, New Zealand.

34. At Auckland International Airport, the collection point is operated by AIAL, which charges the off-airport retailer a service fee. At some other New Zealand airports, such as Wellington International Airport, the operation of the collection kiosk is contracted to a duty free retailer.

Duty Free Retailing at Auckland International Airport

35. In February 2006, AIAL decided to undertake extensive refurbishment and expansion of the international terminal. As a result of this refurbishment, arriving passengers would follow a new path through the terminal building, and in turn, this would create an opportunity to build a new (and larger) arrivals retail space to accommodate the duty free offering. These areas are all part of the new arrivals space which will be operational from 1 April 2008.

36. Both incumbent general duty free retailers at Auckland International Airport, DFS Galleria and Nuance, had duty free concessions that were due to expire in August 2009. These retailers would therefore have to relocate their arrivals stores to the new arrivals area, some 16 months before the expiry of the existing concession.

37. Around the time AIAL decided to refurbish the international terminal, it also conducted a review of the duty free retail offering at the airport. AIAL decided to move to a sole general duty free operator for the period 4 August 2009 to 30 June 2015.[5] AIAL ran a closed tender round, where only DFS Galleria and

[5] The Commission is currently investigating whether the reduction in the number of duty free concessionaires by AIAL could breach Part 2 of the Commerce Act.

Nuance were asked to submit bids. The sole general duty free concession was awarded to DFS Galleria, and following this announcement DFS Galleria and Nuance commenced negotiating the proposed acquisition.

38. DFS Galleria, as the successful bidder for the new sole duty free concession at Auckland International Airport, was granted a 1,200m^2 retail space in the new arrivals area. Nuance, as the unsuccessful bidder, was granted a 400m^2 retail space—this size being consistent with the area currently specified in its existing licence agreement. Nuance accepted AIAL's notice of relocation on 13 September 2007, effectively committing it to relocate its arrivals store to the new arrivals area by 1 April 2008.

39. AIAL advised the Commission that its original intention was that Nuance's retail space would have been taken over by DFS Galleria when Nuance's existing licence agreement expires on 3 August 2009. At that point, DFS Galleria would then have a 1,600m^2 retail space in the arrivals area.

40. Table 2 below provides a timeline of the key events in those developments that are relevant to the Commission's assessment of this Clearance Application.

Table 2. Key Events Relating to Duty Free Retailing at Auckland International Airport

Date	Event
Early- to mid-2006	▪ AIAL decided to refurbish and expand the international terminal at Auckland International Airport, including a new arrivals duty free area. ▪ AIAL conducted a review of the duty free retail offering at Auckland International Airport.
December 2006	▪ AIAL informed DFS Galleria and Nuance of the new arrivals area, and that it was considering options for duty free retailing at Auckland International Airport. One of these options was to move to a sole general duty free concession.
January 2007	▪ AIAL decided to move to a sole general duty free concession. ▪ DFS Galleria and Nuance agreed to participate in a tender for a sole general duty free concession at Auckland International Airport for the period 3 August 2009 to 30 June 2015. ▪ The winning tenderer would be allocated 1,200m^2 of retail space in the new arrivals area. The unsuccessful tenderer would be allocated 400m^2 in the new arrivals area, which it would occupy until its existing licence agreement expires on 03 August 2009.
May 2007	▪ AIAL issued tender documents for the sole general duty free concession at Auckland International Airport.
June 2007	▪ Tenders for the sole general duty free concession at Auckland International Airport closed.
July 2007	▪ AIAL awarded the sole general duty free concession to DFS Galleria. ▪ AIAL served Nuance with a notice of relocation, requesting Nuance's confirmation that it would relocate to the new arrivals area in time to commence operating on 1 April 2008. ▪ Nuance approached DFS Galleria regarding a possible sale of its New Zealand operations.
September 2007	▪ After several time extensions, Nuance accepted AIAL's notice of relocation to the new arrivals area. ▪ Nuance's existing concession provides it with a 400m^2 retail space in the arrivals area. Nuance was allocated this space.
October 2007	▪ Nuance advised AIAL that it intended to sell its New Zealand operations to DFS Galleria. ▪ AIAL agreed to reassign Nuance's duty free concession to DFS Galleria, on a number of conditions. One of these conditions was that, should the proposed acquisition not proceed for any reason, both DFS Galleria and Nuance would be ready to commence operations in the new arrivals area from 1 April 2008. ▪ AIAL received a revised floor plan for the new arrivals area from DFS Galleria. The floor plan provided for a single 1600m^2 duty free retail store for DFS Galleria. ▪ AIAL advised the Commission that "from that date AIAL has made decisions consistent with DFS {Galleria}'s floor plan".
November 2007	▪ The Commission received an Application for Clearance from DFS Galleria to acquire Nuance's New Zealand operations.
1 April 2008	▪ The expected date on which AIAL would open its new arrivals area, which included a new duty free retail space.
3 August 2009	▪ The current expected expiry date of Nuance's existing general duty free concession at Auckland International Airport.

Source: Industry Participants

PREVIOUS DECISIONS

41. The Commission, competition agencies in other jurisdictions, and the Courts have previously considered mergers in duty free goods markets and markets where concessions are let for the rights to retail goods/services at an airport. Many of these were cited by DFS Galleria in support of its submission that the product dimension of the relevant market is the retail supply of duty free goods, and the geographic dimension includes both on- and off-airport retailers.

Duty Free Markets

The Commission

42. The Commission has previously considered a merger in the duty free industry in *DFS Group Ltd / Miles DFS Ltd.*[6] The application before the Commission described the relevant market as "the full range of goods and merchandise normally sold at duty free shops to international passengers departing from Auckland by air and sea". The Commission determined to give clearance for the proposed acquisition.

43. The Commission's decision was subsequently challenged on judicial review by a duty free retailer, which operated an off-airport store in Auckland city and a collection point at Auckland International Airport.[7] The Applicant argued that there were two quite separate markets: one geographically confined to Auckland International Airport and the other in Auckland city generally. The distinction was claimed on the basis that the particular characteristics of duty free shopping at an airport create a captive market without opposition. Such characteristics included: last minute buying; spending of remaining local currency; lack of opportunity for changing or substituting goods; lack of competitive sources because of the distance from the city; and passengers in transit that do not go into the city at all.

44. Wylie J noted these two different approaches to market definition, but considered it unnecessary to resolve the issue of market definition for the purposes of the interim injunction application. The application for interim injunction was declined. Further litigation on this point is not reported.

Australia

45. The Australian Competition and Consumer Commission (ACCC) commented on two mergers that relate to the retailing of duty free goods.

46. In *City International Duty Free / M S McLeod Holdings*,[8] the ACCC considered the effect of the proposed merger on the market for "the retail supply of goods free of sales tax and customs and excise duty". The ACCC considered that the combined entity would continue to face constraint from other dedicated duty free retail chains, in-flight duty free services, international duty free stores, and retailers that offer sales tax free services to travellers. The ACCC retained some

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[6] *DFS Group Ltd / Miles DFS Ltd*, 28 January 1987.
[7] *Compass Tax and Duty Free Shopping Ltd v Miles DFS Ltd* (1987) 2 TCLR 32.
[8] ACCC, *City International Duty Free / M S McLeod Holdings Limited (trading as Downtown Duty Free,* 19 November 1995.

concerns about the ability of the combined entity to increase the price of tax free goods.

47. In *Nuance / Allders International*,[9] the ACCC considered the effect of the proposed merger on the market for "the retail supply of full-range duty-free and sales tax free goods in regional markets in Australia", noting two sectors within this market—sales from duty free shops in central business districts and shopping centres, and sales from duty free concessions at international airports.[10] The ACCC determined not to oppose the merger, as it considered that duty-free products were available for purchase at overseas destinations (or in-flight), and sales tax free retailers posed some constraint by way of substitutes. The ACCC also considered that there was evidence to suggest that duty free goods sold in Singapore, New Zealand, and Europe influenced the price of duty free goods sold in Australia.

European Union

48. The Commission of the European Communities (EC) has commented on a duty free merger, leaving the market definition (product and geographic aspects) open in its decision.

49. *Swissair / Allders International*[11] involved the merger of an airline catering and duty free trading business (Swissair) and a duty free trading business (Allders International). The merger had a Community dimension; less than two-thirds of Swissair Group's Community-wide turnover could not be attributed to just one Member state. In this case, the EC did not define the product market, as it considered that the merger would not lessen competition, even at the narrowest market definition. Similarly, it did not define the geographic market, but noted that the most 'unfavourable' geographic market definition would have been the wider European Economic Area.

Summary

50. Consideration of these cases show that the ambit of both product and geographic aspects of market definition in duty free matters is often debated between the parties. Competition agencies, and the Courts, have shown a hesitancy to delineate the ambit of such markets unless necessary to do so for the purpose of determining the matter before them. The Commission notes that these decisions are over ten years old and do not take into account recent developments, e.g., restrictions on taking liquids on planes. The Commission understands that off-airport duty free sales are much more significant as a proportion of total duty free sales in Australia than in New Zealand. Further, the Commission also notes that New Zealand does not have intra-community travel dimensions such as existed in the European Communities at that time.

Airport-Based Markets

New Zealand

51. In a slightly different context, the New Zealand Courts have considered the appropriateness of separating on-airport and off-airport markets in the context of

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[9] ACCC, *Nuance Limited / Allders International Pty Limited*, 16 October 1996.

[10] The Commission notes that, as a proportion of total duty free sales, off-airport duty free sales are higher in Australia than in New Zealand.

[11] Case No. *IV/M.782 Swissair / Allders International**,** Regulation (EEC) No 4064/89*, 17 July 1996.

the provision of car rental services. In *ARA v Mutual Rental Cars Ltd*,[12] Barker J considered the relevant markets to be:

- the market of concessions for rental car operators at the Auckland Airport; and
- the market for hiring of rental cars at Auckland Airport.

52. The relevant service market was for the provision of rental cars to the public, and the geographic market was national in scope. His Honour considered that the key question was whether there was a clearly defined (sub-) market for the provision of rental car services to passengers requiring rental cars at Auckland International Airport. Barker J concluded, as a matter of fact and commercial common sense,[13] that there was a (sub-) market for rental car services at Auckland International Airport, as there was no acceptable substitute for the convenience of collecting a car and making the necessary arrangements at the airport terminal.

53. In the subsequent decision of *McDonald Motors Ltd v Christchurch International Airport Ltd*,[14] which also concerned the provision of car rental services at an airport, Holland J did not have to make a finding as to the relevant market, although he recognised a number of potential approaches:

- the evidence on both sides showed that the defendant company considered that there were two types of rental car operations at the airport, which were described as on-site and off-site operations;
- the *ARA v Mutual Rental Cars Ltd* approach (outlined above); and
- the *Trade Practices Commission v Ansett Transport Industries (Operations) Pty Ltd* approach (outlined below).

Australia

54. The Federal Court of Australia has considered one case in which the relevant market involved a concession for the rights to retail goods/services at an airport.

55. In *Trade Practices Commission v Ansett Transport Industries (Operations) Pty Limited*,[15] the Court considered whether the proposed acquisition of shares in a rental car operator (Avis) by an airline operating company (Ansett) would be likely to create a position whereby the corporation would control or dominate a market for goods and services. The parties had all submitted that the relevant car rental market should be national. However, there was some disagreement over whether other car rental operators conducted their business within discrete markets having limited geographic boundaries of capital city, country city or town or regional areas.

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[12] *ARA v Mutual Rental Cars Ltd* (1987) 2 TCLR 141.

[13] At the time of *ARA v Mutual Rental Cars Ltd*, market meant **“**a market for goods or services within New Zealand that may be distinguished as a matter of fact and commercial common sense”. That was amended with effect from 1 July 1990 so that a reference to a market is now a reference to “a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them”.

[14] *McDonald Motors Ltd v Christchurch International Airport Ltd* (1991) 4 TCLR 407.

[15] *Trade Practices Commission v Ansett Transport Industries (Operations) Pty Ltd* (1978) 2 ATPR 40-701.

56. Northrop J defined an Australian car rental market.[16] His Honour considered that within this market, national operators carry out their business throughout Australia, local operators carry out business within limited areas, and in all areas within Australia there is substitutability for the service provided by national operators and the local operators that provide service in that area. His Honour noted a more clearly defined distinction between the airport locations and the non-airport locations, as national operators tend to make a feature of the provision of their services at the airports, but at the same time many local operators seek custom from airline passengers and were prepared to deliver and collect cars at airports.

European Union

57. The EC has also commented on a merger in a market for the retail of goods/services at airports.

58. *Autogrill / Altadis / Aldeasa*[17] related to the proposed acquisition of an on-airport retailer (Aldeasa) by a joint venture of Autogrill, an on-airport food retailer, and Altadis, a tobacco manufacturer and distributor. The EC left the product market definition open (although noted the different fiscal regimes for duty-paid and duty-free products may indicate segmentation of the market), noting that the merger would not lessen competition in even the narrowest market definition. The geographic market definition was also left open (with reference given to a similar approach being taken previously in the *Swissair / Allders International* decision).

Summary

59. The ambit of both product and geographic aspects of market definition in airport-based markets is often debated between the parties. Factors such as how competition occurs, whether airport location is a feature of how the provider offers its goods (or services), and whether existing providers consider or treat on-airport and off-airport custom differently, was pertinent. Similarly, the element of convenience has been considered in the context of how practical it was for customers to substitute an on-airport product with an off-airport one.

60. The Commission has considered these cases in the context of this Application.

MARKET DEFINITION

61. The Act defines a market as:

> … a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.[18]

62. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit maximising, sole supplier of a good or service, not constrained by the threat of entry would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised

[16] *Trade Practices Commission v Ansett Transport Industries (Operations) Pty Ltd* (1978) 2 ATPR 40-701 (p 17,705).
[17] Case No. *COMP/M.3728 - Autogrill / Altadis / Aldeasa*, Regulation (EC) No 139/2004, 23 March 2004.
[18] S 3(1A) of the Commerce Act 1986.

is defined in terms of the dimensions of the market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

Product and Functional Dimensions

63. The Applicant submitted that the relevant product market is that for the supply of duty free goods, and that the relevant functional level is retail.

64. There are two different stages at which competition occurs between duty free retailers. At the first stage, duty free operators compete in a bidding process to acquire a concession for the rights to provide on-airport retail supply of duty free goods, and the associated retail space. At the second stage, duty free retailers (if there is more than one concessionaire) compete with one another for the custom of end-consumers.

65. The proposed acquisition is likely to result in aggregation at each of these stages.

Duty Free Concessions and Associated Retail Space

66. As part of the proposed acquisition, Nuance would be bound by a restraint of trade provision that would prevent it from competing for business in New Zealand for the next five years. AIAL advised the Commission that it anticipates that Nuance would participate in the next tender round, which is not expected to occur until at least 2013.

67. In any case, industry participants interviewed by the Commission were all of the view that competition for on-airport duty free concessions is vigorous, and that there would likely be a number of potential bidders. For example, there were [ ] potential bidders at the last WIAL tender round, [ ] of which were ultimately short-listed.

68. Further, AIAL advised the Commission that Sydney International Airport received [ ] different bids for duty free concessions the last time it put a tender to the market. AIAL explained that as it is the second largest airport in Australasia (behind Sydney International Airport), it would expect a similar number of bidders if it were to run an open tender for duty free concessions.

69. However, it does not necessarily follow that because the proposed acquisition is not expected to give rise to any competition concerns in relation to the upstream market for duty free concessions at Auckland International Airport, the proposed acquisition would also not give rise to competition concerns in relation to the downstream market for the retail supply of duty free goods at Auckland International Airport. Competition at each of these two functional levels clearly occurs at different points in time, albeit that bidders for concessions will no doubt tailor their bids with one eye on the returns that they expect to earn in retailing.

70. In most cases in the past where the Commission has considered 'competition for a market', that competition has been to supply a good or service to the party that orchestrated that competition (i.e., ran the tender or bidding process).

71. In this particular case, duty free retailers compete with one another to purchase one of a number of inputs into duty free retailing (i.e., retail space from AIAL). Moreover, competition for duty free retail space determines how profits from duty free retailing are shared between duty free retailers and AIAL (in the form of rents), rather than the outcome in the duty free retail market. After

competition for retail space has taken place, successful duty free retailers must then compete (at a different functional level) for the custom of international travellers. This is an important distinction.

72. Essentially, any change that might occur in the duty free retail market at Auckland International Airport, such as the proposed acquisition, might still give rise to competition concerns in that market, even if there were a great deal of competition in the upstream market for duty free retail space.

73. As a consequence, the Commission has not further assessed the aggregation in upstream market for duty free retail space at Auckland International Airport. Rather, the Commission has confined its attention to the competitive impact of the proposed acquisition on the downstream retail market. The Commission recognises that in this fact scenario, the upstream market for duty free retail space does play a role in potential competition, and the Commission duly factors this into its analysis.

The Retail of Duty Free Goods

74. In general, on-airport retailers of duty free goods, such as DFS Galleria and Nuance, sell a limited range of products. These include various liquors, tobacco products, beauty products, and fragrances, together with a range of tax free goods, such as jewellery and electronics. By far the bulk of their sales are from duty free goods. For example, according to figures supplied by AIAL, sales of duty free goods sold on-airport by both DFS Galleria and Nuance amounted to approximately [ ]% of their total on-airport sales for the year to November 2007, with the balance being sales of tax free goods.

75. Duty free retailers are able to substantially undercut the prices charged by mainstream retailers for the duty free goods they sell to international air travellers, by virtue of their not having to pay duty and GST. Together, these result in overall mark-ups ranging up to 35% to 80% on non-discounted mainstream prices, all else being the same. It is understood that duty free retailers tend to set their prices at the supplier's recommended retail price, less the duty and tax mark-ups.

76. Given the size of the duty free discounts involved, the application of the SSNIP test's 5-10% increase in the prices of duty free would be unlikely to encourage significant switching by international travellers away from duty-free goods to their non-duty equivalents. This indicates both that the two types of goods are not close substitutes, and that the relevant customer dimension of the market in this case is important, being international air travellers.

77. The differences in the prices of tax free and the equivalent non-tax free goods are much less significant, because the GST rate is much lower than the duty plus tax rate that apply to dutiable goods. Indeed, the price ranges of these products in duty free and mainstream retail shops often overlap. This may be due in part to the relatively low volumes of tax free goods sold by general duty free retailers like DFS Galleria and Nuance, such that they might not be able to achieve the same economies of scale that may be enjoyed by specialist electronics and jewellery retailers. On the other hand, duty free retailers might be expected to enjoy some economies of scope from the wider range of products they stock compared to specialist stores.

78. In addition, specialist shops may offer non-price advantages over duty free outlets, in terms of providing a wider choice within the narrow range of goods

on offer, a greater range of complementary goods and superior product advice. Overall, the application of the SSNIP-based 5-10% increase in tax free prices would be likely to encourage a significant switching between the tax free and non-tax free equivalent products, given the already small price differences between them.

79. Although from a consumer's point of view there is very little substitutability between different types of duty free goods—for example, tobacco products would not usually be considered close substitutes for liquor from a demand-side perspective—there is a high degree of supply-side substitutability at the retail level, in the sense that a range of lines can be retailed together, and new lines can easily be added by a retailer within its existing format. Thus, all general duty free retailers interviewed by the Commission reported that they provide the entire range of duty free products in their stores, and that providing an additional category of duty free product merely involves establishing an arrangement with a wholesale supplier. Consequently, the market can reasonably be defined to encompass the range of duty free goods (but excluding tax free goods) normally stocked by duty free retailers. This provides the range of products for which competition could be reduced as a result of the proposed acquisition.

80. Accordingly, the Commission concludes that for the purposes of analysing the competition effects of the proposed acquisition, the relevant product, functional and customer dimensions of the market are captured in the following definition: the retail supply of duty free goods to international air travellers.

Geographic Dimension

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

82. The current application involves DFS Galleria acquiring Nuance's concessions for duty free retailing at both Auckland International Airport and Wellington International Airport. DFS Galleria currently has no presence at Wellington International Airport but it does have an ongoing concession for duty free retailing at Auckland International Airport. Therefore, aggregation would occur only at Auckland International Airport.

83. The Applicant submitted that the relevant geographical market is wider than just the airport; it extends to the Auckland region, and includes both on-airport duty free retailers and off-airport duty free retailers.

84. In reaching a view on the appropriate geographic dimension for the relevant market, the Commission has considered the extent to which duty free retailers located off-airport (including internet and in-flight duty free retailers) interact with duty free retailers located on-airport. The potential constraint posed by duty free operators located at overseas airports is also discussed at this point.

Off-Airport Duty Free Retailers

85. Off-airport duty free retailers comprise internet retailers, duty free retailers located in high street shopping precincts (including speciality stores), and in-flight duty free offerings.

86. Table 3 provides estimated market shares for on-airport and off-airport duty free retailers, based on the volume of sales (in New Zealand dollars) made to Auckland International Airport travellers each year over the period 2002-07.

Table 3. Duty Free Sales for Auckland International Airport Travellers 2002-07

	Year					
Retailer	**2002****	**2003**	**2004**	**2005**	**2006**	**2007*****
DFS Galleria on-airport	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%
Nuance on-airport	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%
All off-airport sales*	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: AIAL
* includes sales from Nuance's off-airport duty free store.
**market shares for 2002 are based on July to December volume sales only.
***market shares for 2007 are based on January to November sales only.

87. Table 3 shows that although the proportion of duty free purchases made off-airport by travellers through Auckland International Airport has steadily increased since 2002, these purchases are very small compared to purchases made at on-airport duty free stores. In only one out of the last six years have off-airport purchases exceeded [ ]% of total purchases passing through Auckland International Airport.

88. Industry participants also advised that there are important differences between off-airport retailers, particularly high street duty free retailers, and on-airport retailers.

89. Duty free retailers indicated that high street duty free stores tend to be 'destination' stores. The products on offer are generally specialised and premium items, most of which are tax free goods, rather than duty free goods. AIAL advised the Commission that it considers that its collection point, from which consumers collect goods purchased off-airport, services product ranges beyond those offered by the airport, including "a whole range of products that do not compete with what we deliver here."

90. For example, DFS Galleria advised the Commission that its Customhouse St store in Auckland CBD mainly sells tax free luxury goods to Asian travellers who visit the store as part of their tour group travel itinerary. AIAL advised the Commission that this store "does compete {with on-airport duty free retailers} on some product ranges, but there are a lot of ranges that it doesn't".

91. Information provided by AIAL, in relation to all off-airport sales, indicates that duty free goods are not typically a major source of revenue for off-airport retailers. Collectively, approximately [ ]% of off-airport sales for Auckland International Airport travellers relate to tax free goods.

92. Further, the range of duty free products offered by these high street duty free retailers (and also in-flight duty free offerings) is typically more limited than the product range offered at on-airport stores.

93. In contrast, according to figures provided by AIAL, by far the majority of DFS Galleria's and Nuance's on-airport sales are from liquor, tobacco, fragrances and cosmetic products. These products are ones that consumers are typically less likely to shop around for, or seek further information about, compared to electronic goods such as cameras, as they are relatively inexpensive and their characteristics are more familiar to consumers.

94. Industry participants advised the Commission that on-airport duty free retailing tends to be more of a 'convenience' shopping experience. On-airport duty free retailers rely on foot traffic for sales, and employ attractive merchandising and promotions to entice travellers into their stores. AIAL and WIAL advised the

Commission that it is for this reason that the layout of their new duty free retail shopping areas would be reconfigured from the current deep stores to a "walk through" environment that would provide 100% footfall.

95. Nuance advised the Commission that off-airport duty free retailing is a "dying market"—a situation it considers has been brought about by new legislation and security measures, which restrict the items that can be taken as carry-on luggage on flights. Nuance stated that its sales through this avenue had been steadily decreasing, so much so that in 2005 it made the decision to close its store at Victoria Street in downtown Auckland.[19]

96. DFSW advised the Commission that it used to operate a duty free store in downtown Wellington, but closed this store at the end of 2005 as rising rental costs had made its operation increasingly uneconomic. At its peak, the downtown Wellington store accounted for only [ ]% of duty free purchases made by travellers through Wellington International Airport. DFSW advised the Commission that travellers would not make purchases at this store when they could make the same purchases at the airport. It considers this is because there was no advantage for consumers to shop at its off-airport store, in terms of either price or convenience.

97. DFSW explained that the reason it has been able to expand its internet business is because it provides discounts and loyalty schemes to its shoppers, e.g., its frequent buyer club scheme offers customers a 20% discount for online purchases. DFSW said that it had to offer consumers lower prices to give it an advantage over the convenience offered by on-airport duty free retailers. DFSW explained that its online duty free store is "not like normal internet retail, where you are saving a customer a trip to the point to pick up the goods, the customer is going to that point anyway. So there has got to be a price advantage for that to work."

98. DFSW estimates that sales through its online store would only account for approximately [ ]% of all duty free purchases made by travellers through Wellington International Airport. [ ]. Nuance estimated that its online sales might account for up to [ ]% of its total New Zealand duty free sales.

99. On the evidence before it, the Commission considers that there is limited substitutability between on-airport and off-airport duty free offerings. Therefore, it is unlikely that significant numbers of international air travellers would switch between on-airport and off-airport duty free retailers in the face of a SSNIP.

Duty Free Retailers at Route-Paired International Airports

100. DFS Galleria and AIAL both advised the Commission that Auckland International Airport passengers are likely to be able to choose from duty free goods offered at each of the airports they are travelling between.[20]

101. Consumers may be willing to substitute goods retailed in New Zealand international airports with goods retailed in other countries. If this were the case, duty free prices at route-paired airports would be very similar, differences in

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[19] AIAL advised the Commission that it agreed to allow Nuance to close its Victoria Street store at the end of its original Licence Agreement, August 2007, as it could see that sales through this avenue were dwindling.

[20] The Commission notes that duty free purchases on arrival are not currently available at many international airports.

duty free prices would not persist for long, and as a consequence, the two international airports would fall in a broader geographic market.

102. Hence, the Commission has considered whether consumers can readily substitute duty free goods retailed at New Zealand international airports with duty free goods retailed at international airports located in other countries.[21]

103. Nuance and DFSW advised the Commission that, in New Zealand duty free sales on arrival have become increasingly important in recent years, due to the advent of greater security measures.[22] It seems likely that this general purchasing preference may reduce the extent to which international air travellers would substitute duty free goods at New Zealand international airports with duty free goods at route-paired international airports.

104. The Commission used empirical analyses, discussed below, to assess demand- and supply-side substitutability for duty free goods at route-paired international airports. The results of the Commission's analyses indicated that there is a weak association between prices of duty free goods sold at Auckland International Airport and Sydney International Airport. For example, a price change for duty free goods sold at Sydney International Airport would not yield a significant price change for duty free goods sold at Auckland International Airport. Further, price levels for a number of products were significantly different between the duty free stores located at Auckland International Airport and Nuance's Sydney International Airport store.[23] Such pricing differences appeared to be particularly pronounced for fragrance products, some of which have price variances of up to 20%. This evidence suggest that there are unlikely to be significant numbers of international air travellers switching between duty free goods retailed in New Zealand with duty free goods retailed in other countries, and hence that overseas route-paired international airports are unlikely to be in the same market.

105. When presented with particular examples of price differences observed by the Commission,[24] Nuance advised the Commission that these price differences had arisen as there is no link between its pricing strategies for its New Zealand and Australian operations. Rather, "the New Zealand and Australian buying and operations run separately and pricing is a function of cost, target margin and promotion strategy in each location."[25] This is also consistent with route-paired international airports in the two countries not being in the same market.

106. DFS Galleria explained that "there are factors specific to fragrance pricing such that any differential that may exist should not be seen as undermining the wider

[21] Consistent with the provisions of the Act, while the market relates primarily to New Zealand, a market in New Zealand may still be competitively constrained to a greater or lesser extent by conduct abroad.

[22] This is discussed this in greater detail in the 'Industry Background' section above.

[23] Specifically, 59% of the products observed at both Auckland International Airport and Sydney International Airport differ in price by more than 5%. Further, 34% of products observed differ in price between the two airports by more than 10%.

[24] The Commission requested that Nuance provide comment on i) pricing variances for duty free prices set by Nuance for its stores at Auckland International Airport and Sydney International Airport for the period January 2007-December 2007, for Kahlua Regular 1L, Baileys Irish Cream 1L, and Smirnoff Blue Label 1L; and ii) pricing variances for the top ten liquor products and top ten fragrance products sold at Wellington International Airport, during the period 1 December 2007 – 30 April 2007, for Nuance's Wellington International Airport store, Nuance's Sydney International Airport store, and DFS Galleria's Auckland International Airport store.

[25] Letter to Commerce Commission from Fortune Manning, 12 February 2008, para 4 a) and b).

constraint" imposed by duty free retailers located at route-paired international airports. DFS Galleria suggested several possible reasons for these pricing discrepancies, such as:

- the single operator model at Sydney International Airport could leverage volume benefits and negotiate lower supply prices;
- liquidation of inventory;
- new product launches, and accompanying promotional activity, which occur at different times in New Zealand and Australia; and
- duty free pricing of fragrances is benchmarked to the domestic market price, and these prices tend to be higher in New Zealand.

107. However, these reasons do not counter the weight of the evidence, which indicates that there are clear differences in the pricing strategies and pricing behaviours of duty free retailers at Auckland International Airport and Sydney International Airport, which in turn suggests that each may not be significantly constrained by the other. The Commission turns now to discuss its empirical analyses further.

<u>Empirical Analyses</u>

Methodologies

108. The Commission's general approach to the analysis was based on two assumptions:

- if duty free retailers located at route-paired international airports and duty free retailers located at Auckland International Airport compete with one another, the prices of duty free products sold at each airport should be similar, due to demand- and/or supply-side substitutability; and similarly
- any change in prices of duty free products by a retailer at a particular airport should be closely matched by duty free retailers at route-paired international airports, again because of demand- and/or supply-side substitutability.

109. Table 4 shows that the most common route-paired flights to/from Auckland International Airport are with Sydney International Airport, followed by Brisbane International Airport and Melbourne International Airport.

Table 4. Auckland International Airport's Top Route-Paired Airports 2007

Origin/Destination	Proportion of All Arrivals	Proportion of All Departures
Sydney	20%	20%
Brisbane	14%	13%
Melbourne	12%	11%
Los Angeles	8%	8%
Hong Kong	7%	7%
Singapore	5%	6%
Nadi	5%	5%
Other	29%	30%
Total	**100%**	**100%**

Source: AIAL

110. These three Australian airports account for 46% of arriving and 44% of departing passengers from Auckland International Airport.

111. Each of these three airports has multiple route pairings with various other international airports. Potentially, this could make setting duty free prices that match those at all route-paired international airports a complex exercise.

112. Nuance is the incumbent duty free operator at all three of these Australian airports, and advised the Commission that it sets its Australian prices on a national basis. On the one hand this could suggest that the relevant market could be a narrow, on-airport duty free market. This is because setting prices on a national basis would make it difficult for Nuance to react differently to accommodate the different competitive pressures from route-paired international airports at each of the three Australian airports at which it operates. Being able to react differently at each of its Australian airports may not matter so much to Nuance if duty free retailers at route-paired international airports are not in the same economic market.

113. On the other hand, often the presence of national pricing might be used to argue for a wider geographic market. This further highlights the need for the empirical analysis that the Commission has undertaken.

114. For the purposes of assessing this Application, the Commission has used the duty free prices at Sydney International Airport as a proxy for duty free prices at overseas airports.

115. Data used for analysis was sourced primarily from Nuance. Nuance is the incumbent on-airport duty free retailer at a number of different airports in New Zealand and Australia. At each of these airports, Nuance operates within a different competitive landscape. At Sydney, Brisbane, and Melbourne International Airports, Nuance is the sole duty free concessionaire. At Auckland and Wellington International Airports, Nuance is one of two duty free concessionaires.

116. It is expected that there would be a strong price correlation between duty free retailers that compete in the same market. Therefore, the Commission considers that Nuance's prices at each of Auckland and Wellington International Airports are likely to be representative of the prices charged by the second, on-airport duty free concessionaire, namely DFSW at Wellington International Airport, and DFS Galleria at Auckland International Airport.

117. Nuance provided the Commission with weekly sales revenue and sales volume information in 2007, for close to 200 of its top selling products at each of Auckland, Wellington and Sydney International Airports respectively. Monthly average bilateral exchange rates were also used to express duty free prices in New Zealand and Australia in a common currency (New Zealand dollars).

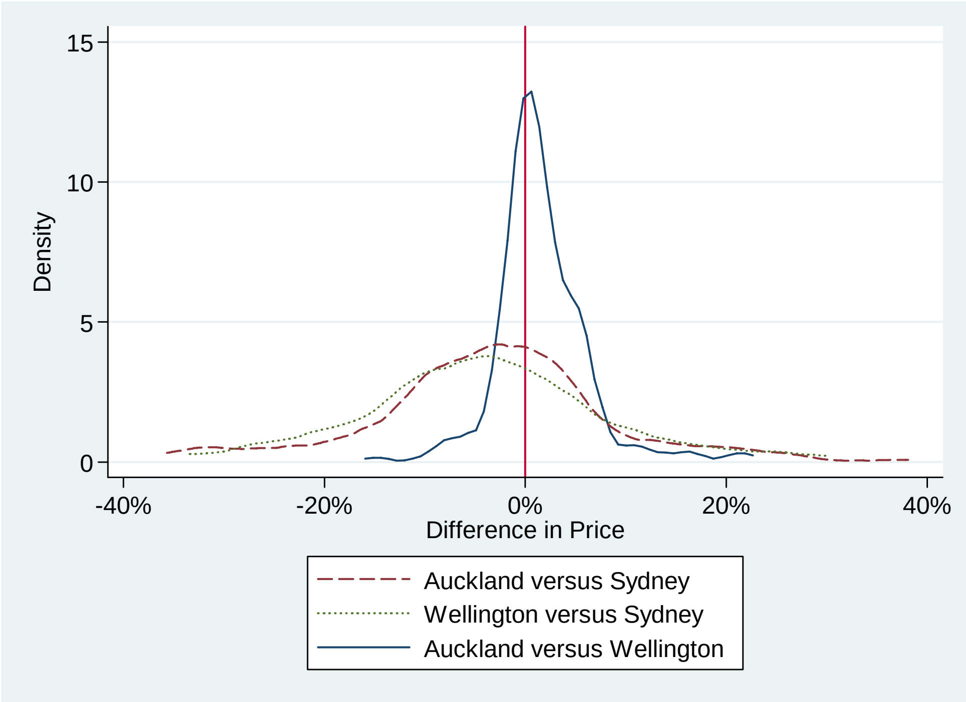
Results

118. Results of cross-sectional analysis of average annual price differences between identical duty free products sold at different airports showed that price differences between the two New Zealand international airports and Sydney International Airport can be substantial.

119. Three distributions of annual average price differences between identical duty free products sold at various international airports are shown in Figure 1. The dashed line shows the distribution of price differences between identical duty

free products sold at both Auckland International Airport and Sydney International Airport (expressed as a proportion of each respective product's price at Sydney International Airport). The distribution of price differences between identical duty free products sold at both Wellington International Airport and Sydney International Airport is given by the dotted line. The solid line shows the distribution of price differences between identical duty free products sold at both Auckland International Airport and Wellington International Airport.

Figure 1: Distributions of Annual Average Duty Free Product Price Differences between International Airports



120. The higher these lines (density) at any particular point along the horizontal axis, the more observations are located there. For the two distributions which compare New Zealand duty free prices with duty free prices at Sydney International Airport, observations to the left of zero represent duty free products that were less expensive at each respective New Zealand international airport than they were at Sydney International Airport. Conversely, observations to the right of zero are duty free products that were less expensive at Sydney International Airport than they were at each respective New Zealand International Airport.

121. For the distribution that compares duty free prices at Auckland International Airport with duty free prices at Wellington International Airport, observations to the left of zero represent duty free products that were less expensive at Auckland International Airport than they were at Wellington International Airport. Conversely, observations to the right of zero represent duty free products that were less expensive at Wellington International Airport than they were at Auckland International Airport.

122. Marked price differences between duty free products sold at both Auckland International Airport and Sydney International Airport were common. For instance, 59% of the duty free products observed at both Auckland International Airport and Sydney International Airport differ in price by more than 5%, while

34% of products observed at both Auckland International Airport and Sydney International Airport differ in price by more than 10%.

123. Also common were marked price differences between duty free products sold at both Wellington International Airport and Sydney International Airport. For instance, 67% of the duty free products observed at both Wellington International Airport and Sydney International Airport differ in price by more than 5%, while 39% of products observed at both Wellington International Airport and Sydney International Airport differ in price by more than 10%.

124. This suggests that neither duty free retailers located at Wellington International Airport nor duty free retailers located at Auckland International Airport compete with duty free retailers located at Sydney International Airport.

125. For most international travellers, there is no opportunity to make duty free purchases from both Wellington International Airport and Auckland International Airport on the same trip, and therefore, they could not be considered to be substitutes. For this reason, whilst duty free prices at Auckland International Airport are more strongly related to duty free prices at Wellington International Airport than to Sydney International Airport, the Commission considers that duty free retailers at Auckland International Airport and Wellington International Airport do not fall within the same market.

126. However, analysis of the association between duty free prices at Wellington International Airport and Auckland International Airport can provide a useful reference point upon which to assess any association found between duty free prices at Auckland International Airport and Sydney International Airport.

127. The distribution of price differences between identical duty free products sold at both Auckland International Airport and Wellington International Airport is by far the most concentrated of the three distributions shown in Figure 1. In other words, large price differences between identical duty free products sold at both Auckland International Airport and Wellington International Airport are far less common than they are between either of the two New Zealand international airports and Sydney International Airport respectively. For instance, only 21% of the duty free products observed at both Auckland International Airport and Wellington International Airport differ in price by more than 5%, while only 6% of products observed at both Auckland International Airport and Wellington International Airport differ in price by more than 10%.

128. An examination of the movement of average duty free prices at each airport over time, using various price indices, shows a very weak association between each of Auckland International Airport and Sydney International Airport, and Wellington International Airport and Sydney International Airport. Again, the association between Wellington International Airport and Auckland International Airport appears stronger.

129. Results of regression analyses, which examine both the contemporaneous and lagged relationship between duty free prices of identical products at these different airports, did not yield an economically significant relationship between different airports. For example, one set of results suggests that a 4% change in duty free prices at Sydney International Airport, spread over four weeks, would on average lead to only a 0.11% change in duty free prices at Auckland International Airport. If duty free retailers at Auckland International Airport and Sydney International Airport acted as a constraint on one another's pricing

behaviour, then price changes at one airport would be expected to be more closely matched by price changes at the other airport.

130. Finally, an estimation of demand functions for duty free products failed to find any relationship between prices of duty free products at Auckland International Airport and Sydney International Airport, and between Wellington International Airport and Sydney International Airport, respectively.

131. The Applicant, through Frontier Economics, commented on the Commission's construction of price indices, and the way in which price observations were weighted in the construction of price indices and in various regressions.

132. In order to test the validity and robustness of its analyses, the Commission used around ten different approaches to assess the constraint posed by the duty free retailers located at route-paired international airports on the duty free operators at Auckland International Airport. However, none of these approaches yielded results that might suggest that the duty free retailers located at route-paired international airports would fall within the same economic market as the duty free retailers located at Auckland International Airport.

133. There are many ways that one can construct price indices, each with their own advantages and disadvantages. Frontier Economics proposed a different price index methodology to those used by the Commission. However, the Commission is of the view that the choice of price index construction is likely to have little effect on its overall findings, particularly with the large number of duty free product price observations that have been used, and the variety of weighting methodologies employed.

134. The Commission re-estimated a selection of its analysis in acknowledgement of some of the Applicant's concerns. The Commission has ensured that in this instance, both the duty free product mix and the weight given to each observation was held constant over time, even though this gave rise to other limitations.[26] However, results did not change appreciably.

135. Each stream of economic analysis undertaken by the Commission consistently indicated that duty free prices at route-paired international airports were not similar (in the context of demand- and/or supply-side substitutability), and that changes in duty free prices at one international airport were not closely matched by duty free price changes at other route-paired international airports.

136. In conclusion, the Commission is of the view that the results of these analyses indicate that duty free retailers at route-paired international airports do not fall within the same market as duty free retailers located at Auckland International Airport.

The Experience at Wellington International Airport

137. Changes in duty free retailing at Wellington International Airport, and the Commission's analysis of the effects of these changes, are discussed fully in the 'Modelling the Potential for Unilateral Effects' section of this document. However, this analysis is also relevant to the market definition, in that if a sole duty free retailer at a particular international airport were shown to be able to exert market power, then it must be unconstrained by possible sources of

[26] For instance, this means in some cases around half of the Commission's pricing data would be excluded. It also means that consumer switching (say, in response to price changes) is not taken into consideration.

competition from outside of the airport. This in turn would imply that the relevant market is confined to the airport alone. Therefore, this analysis is also briefly discussed here.

138. Until Nuance commenced its duty free retail operations in December 2006, DFSW was the incumbent and sole duty free retailer at Wellington International Airport. This change in market structure at Wellington International Airport was essentially the reverse of the change that would be brought about at Auckland International Airport by the proposed acquisition.

139. The Commission's analysis revealed that the entry of Nuance in December 2006 was associated with a fall in duty free prices at Wellington International Airport of approximately 10% on average. This suggests that off-airport duty free retailers and duty free retailers located at route-paired international airports are unlikely to fall within the same geographic market as on-airport duty free retailers at a particular international airport, as they evidently posed very little constraint on the sole on-airport duty free retailer. If they had imposed a significant constraint, it is unlikely that the entry of a single new competitor would have had such a significant effect on duty free prices.

140. This accords with statements made to the Commission by DFSW, in respect of the extent of competition and its price monitoring behaviour at Wellington International Airport, since the entry of Nuance in December 2006. DFSW advised the Commission that competition had become "incredibly much more intense" since entry. DFSW said that it price checks Nuance's Wellington International Airport store "constantly" to ensure that DFSW retains its prices at levels that are competitive with Nuance's. It had not undertaken this extent of price comparison with Nuance's duty free operations located at route-paired international airports.

Conclusion on Geographic Market

141. The Commission is of the view that off-airport duty free retailers (including internet retailers, in-flight duty free offerings, and high street duty free retailers), and duty free retailers located at route-paired international airports, are unlikely to fall within the same geographic market as on-airport duty free retailers. A 5-10% increase in duty free prices would be unlikely to result in a significant number of duty free consumers switching from on-airport providers to either off-airport duty free retailers or duty free retailers located at route-paired international airports.

142. The Commission therefore concludes that the geographic scope of the market should be confined to Auckland International Airport.

Conclusion on Market Definition

143. The Commission concludes that the market relevant for the purpose of assessing the current Application is the retail supply of duty free goods at Auckland International Airport to international air travellers.

FACTUAL AND COUNTERFACTUAL

144. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission compares the likely outcomes in two hypothetical situations, one with the acquisition (the factual)

and one without (the counterfactual).[27] The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition. The Commission uses a forward-looking type of analysis to assess whether a lessening of competition is likely in the defined market(s).

Factual

145. In the factual, DFS Galleria would acquire all the shares in, or assets of, Nuance's duty free operations in New Zealand. The memorandum of understanding between DFS Galleria and Nuance specifies that the proposed acquisition would include:

- all fixed and intangible assets (including the "Regency" brand);
- assignment or novation of contracts, including the duty free concession licence agreements with AIAL and WIAL, and the licence agreements for the specialty stores 'The Cellar', 'Made in New Zealand', 'Chocovino', and 'Discover New Zealand' at each of Auckland, Wellington, and Christchurch International Airports;
- leases for the Auckland (and any other) administration offices and warehouse (excluding Nuance's Victoria Street store in Auckland, which Nuance intended to close before the end of September 2007); and
- a covenant by Nuance not to compete in New Zealand against the business being acquired by DFS Galleria, for five years.

146. For the purpose of assessing this application, the Commission has only considered the competitive impact of the proposed acquisition in respect of duty free retailing at Auckland International Airport.

147. Presently, DFS Galleria and Nuance each hold a general duty free concession at Auckland International Airport. DFS Galleria's and Nuance's existing licence agreements were set to expire on 3 August 2009.

148. The current state of play is that AIAL has determined that DFS Galleria would be the sole duty free retailer at Auckland International Airport for the period 4 August 2009 – 30 June 2015. AIAL has advised the Commission that DFS Galleria has a new licence agreement, which will come into effect on 1 April 2008. This coincides with the opening of Auckland International Airport's new arrivals terminal.

149. In the factual, the combined entity would hold both of the two general duty free concessions at Auckland International Airport until at least 3 August 2009, when Nuance's current general duty free concession expires. From that point on, there would be only one duty free concession at Auckland International Airport.

150. This would result in a loss of the competition that would have occurred between DFS Galleria and Nuance over the sixteen month period to 3 August 2009.

Counterfactual

151. The counterfactual is the Commission's view of what would be likely to occur if the acquisition being considered were not to proceed. It is the benchmark against which any changes arising from the proposed acquisition is assessed. When making this assessment, the Commission recognises that future scenarios

[27] *Air New Zealand & Qantas Airways Ltd v Commerce Commission*, (2004) 11 TCLR 347, Para 42.

may include either the existing owners continuing to control the target entity, or other parties that are interested in purchasing the target entity if the Applicant's proposed acquisition were not to proceed and the sale to continue.

DFS Galleria's View of the Counterfactual

152. In its Clearance Application, DFS Galleria submitted that in the counterfactual Nuance would continue operating until such time that its duty free concession at AIAL expires.

153. [ ]:

> [ ].[28]

154. [ ].

155. [ ].

Nuance's View of the Counterfactual

156. Jonathan Stent-Torriani (Vice Chairman, Nuance Australia & New Zealand) advised the Commission that [ ]:

> [ ].
>
> [ ].
>
> [ ].[29]

157. Furthermore, Mr Stent-Torriani advised Nuance's operations at Auckland International Airport had consistently been providing approximately [ ]% of its sales in New Zealand.[30] [ ].

158. [ ].

159. [ ]:

> [ ].[31]

160. [ ].

161. [ ].

162. [ ].

163. [ ].

164. [ ].

165. [ ].

166. [ ].

167. [ ].

168. [ ].

169. [ ].

170. [ ].

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[28] Letter to the Commission from Bell Gully, 7 March 2008, para 4.2 a).
[29] Letter to the Commission, from Jonathan Stent-Torriani, Vice Chairman, Nuance Australia & New Zealand, 4 February 2008.
[30] Christchurch comprises [ ]% and Wellington [ ]%.
[31] Letter to Commerce Commission from David Fletcher, Chief Financial Officer, Nuance Australia & New Zealand, 25 March 2008, para 36.

AIAL's View of the Counterfactual

171. [ ].

172. [ ].

173. [ ].

174. AIAL considers its primary goals are to "maintain, as a minimum, the current standard of duty free offering at the airport … and not have its financial position adversely affected by any change to the retailing operations".

175. [ ], AIAL advised the Commission that it was seeking to negotiate a structured outcome with Nuance, whilst preserving its legal options.

176. [ ].

177. [ ].

178. [ ].

179. [ ]:

> [ ][32]

180. [ ].

181. [ ].

182. [ ].[33]

183. Further, Nuance had accepted AIAL's notice of relocation of its arrivals store, and AIAL's condition that both DFS Galleria and Nuance would be ready to commence operating in the new arrivals terminal on 1 April 2008, should the proposed transaction not proceed for any reason. AIAL informed the Commission that it had requested the details relating to any contingency plans from DFS Galleria and Nuance in November 2007, but had not received a response.

184. [ ].

185. [ ], any closure costs faced by Nuance at the end of its licence agreement are standard for any retail operator at Auckland International Airport.

186. [ ].

The Commission's View of the Counterfactual

187. The Commission considers the likely counterfactual scenario for Nuance's Auckland business would be different to that for Nuance's other New Zealand operations. The Commission has therefore separately addressed Nuance's Auckland operations and its Christchurch and Wellington operations below.

<u>Nuance's Christchurch and Wellington Operations</u>

188. The Commission considers that in the counterfactual, Nuance would sell its Wellington and Christchurch businesses to an independent third party.

[32] Letter from Russell McVeagh to Commerce Commission, 27 March 2008, para 2.
[33] AIAL advised DFS Galleria and Nuance, in letters dated 8 December 2006, that it was in the process of constructing a new arrivals area, which would include a new space for duty free stores. AIAL stated in this letter that the change would require a relocation of the existing arrivals duty free stores.

189. Nuance advised the Commission that it was “highly likely” that it would seek to sell its Wellington and Christchurch businesses separately, should the proposed acquisition not proceed. Nuance considered that [ ] would be the most likely and highest price bidder. The Commission identified [ ] further duty free operators that would consider purchasing some of Nuance’s New Zealand operations in the counterfactual ([ ]).

190. [ ].

191. [ ] advised the Commission that following the announcement of Nuance’s unsuccessful bid for the AIAL concession, [ ]. [ ] is primarily interested in acquiring Nuance’s Wellington business, as its sees value in Nuance’s position as being a sole general duty free concessionaire in the period 2009-2015.

192. [ ] indicated that the sale of only Nuance’s Auckland International Airport business to a third party would not be a viable option. [ ] agreed, advising the Commission that Nuance’s Auckland International Airport duty free concession had less than two years to run, which would not be sufficient to recoup the investment made.

193. The Commission now turns to discuss the likely counterfactual in respect of Nuance’s operations at Auckland International Airport.

<u>Nuance’s Auckland International Airport Operations</u>

194. For the reasons discussed below, the Commission considers that Nuance staying at Auckland International Airport is a real and substantial prospect. Accordingly, the Commission has adopted this outcome as the likely counterfactual scenario in respect of Nuance’s Auckland International Airport operations.

195. The Commission’s assessment of Nuance’s financial statements indicated that historically, Nuance [ ] had achieved a gross profit margin of around [ ]%.

196. [ ]. Consequently, the Commission considers that Nuance could continue to operate at Auckland International Airport in the counterfactual.

197. [ ].

198. At the end of its concession at Auckland International Airport, Nuance would be likely to incur some closure costs, such as redundancy payout costs. These costs could be significant. However, they could be offset by residual revenue generated by the sale of on-hand stock and fixtures/fittings. Nuance’s licence agreement also provides for AIAL potentially to purchase the fixtures and fittings at the end of Nuance’s concession.

199. [ ].

200. [ ].”

201. [ ].

202. As of 28 March 2008, both AIAL and Nuance had indicated a willingness to negotiate an amendment to the existing licence agreement, in contemplation of Nuance’s continued presence at Auckland International Airport.

203. Central to agreeing a variation is the allocation, or lack thereof, of a space for Nuance in the new arrivals area. [ ].

204. [ ].

205. [ ].

206. The Commission is not able to determine the merits of the legal arguments raised by Nuance in respect of its licence agreement with AIAL. [ ].

207. [ ]. The Commission considers it most likely that Nuance and AIAL would find a solution whereby Nuance would remain at Auckland International Airport until 3 August 2009.

Conclusion on the Counterfactual

208. The Commission concludes that the likely counterfactual is that Nuance would sell its Wellington and Christchurch businesses to a third party, whose acquisition would not raise competition concerns.

209. In respect of Nuance's Auckland business, the Commission considers that there is a real and substantial prospect that Nuance would stay and continue to operate at Auckland International Airport until at least 3 August 2009. Accordingly, the Commission has adopted this outcome as the likely counterfactual scenario.

COMPETITION ANALYSIS

Introduction

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

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

211. The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in the market between those two scenarios.

212. A substantial lessening of competition (SLC) would be likely if the Commission were to reach the view that in the factual, the potential for the merged entity, or other market participants, to exercise market power would be enhanced when compared to the counterfactual. Acquisitions that increase concentration in markets enhance the potential for market power to be exercised in two main ways:

- by reducing competition constraints that lead to an increase in market power of the remaining firms acting independently (non-coordinated, or unilateral, effects); and/or
- by changing the nature of competition in a way that makes tacit or express coordination between firms more likely, effective and stable (coordinated effects).

213. The potential for the enhancement of a unilateral or a co-ordinated exercise of market power is assessed in terms of:

- existing competition;
- potential competition; and

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

214. In summary, the competition analysis carried out by the Commission assesses whether the potential for exercising unilateral or co-ordinated market power is enhanced in the factual, when compared to the counterfactual, by analysing changes in existing competition, and whether constraints would be provided by potential competition and other possible competition factors.

215. The Applicant has submitted that competition concerns are unlikely to arise as a result of the proposed acquisition, as the combined entity would face:

- competition from off-airport duty free retailers and duty free retailers located at route-paired international airports; and
- constraint in the form of the countervailing power of AIAL, which has the ability to ensure prices are competitive and facilitate new entry.

216. The Commission's analysis (set out below) did not conclude that these forces would be sufficient to constrain the potential for the unilateral exercise of market power in the factual, as compared to the counterfactual. In summary, the Commission considers that the facts and analysis below show that:

- in the factual, duty free consumers would no longer have a choice of duty free retailers, and no longer have the ability to compare prices and promotional offers at Auckland International Airport, due to the removal of the competition posed by Nuance;
- in order for the combined entity to face constraint from potential competition, AIAL would need to be able to credibly threaten to create an additional duty free concession to facilitate new entry. This seems unlikely as it is contrary to AIAL's announced policy of having a sole duty free concessionaire at Auckland International Airport;
- AIAL would have little reason to ensure that the combined entity's duty free prices do not exceed revenue-maximising levels, or to enforce the relevant contractual obligations by creating an additional duty free concession, or by terminating the combined entity's duty free concession; and
- there may be some small degree of competition from duty free retailers outside the market, but this competitive constraint would be well short of that posed by Nuance in the counterfactual, and unlikely to be sufficient to counter an exercise of market power by the combined entity in the factual scenario.

217. This section sets out the Commission's reasoning and views on the likelihood of an SLC in its comparison of the competitive environments in the factual and the counterfactual.

Unilateral Effects

Existing Competition

218. Existing competition occurs between those businesses in the market that already supply the product, and those that could readily do so by adjusting their product-mix (near competitors).

219. An examination of concentration in a market can provide a useful indication of the competitive constraints that market participants may place upon each other,

providing there is not significant product differentiation. Moreover, the increase in seller concentration caused by a reduction in the number of competitors in a market by an acquisition is an indicator of the extent to which competition in the market may be lessened.

220. The Commission considers that a business acquisition is unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

- the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is below 70% and the market share of the combined entity is less than in the order of 40%; or
- the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is above 70%, the market share of the combined entity is less than in the order of 20%.

221. Table 5 below shows estimated market shares, based on the volume of sales in New Zealand dollars, for the two duty free concessionaires in the market at Auckland International Airport for the five year period from 2002 to 2007.

Table 5. Shares of Total Duty Free Sales at Auckland International Airport, 2002-07

	Year					
Retailer	**2002***	**2003**	**2004**	**2005**	**2006**	**2007****
DFS Galleria	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%
Nuance	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%	[ ]%
TOTAL	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: AIAL
*market shares for 2002 are based on July to December volume sales only.
**market shares for 2007 are based on January to November sales only.

222. Post-acquisition, the combined entity would be the only duty free retailer operating at Auckland International Airport.

223. The Commission recognises that concentration is only one of a number of factors to be considered in the assessment of competition in a market. In order to understand the impact of the acquisition on competition, and having identified the level of concentration in a market, the Commission considers the behaviour of the businesses in the market.

224. At Auckland International Airport, DFS Galleria and Nuance trade alongside each other. Both operators have retail stores in the departures lounge, the arrivals area, and landside (the area of the airport that is not controlled by New Zealand Customs). These two duty free retailers operate identical business hours and share many of the same product ranges.

225. Table 5 shows that over the last five years, both duty free retailers' market shares have been approximately [ ]. Nuance's market share [ ].

226. Nuance and DFSW advised the Commission that duty free consumers are price sensitive. Consumers like to have a choice between retailers, will check prices, and readily switch between duty free retailers. It is for this reason that on-airport duty free retailers tend to mirror one another in terms of price and promotional offers.

227. Mathew Talbot, Customer Team Manager Australia and New Zealand, Diageo GTME (Diageo)[34] advised the Commission that some of these prices and promotional activities coincide as they are initiated by suppliers. However, duty free retailers at the same airport are mindful of maintaining their competitive position and will ensure that they secure the same promotional price or 'gift with purchase' offers as their competitors.

228. For example, DFSW stated that it ensures that it is able to provide a competitive offer to consumers at Wellington International Airport, by dropping prices to match those offered by Nuance, as soon as Nuance starts a new deep-discount promotion. Similarly, DFSW has also matched Nuance's "20% off any two bottles to Australia", which Nuance has been offering since opening its new stores at Wellington International Airport in December 2006.

229. Duty free retailers also seek to differentiate themselves, in order to gain an advantage over their competitors, by vying for the opportunity to secure special offers and lead times for new products. For example, DFS Galleria recently negotiated an exclusive deal for the launch of Absolut Disco, a packaged vodka, at Auckland International Airport.

230. All this indicates that the factual would result in the elimination of Nuance, and therefore the loss of a key source of competition at Auckland International Airport that would otherwise exist in the counterfactual until 3 August 2009. Duty free consumers would no longer have the ability to compare prices and promotional offers, and would no longer have a choice of duty free retailers from which they could make purchases. Essentially, there would no longer be competing retailers vying for the patronage of customers.

<u>Conclusion on Existing Competition</u>

231. The proposed acquisition would result in a reduction in the number of general duty free retailers at Auckland International Airport from two to one. Accordingly, the Commission concludes that existing competition would cease in the factual scenario.

Potential Competition

232. An acquisition is unlikely to result in a substantial lessening of competition in a market if the businesses in that market continue to be subject to real constraints from the threat of market entry. The Commission's focus is on whether businesses would be able to enter the market and thereafter expand should they be given an inducement to do so, and the extent of any impediments they might encounter should they try.

233. The Applicant submitted that, as its duty free concession is non-exclusive, on-airport entry is possible and would act to constrain the combined entity post-acquisition.

234. There is a range of international duty free operators that DFS Galleria considers could take on a duty free concession at AIAL's invitation, including DFSW, and [ ]. The only condition of entry relevant to these firms' potential entry would be the requirement to hold a duty free licence for on-airport retailing, which is within the absolute control of AIAL.

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[34] Diageo is a major supplier of liquor to duty free retailers.

Entry Conditions

235. The likely effectiveness of the threat of new entry in preventing a substantial lessening of competition in a market following an acquisition is determined by the nature and effect of the aggregate barriers to entry into that market.

236. Industry participants advised the Commission that in order to enter the market for the retail supply of duty free goods at Auckland International Airport, a new entrant would require:

- stock and a supply chain network;
- a Customs Controlled Area Licence;
- sufficient scale; and
- a duty free concession and retail space at Auckland International Airport.

Stock and Supply Chain

237. None of the parties interviewed by the Commission considered sourcing stock to be particularly difficult. In most cases, forming an agreement with suppliers is relatively easy and straightforward.[35]

238. Nuance and Diageo advised the Commission that the duty free shopping environment is important to suppliers, as it gives them an opportunity to showcase their brands and invite consumers to trial products. Suppliers often use the duty free offering as an opportunity to market and advertise their product ranges to consumers.

239. Nor did industry participants consider establishing a supply chain network to constitute a barrier to entry. Industry participants advised the Commission that duty free operators compete vigorously to secure duty free concessions at airports, and it is not uncommon for international duty free operators to bid for contracts in New Zealand, using a variety of strategies to overcome any disadvantages of not having an established local presence.

240. [ ].

Customs Controlled Area Licence

241. Industry participants advised the Commission that obtaining a Customs Controlled Area Licence only involves filling in and submitting paperwork to the New Zealand Customs Service.

Scale, Concession and Retail Space

242. Contrary to DFS Galleria's contention, smaller duty free retailers, [ ], advised the Commission that they would be unlikely to bid for a concession at a large international airport, because they would not have sufficient scale and the financial backing required to submit a competitive bid.

243. Retailers had mixed views as to whether scale provides an advantage when negotiating with suppliers. [ ].

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[35] Industry participants advised the Commission that in rare cases, suppliers prefer to have exclusive arrangements with one particular retailer, and would therefore be unwilling to supply products to multiple retailers within proximity to one another. This tends to be limited to luxury brands, such as Chanel, which comprise a minor proportion of duty free retail sales.

244. Nuance, [ ], advised the Commission that there is a benefit to being a large, global company when it comes to negotiating with suppliers, and that global duty free operators tend to have global supply agreements, although the terms and product mixes may differ between airports.

245. Similarly, [ ] advised that because it is a comparatively small retailer, it does not have the ability to negotiate prices as low as those secured by the likes of DFS Galleria and Nuance. However, it has a lower cost structure than international firms, and leverages against this to offer prices that are competitive with those offered by larger firms.

246. Overall, airport companies and duty free retailers considered there would likely be many potential entrants, given the number of participants in the recent tender rounds for duty free concessions at Wellington International Airport and Sydney International Airport.

247. Although there are a number of likely potential entrants, those duty free retailers would require a duty free concession and retail space allocated by AIAL in order to commence operations at Auckland International Airport.

248. In the factual, the combined entity would hold both general duty free concessions at Auckland International Airport. Accordingly, there would be no concession available for a new entrant.

249. DFS Galleria and AIAL advised the Commission that DFS Galleria's licence agreement stipulates that its duty free concession is non-exclusive. Technically, AIAL could create an additional duty free concession at Auckland International Airport at any time.

250. [ ].

251. Nuance, [ ], considered that the ability to create sufficient retail space would present challenges in appointing an additional duty free concessionaire. AIAL would need to create this space by taking it from existing retailers.

252. AIAL advised the Commission that it does not have unallocated retail space at Auckland International Airport. Rather, when creating retail space for a new concessionaire, it acquires retail space from existing tenants by negotiation. For example, when AIAL created a 150m^2 specialist Adidas 'All Blacks' store in 2007, [ ].

<u>The "LET" Test</u>

253. In order for market entry to be a sufficient constraint, entry of new participants in response to a price increase or other manifestation of market power must be:

- Likely in commercial terms;
- sufficient in Extent to cause market participants to react in a significant manner; and
- Timely, i.e., feasible within approximately two years from the point at which market power is first exercised.

254. Industry participants considered that entry, once the necessary concession had been secured, could occur in a *timely* manner. Sourcing stock, establishing a supply chain network and obtaining a Customs Controlled Area Licence, would be unlikely to take a significant amount of time, and could occur simultaneously with constructing and fitting-out the retail store.

255. Nuance was of the view that the selection of a new concessionaire could be expected to take three to four months, and creation of infrastructure and shop fit-out would likely take four to six months. AIAL advised the Commission that in normal circumstances, where a straightforward tender process is being followed, entry by a new duty free concessionaire would take in the order of 12-18 months. In circumstances where AIAL is seeking to introduce a new retailer as a matter of urgency, it could accelerate the introduction of that new retailer to within approximately four months.

256. When Nuance entered Wellington International Airport in December 2006, it secured a market share of [ ]% within its first month of trading. AIAL, Nuance, and DFS Galleria informed the Commission that a new entrant would be *sufficient in extent* to act as a constraint on the combined entity, even if it had a smaller retail space, as it could focus on stocking top selling items.[36]

257. In order for new entry to be *likely*, AIAL would have to create an additional duty free concession, and allocate retail space for this concessionaire. This would be contrary to AIAL's announced policy of a sole duty free concessionaire at Auckland International Airport.

258. In any case, for the reasons discussed in detail in the 'Countervailing Power' section of this Decision, the Commission considers that AIAL would be unlikely to create an additional duty free concession at Auckland International Airport.

<u>Conclusion on Potential Competition</u>

259. The Commission considers that, as AIAL is unlikely to create an additional duty free concession at Auckland International Airport, "likely, sufficient in extent and timely" entry by a potential competitor is in unlikely to occur in the factual scenario.

260. The Commission therefore concludes that the combined entity is unlikely to face constraint in the form of potential competition post-acquisition.

Countervailing Power

261. The potential for a business to wield market power may be constrained by countervailing power in the hands of its customers or its suppliers. The Applicant and Nuance have submitted that AIAL has countervailing power; AIAL was also of this view. Essentially, the argument is that AIAL could act as a regulator by ensuring that competitive outcomes are emulated through the contractual provisions of the general duty free licence agreements. This is an unusual argument—AIAL is not a purchaser of duty free goods, or a supplier of duty free goods. It is simply the landlord of the concessionaire's premises.

262. In order to exercise countervailing power, a firm must have both the incentive and the ability to do so. In respect of the current Application, the Commission considers that AIAL appears to have limited ability and incentive to constrain duty free operators at Auckland International Airport.

263. In this section a number of economic concepts will be referred to, including profit- and revenue-maximising prices and quantities. Profit-maximising prices and quantities are simply those that a firm would set to maximise its profits. Similarly, revenue-maximising prices and quantities are those that would

[36] For example, Diageo advised that approximately [ ]% of its sales through duty free are from its top ten brands.

maximise a firm's revenue. For any firm that faces a downward sloping demand curve, revenue-maximising prices will always be lower than profit-maximising prices (and quantities will be higher). The Commission has included a more complete explanation of these concepts in Appendix 2.

264. The Applicant submitted that AIAL has overriding countervailing power in respect of a duty free retailer's pricing and service standards by virtue of the obligations in the licence agreement. DFS Galleria advised that its new licence agreement, which is expected to take effect on 1 April 2008, includes clauses that provide that:

- DFS Galleria is to ensure that its prices are 'competitive', and to provide price comparisons to AIAL on a monthly basis;
- AIAL retains the right to create an additional general duty free concession; and
- AIAL retains the right to terminate DFS Galleria's concession should DFS Galleria fail to meet its contractual obligations.

265. The Commission now goes on to consider the evidence bearing on AIAL's incentives and ability to exert countervailing power and curtail an exercise of market power by duty free retailers at Auckland International Airport.

<u>Competitive Pricing</u>

266. AIAL advised that it conducts various forms of price monitoring on a frequent basis. It obtains prices of various high-selling duty free products for comparison from a number of sources, including advertising flyers, newspapers, websites, and observations at other airports.

267. The existing licence agreements of DFS Galleria and Nuance with AIAL also include competitive pricing provisions, which require these duty free retailers to:

- "[ ]";
- "[ ]";
- "[ ]"; and
- "[ ]".[37]

268. The Commission has reviewed these pricing conditions, but considers there to be uncertainty over their effectiveness. They appear to be ambiguous, and enforcement could require AIAL taking action through legal processes. This appears to be a poor substitute for competition.

269. For example, it is not clear why there is a requirement that prices be "competitive" if the real work is done by the requirement that prices be "not higher" than those of competitors. Similarly, if the real requirement is that prices are "not higher" than those of competitors, it is not clear whether this means that the price of every product offered for sale by a duty free retailer at the airport must be lower than the price of every comparable item sold by a competitor (i.e., duty free retailers' price for every product must be the lowest), whether on average retailers' prices must not be higher than competitors, or

[37] AIAL and DFS Galleria Deed of Licence to Operate Duty Free Retail Outlets International Terminal Building 30 December 2005 – 3 August 2009, clause 11.4; AIAL and Nuance Deed of Licence to Operate Duty Free Retail Outlets International Terminal Building 4 July 2002 – 3 August 2007, clause 11.4.

whether on average retailers' prices must not be so much higher than competitors that they could be considered to be not competitive.

270. AIAL advised the Commission that as of 1 April 2008, DFS Galleria's licence agreement will include a more formal price monitoring process, which would be undertaken through a joint information forum between AIAL and DFS Galleria. DFS Galleria's new licence agreement provides that DFS Galleria is required to:

> "[ ]".[38]

271. AIAL informed the Commission that this joint information forum would provide a "snapshot" of prices at a specific point in time, and would be in addition to the regular monitoring as part of AIAL's normal business activities. AIAL further advised:

> [ ].[39]

272. In the factual, there would be no on-airport competitor against which the combined entity's prices could be compared. Any price comparisons undertaken by the combined entity as part of its licence agreement with AIAL would therefore be against prices offered by off-airport duty free retailers and duty free retailers located at route-paired international airports.

273. The Commission notes that, despite significant and sustained price differences between duty free products sold at Auckland International Airport and Sydney International Airport,[40] AIAL has only requested that DFS Galleria and Nuance adjust their prices on one occasion, in March 2006.[41]

274. Further, these price comparisons (and the AIAL/DFS Galleria joint information forum arrangements) offer a somewhat limited proxy to the competitive constraint posed by Nuance in the counterfactual. The Commission considers it is unlikely that AIAL would be as effective a constraint on a sole on-airport duty free retailer, as a second, competing retailer at the same airport.

275. The Applicant submitted that AIAL has two key incentives to ensure that duty free prices are maintained at 'competitive' levels:

- AIAL provides complementary goods/services, sales of which would suffer if duty free prices were high; and
- AIAL wants to maximise its own revenues, and greater sales could achieve this by resulting in greater rental income.

Complementary Goods/Services

276. The Applicant submitted that AIAL has an incentive to require duty free retailer(s) to charge prices below those set by a profit-maximising monopoly. This is because the airport sells goods that are complements in demand, namely air travel and duty free services.

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[38] AIAL and DFS Galleria Deed of Licence to Operate Duty Free Retail Outlets International Terminal Building 1 April 2008 – 3 August 2009, clause 11.4.
[39] Letter to Commerce Commission from AIAL, 12 February 2008, para 3.1.c.
[40] For example, the Commission's analysis of up to 200 duty free products sold at Auckland International Airport and Sydney International Airport in 2007, revealed that 16.1% of products were more than 5% more expensive, and 10.5% of products were more than 10% more expensive at Auckland International Airport than Sydney International Airport.
[41] Although, Nuance states it has never been required to review its prices by AIAL.

277. In terms of economic theory, a profit-maximising monopolist selling goods that are complements in demand would set the prices of those goods at levels that are below those set by two profit-maximising firms, each with a monopoly over one of the two goods.[42]

278. To consider the Applicant's submission, the Commission takes, for argument's sake, a subset of travellers that are equidistant between Auckland and Wellington International Airports and who want to fly to Sydney International Airport. One factor that these travellers may take into account in determining which airport to fly from may be the amenity of the terminal services offered by each of the airports, including the duty free offerings. Airports have an interest in attracting international travellers. AIAL therefore might have an interest in ensuring that duty free prices charged at its airport are below profit-maximising levels in order to attract these marginal travellers.

279. However, although there may be some correlation between the demand for air travel and the demand for duty free services, the Commission expects that it is likely to be low. That is, an increase in the amenity of terminal services in general and duty free goods in particular is likely to have a lesser influence on which airport international travellers fly from, even for those on the cusp between using Auckland International Airport or Wellington International Airport, than factors such as the availability of routes and the frequency of flights. For those living closer to either airport, the choice is likely to favour the airport that presents lower travel time and costs. This would mean that duty free prices at a particular airport could increase substantially with a likely negligible effect on the demand for air travel from that airport.

280. The Commission is therefore of the view that the complementarity of air travel and duty free retail services is likely to be very limited.

<u>Revenue-Maximising Prices</u>

281. An airport has an incentive to ensure that duty free retailers operate on-airport in a way that maximises its profit. One option would be to operate its own duty free outlet. In circumstances where it grants concessions to others, the airport may have an incentive to install a monopoly franchise (from which it extracts monopoly profits) in order to secure as large a return as possible.

282. The Applicant advised the Commission that AIAL has an incentive to ensure that duty free retailers charge revenue-maximising prices, which are lower than profit-maximising monopoly ones. This is because AIAL may receive rent in the form of a proportion of the duty free retailers' revenues. Accordingly, the Applicant considers that AIAL faces incentives to exercise its countervailing power to ensure that its duty free concessionaires' prices do not exceed revenue-maximising levels.

283. As the discussion in the 'Industry Background' section above shows, the concession fee (i.e., rent) payable by duty free retailers to AIAL is the higher of the MAG payment and proportional payment amounts. In the past two years, [ ] monthly rental payments, and [ ] monthly rental payments, to AIAL were MAG payments.

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[42] Frontier Economics, *Note on Incentives facing AIAL and DFS*, February 2008.

284. [ ].[43]

285. [ ].

286. The Commission has no reason to expect that these variances,[44] or revenues,[45] would change materially in the period until 3 August 2009.

287. On closer examination it appears that when rent is charged as a proportion of a duty free retailer's revenues, that retailer is actually incentivised to charge quite different prices from those that would maximise revenue, because of the effect that the rental arrangement would have on the retailer's cost structure.[46] In fact, the retailer would be incentivised to charge prices higher than those that would maximise revenue, and even higher than those it would have charged if they had instead been paying fixed rents, or no rents at all. In neither case would the form of the rental payment cause the profit-maximising firm to move close to the revenue-maximising point.

288. Further, even if AIAL did face incentives to ensure that prices for duty free goods did not exceed revenue-maximising levels, these prices would not necessarily be at the level likely to be seen in the counterfactual.

<u>Creation/Termination of Concession</u>

289. DFS Galleria's and Nuance's existing licence agreements, and DFS Galleria's new licence agreement, provide that AIAL may grant an additional duty free concession at any time.[47]

290. Nuance's and DFS Galleria's existing licence agreements also provide that AIAL may immediately terminate the concession if either duty free concessionaire fails to comply with any contractual obligations.[48] Both of these provisions are retained in DFS Galleria's new licence agreement.[49]

291. DFS Galleria and AIAL advised the Commission that AIAL would be incentivised to create an additional duty free concession at Auckland International Airport should the combined entity not uphold its contractual obligations, particularly those in respect of pricing, product range, and operational hours. These contractual obligations, it is claimed, are essentially designed to maximise sales, and therefore revenue, of duty free retailers at Auckland International Airport.

292. [ ].

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[43] These variances are consistent with the observed revenue trends for DFS Galleria and Nuance for the period 2002-2007.

[44] In the factual, Nuance's licence agreement would be reassigned to the combined entity, and so the value of MAG payments and proportional payments would remain the same.

[45] As discussed in the 'Industry Background' section of this Decision, duty free retailers have experienced a decline in revenue growth in recent years.

[46] Lump sum rents do not affect retailer's marginal costs, i.e., the costs of selling one extra item. Conversely, proportional payment rents can affect retailers' marginal costs as selling one extra item might result in an increase in value of the rental payment.

[47] AIAL and DFS Galleria Deed of Licence to Operate Duty Free Retail Outlets International Terminal Building 30 December 2005 – 3 August 2009, clause 7.3; AIAL and Nuance Deed of Licence to Operate Duty Free Retail Outlets International Terminal Building 4 July 2002 – 3 August, clause 7.3.

[48] AIAL and DFS Galleria Deed of Licence to Operate Duty Free Retail Outlets International Terminal Building 30 December 2005 – 3 August 2009, clause 23.2; AIAL and Nuance Deed of Licence to Operate Duty Free Retail Outlets International Terminal Building 4 July 2002 – 3 August, clause 23.2.

[49] AIAL and DFS Galleria Deed of Licence to Operate Duty Free Retail Outlets International Terminal Building 1 April 2008 – 3 August 2009, clause 7.2, 23.2.

293. Therefore, the Commission considers that post-acquisition, AIAL would have little reason to enforce these contractual obligations by creating an additional duty free concession or terminating the combined entity's duty free concession.

294. The Commission also notes that, in respect of terminating the combined entity's duty free concession, replacing a retailer is time-consuming, expensive, and risky for the airport. Furthermore, a new operator would not necessarily operate its business in a manner that is markedly different from the previous incumbent.

Conclusion on Countervailing Power

295. A number of arguments have been raised as to why AIAL may have the incentive and ability to use countervailing power to constrain the pricing behaviour of the combined entity. Having reviewed each of the points raised, the Commission remains unconvinced of the effect of these arguments.

296. Firstly, AIAL has attempted to use a benchmarking approach to keep prices at some sort of competitive level, but this appears to be difficult to enforce, and to have not been enforced to any notable extent. Second, it is difficult to envisage that the alleged complementarity in demand for air travel and duty free goods could be strong enough to ensure that duty free prices are kept low so that the demand for air travel is kept higher. Third, although it is true that revenue-maximisation by a duty-free concessionaire would maximise AIAL's rents when rents are proportional to turnover, the act of levying of rents on this proportional basis have the contrary effect of changing the duty free retailer's cost structure in such a way as to cause it to increase prices to maximise profits, all else being the same. [ ]. Finally, there is little reason to consider that AIAL would enforce pricing terms in contracts either by terminating a concession, or by encouraging another operator to take up a second concession.

297. Accordingly, the Commission concludes that AIAL would be unlikely to sufficiently constrain an exercise of market power by the combined entity in the factual scenario.

Other Constraints

298. The evidence discussed above suggests that, in the context of the present Application, off-airport duty free retailers and duty free retailers at route-paired international airports are not in the same market as duty free retailers at Auckland International Airport. However, the Commission has considered the extent to which these retailers might provide some constraint on the combined entity from outside the market.

299. The Commission's analysis, which was discussed in the 'Market Definition' section above, indicates that there are differences in price movements over time for duty free retail stores located at Auckland International Airport and Sydney International Airport for a number of products, particularly during periods of promotional activity. Further, price levels for a number of products are significantly different between the duty free stores located at Auckland International Airport and Nuance's Sydney International Airport store.[50] This is inconsistent with what would be expected if the stores in the two airports were competing with each other.

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[50] Specifically, 59% of the products observed at both Auckland International Airport and Sydney International Airport differ in price by more than 5%. Further, 34% of products observed differ in price between the two airports by more than 10%.

300. Off-airport duty free retailers, which sell duty free goods to Auckland International Airport travellers, are numerous and fragmented. Their combined sales account for little more than [ ]% of sales through on-airport duty free stores. Nuance has closed its Auckland CBD store, and DFS Galleria's store mainly sells tax free goods. There is little evidence that off-airport stores compete with on-airport stores in the Auckland region.

301. On the evidence before it, the Commission considers that there may be very limited competition from duty free retailers outside the market. However, this would be likely to fall well short of the competition posed by Nuance in the counterfactual, and unlikely to be sufficient to counter an exercise of market power by the combined entity in the factual scenario.

<u>Conclusion on Other Constraints</u>

302. The Commission concludes that the competitive constraint posed by off-airport duty free retailers and duty free retailers located at route-paired international airports would be unlikely to be sufficient to constrain an exercise of market power by the combined entity in the factual scenario.

Modelling the Potential for Unilateral Effects

303. Once existing and potential competition and other competition factors have all been considered, the Commission is in a position to draw a conclusion as to whether the proposed acquisition would result in circumstances where there would be a substantial lessening of competition in the relevant market or markets relative to the level of competition in the counterfactual.

304. Equivalently, the question is whether circumstances would be such as to lead to the 'creation, enhancement or facilitation of the exercise of market power' in those markets in the factual, relative to the counterfactual. It is the creation of the potential for a business to exercise market power that is the focus of the analysis, rather than whether or not the market power would actually be exercised, should it be obtained.

305. Presently, there is observable evidence of competition occurring between on-airport duty free retailers at Auckland International Airport. The proposed acquisition would see the removal of the competitive constraint posed by Nuance. Duty free consumers would no longer have a choice of duty free retailers, or the ability to compare prices and promotional offers at Auckland International Airport.

306. The Commission has considered whether other competition forces could offer a constraint on the combined entity. The Commission considers that the combined entity would be unlikely to face constraint in the form of potential competition. Further, AIAL would be unlikely to sufficiently constrain supra-competitive price increases imposed by the combined entity in the factual. There may be a very limited degree of competition from duty free retailers outside the market. However, this would likely fall well short of the competition posed by Nuance in the counterfactual, and unlikely to be sufficient to counter an exercise of market power by the combined entity in the factual scenario.

307. In the absence of these competitive factors, the Commission considers that the proposed acquisition, and subsequent removal of Nuance as an independent on-airport competitor, is likely to enhance the scope for unilateral market power in the factual scenario.

308. A useful test is provided by the change in market structure at Wellington International Airport. Until Nuance commenced its duty free retail operations in December 2006, DFSW was the incumbent and sole duty free retailer at Wellington International Airport.

309. This change in market structure at Wellington International Airport is essentially the reverse of the change that would be brought about by the proposed acquisition. Hence, it provides the Commission with a 'natural experiment' from which it can consider the likelihood of whether the combined entity's ability to exercise market power and increase prices to supra-competitive levels would be enhanced in the factual scenario.

<u>The Experience at Wellington International Airport</u>

310. Nuance advised the Commission that it used its standard pricing policy when it entered Wellington International Airport, but the incumbent operator, DFSW, had aggressively discounted its prices in an attempt to retain market share:

> Nuance did not engage in such discounting as that discounting could only have been a temporary measure and could not be sustainable by the incumbent (or for that case Nuance) in the longer term. Nuance in some product lines responded to the incumbents discounting but only on a temporary basis.[51]

311. DFSW, on the other hand, considered that Nuance's entry into Wellington International Airport had resulted in an increase in non-transitory price competition. DFSW provided the example of its December 2007 catalogue, when Nuance had Smirnoff vodka on sale, and DFSW had Absolut vodka on sale. DFSW said that it would retain the Absolut promotion, but would also match the price offered by Nuance for Smirnoff.

312. The Commission has examined in detail the pricing of DFSW before and after Nuance's entry into Wellington International Airport.

Methodology

313. Data used for analysis was sourced primarily from DFSW. DFSW provided the Commission with monthly sales revenue and sales volume information for approximately 40 of its top-selling products at Wellington International Airport for the period April 2005 to December 2007 inclusive. This data encompasses products from four different categories (liquor, tobacco, wine, and fragrances).

314. Similar data, sourced from DFS Galleria for approximately 40 tobacco products sold at Auckland International Airport during the period June 2006 to December 2007 was also used in some instances to control for non-competition related factors affecting the prices of tobacco products at Wellington International Airport, which could not be explicitly observed.

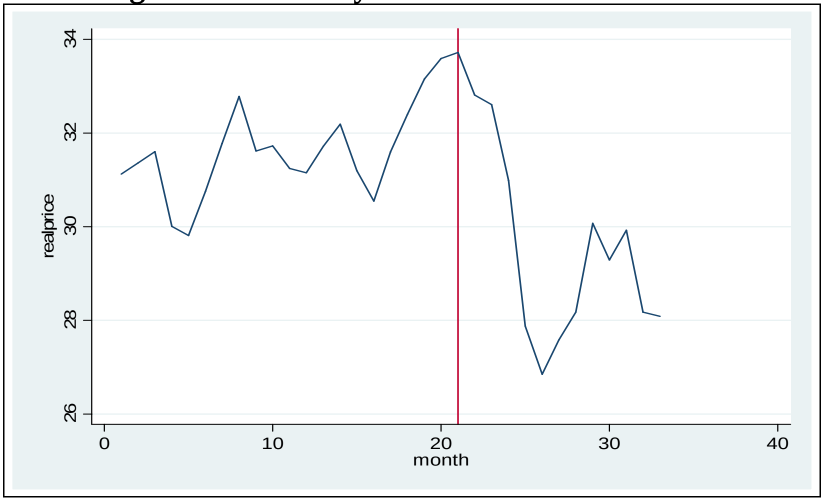
315. Because the analysis spans several years and is primarily concerned with changes in prices over time, the Commission has used the New Zealand Consumer Price Index (CPI) to control for the effects of inflation. Monthly average real prices for each duty free product are calculated by first dividing monthly sales revenue by monthly sales volume for each product respectively, and then dividing further by the CPI.

[51] Letter to Commerce Commission from David Fletcher, Chief Financial Officer, Nuance Australia & New Zealand, 25 March 2008, para 37.

Results

316. The movement of average duty free prices over time at Wellington International Airport is illustrated by the real price index shown in Figure 2. The vertical line at month 21 marks the entry of Nuance at Wellington International Airport in December 2006.

Figure 2. Real Duty Free Product Price Index



317. Figure 2 demonstrates that shortly after the entry of Nuance, DFSW sharply reduced prices of the duty free products examined. Further, 12 months after the entry of Nuance, DFSW's prices remained substantially lower than they were immediately prior to Nuance's entry.

318. Regression analysis yields similar results, which are presented in Table 6 below. Each figure in the table relates to a separate regression and shows the average percentage difference in prices after the entry of Nuance at Wellington International Airport, for each duty free product type respectively.

Table 6. Average Real Price Changes after the Entry of Nuance

Product	Average price change
Liquor	[ ]%
Tobacco	[ ]%
Tobacco (adjusted)	[ ]%
Wine	[ ]%
Fragrances	[ ]%
All products	**[ ]%**
All products (adjusted)	**-10.4%**

319. Large, discrete price increases for tobacco were observed prior to Nuance's entry. In order to control for any extraneous factors which may have been affecting tobacco prices,[52] an adjustment was made to the above regressions for tobacco products using data pertaining to tobacco products sold by DFS Galleria at Auckland International Airport, where the level of competition (i.e., the number of competitors) has remained constant over the period of analysis. The Commission is of the view that the adjusted results would more accurately quantify any price changes at Wellington International Airport pursuant to Nuance's entry.

[52] For example, duties/taxes on tobacco products are changed on an annual basis.

320. Table 6 demonstrates that the unadjusted results suggest that after the entry of Nuance at Wellington International Airport, [ ]. Adjusted results suggest that duty free prices fell, on average, by more than 10%.

321. Both the descriptive and regression analysis indicate that Nuance's entry at Wellington International Airport was associated with a reduction of approximately 10% for prices of duty free goods sold by DFSW.

322. Based on the above analysis, the Commission concludes that the presence of on-airport duty free competition clearly has an impact on pricing behaviour of duty free retailers at Wellington International Airport. Further, the Commission is not aware of any evidence that would suggest that the combined entity at Auckland International Airport would face any greater degree of competitive constraint in the factual than did DFSW, prior to Nuance's entry to Wellington International Airport.

323. The Commission considers that, on the basis of the qualitative assessments previously outlined in this decision, the scope for unilateral market power is likely to be enhanced by the proposed acquisition. The quantitative analysis supports this conclusion.

324. In reaching its conclusions on unilateral effects, the Commission has not solely relied on its quantitative analysis for the purpose of assessing the effects of the merger. In almost all cases, measuring the competition impacts of acquisitions necessarily involves a mix of quantitative and qualitative assessments. However, the Commission acknowledges that — without due care — there could be a risk that undue focus is given to those factors that can be quantified at the expense of those that cannot.

325. In the context of this Application, the economic analysis provided a quantitative cross-check on the Commission's conclusions on the scope for increased unilateral market power, arrived at as a result of the Commission's qualitative analysis.

326. The Commission considers that it could reasonably be anticipated that prices would increase at Auckland International Airport following the proposed acquisition. If the experience at Wellington International Airport is replicated at Auckland International Airport, consumers of duty free goods could expect to face price increases of the order of 10%.

Overall Conclusion of Potential for Unilateral Effects

327. The Commission has assessed the potential for unilateral market power to be enhanced by the proposed acquisition, such that an SLC would arise in the factual, when compared to the counterfactual.

328. The Commission concludes that the potential for unilateral market power would arise from the acquisition, as the combined entity would become the only retailer in the defined market. Further, the Commission considers that the combined entity is unlikely to face constraint from potential competition, AIAL, or duty free retailers outside of the market. It is anticipated that prices would increase in the factual, and if the experience at Wellington International Airport is replicated, these price increases could be of the order of 10%.

Timeframe and Substantiality

329. The Applicant has submitted that the removal of Nuance for the period until 4 August 2009 falls short of what should properly be considered as 'substantial' in the context of the substantial lessening of competition test, reiterating that competition is a long-run test. This is because the period during which competition would be eliminated by the acquisition would be limited to the period between the earliest likely acquisition date, and 3 August 2009 when Nuance's current general duty free concession at Auckland International Airport will expire. From this time, DFS Galleria would be the only concessionaire licenced by AIAL to retail duty free goods at Auckland International Airport.

330. Substantial lessening of competition means real or of substance, or material. The Commission takes the view that substantial means something more than insubstantial or nominal, and that the judgment is a question of degree to be made on the merits of each case.[53]

331. The Commission considers that it is necessary to identify a real lessening of competition that is not minimal.[54] The lessening needs to be of such size, character and importance that it is worthy of consideration for the purposes of the Act.[55] Competition must be lessened in a considerable and sustainable way.

332. This in turn relies on an understanding of the market before it can be said that any particular lessening of competition is substantial. Overall, 'substantial' is a relative concept, one that can be assessed in either qualitative or quantitative terms.[56]

333. In this fact scenario, the Commission is able to assess the likely impact of the proposed acquisition for the period until at least 3 August 2009. On the basis of its analysis in this Decision, the Commission considers that the scope for unilateral market power is likely to be enhanced by the proposed acquisition and subsequent removal of Nuance as an on-airport competitor. Consequently, price increases are likely. If the experience at Wellington International Airport is replicated at Auckland International Airport, consumers of duty free goods could expect to face price increases of up to 10%. At Auckland International Airport, such a price change could equate to consumers of duty free goods facing detriment in the order of $[ ]m, for the period until 3 August 2009.[57]

334. In DFS Galleria's view, even if the proposed acquisition were to give rise to an adverse impact on competition (which it denies), that effect would be so transitory in nature that it would not amount to a substantial lessening of competition.

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[53] Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004, p 11.

[54] *Fisher & Paykel Limited v Commerce Commission* [ ] 2 NZLR 731, 758 and also *Port Nelson Limited v Commerce Commission* [ ] 3 NZLR 554.

[55] *Dandy Power Equipment Pty Ltd v Mercury Marina Pty Ltd* (1982) ATPR 40-315, 43-888; *South Yorkshire Transport Ltd v Monopolies & Mergers Commission* [ ] 1 All ER 289

[56] Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004, p 12.

[57] On average, $[ ]m worth of duty free goods were purchased each month at Auckland International Airport in 2007. The total value of duty free goods purchased at Auckland International Airport between April 2008 and August 2009 (i.e., the period during which aggregation would occur as a result of the proposed acquisition) would therefore amount to $[ ]m, everything else being the same.
The consumer detriment is equal to the percentage increase in price multiplied by the value of sales that would still occur at the increased price. In the scenario where sales amount to $[ ]m, an elasticity of demand of -1 (i.e., a 10% increase in prices would result in a 10% decrease in volume sales), and a 10% price increase, the consumer detriment would equal $[ ]m.

335. AIAL has indicated that, through the award of a sole general duty free concession, the same market structure may continue beyond 3 August 2009 and through to 30 June 2015, when DFS Galleria's concession licence expires.

336. Essentially, the underlying cause of sustained supra-competitive pricing would change on 4 August 2009, from being as a result of the proposed acquisition, to being as a result of AIAL's decision to grant only one general duty free concession at Auckland International Airport. However, the Commission considers that this does not necessarily preclude the proposed acquisition from being considered as anti-competitive. The fact that there may be an intervening event prior to the expiry of the two year time period normally used to assess competition, does not mean that the market would be any more competitive in the period up to this intervening event. Significantly, the intervening effect here is unlikely, on the Commission's analysis, to make the market more competitive. Rather, it is likely to continue the structure of a single on-airport duty free retailer until at least 2015.

337. Accordingly, the Commission considers that the lessening of competition that would arise in this market should the proposed acquisition proceed, is in fact, substantial.

OVERALL CONCLUSION

338. The Commission has considered the probable nature and extent of competition that would exist, subsequent to the proposed acquisition, in the market for the retail supply of duty free goods at Auckland International Airport to international air travellers.

339. In comparing the amount of competition expected in the factual with that expected in the likely counterfactual, the main competition factors bearing on the Commission's decision are as follows:

- the absence of existing competition in the factual, compared to the competition between DFS Galleria and Nuance in the counterfactual;
- the threat posed by potential competition would be insubstantial or non-existent in both scenarios; and
- AIAL would have little reason to constrain the combined entity's duty free prices, or to enforce the relevant contractual obligations by creating an additional duty free concession, or by terminating the combined entity's duty free concession in both scenarios; and
- there may be very limited competition from duty free retailers outside the market. However, this competitive constraint would be likely to fall well short of the competition posed by Nuance in the counterfactual, and unlikely to be sufficient to counter an exercise of market power by the combined entity in the factual scenario.

340. Against this background, the Commission considers that, relative to the counterfactual, the proposed acquisition is likely to enhance the scope for the exercise of unilateral market power by the combined entity. The Commission considers that prices would increase post-acquisition, and if the experience at Wellington International Airport is replicated at Auckland International Airport, to the effect on consumers could be of the order of 10%. At Auckland International Airport, such a price change could equate to consumers of duty free goods facing detriment in the order of $[ ]m, for the period until 3 August 2009.

341. Accordingly, the Commission cannot be satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the market for the retail supply of duty free goods at Auckland International Airport to international air travellers.

DETERMINATION ON NOTICE OF CLEARANCE

342. Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission determines to decline clearance for the proposed acquisition by DFS Group Limited (DFS Galleria) to acquire 100 per cent of the shares in, or the assets of, the New Zealand operations of The Nuance Group (Nuance), trading principally as Regency, or any interconnected body corporate of Nuance.

Dated this 28th day of March 2008

Peter J M Taylor
Commissioner
for
Paula Rebstock
Chair

APPENDIX 1: RELEVANT PARTIES

Key Parties	
DFS Group Limited (DFS Galleria)	Acquirer
The Nuance Group Limited (Nuance)	Vendor
Other Parties	
Duty Free Retailers	
Duty Free Stores New Zealand Limited (DFSW)	Duty Free Retailer at Wellington, Hamilton, Queenstown and Dunedin International Airports
Skywards Duty Free Limited (Skywards)	Duty Free Retailer at Palmerston North International Airport
[ ]	[ ]
The Tappoo Group of Companies (Tappoo)	Duty Free Retailer at Nadi International Airport
Airport Companies	
Auckland International Airport Limited (AIAL)	
Wellington International Airport Limited (WIAL)	
Christchurch International Airport Limited (CIAL)	
Suppliers	
Diageo GTME (Diageo)	Liquor supplier
Louis Vuitton New Zealand Limited (Louis Vuitton)	Luxury goods supplier

APPENDIX 2: PROFIT MAXIMISING, REVENUE MAXIMISING, AND PERFECTLY COMPETITIVE PRICES

343. Profit maximising prices and quantities are simply those which a firm would set to maximise its profits. Similarly, revenue maximising prices and quantities are those that would maximise a firm's revenue. For any firm that faces a downward sloping demand curve, revenue maximising prices will always be lower than profit maximising prices (and quantities higher).

344. To see this, in Figure A2.1, we take as our starting point a firm that faces demand for its output of (D) and has constant marginal costs of (MC) (the costs of an additional unit of output). The additional revenue the firm gets from selling one extra unit of output at any given level of output (marginal revenue) is represented by (MR). The marginal revenue curve lies below the demand curve, because for every extra unit of output the firm sells it must lower price slightly and give up a small amount of revenue it otherwise would have earned on all previous output.

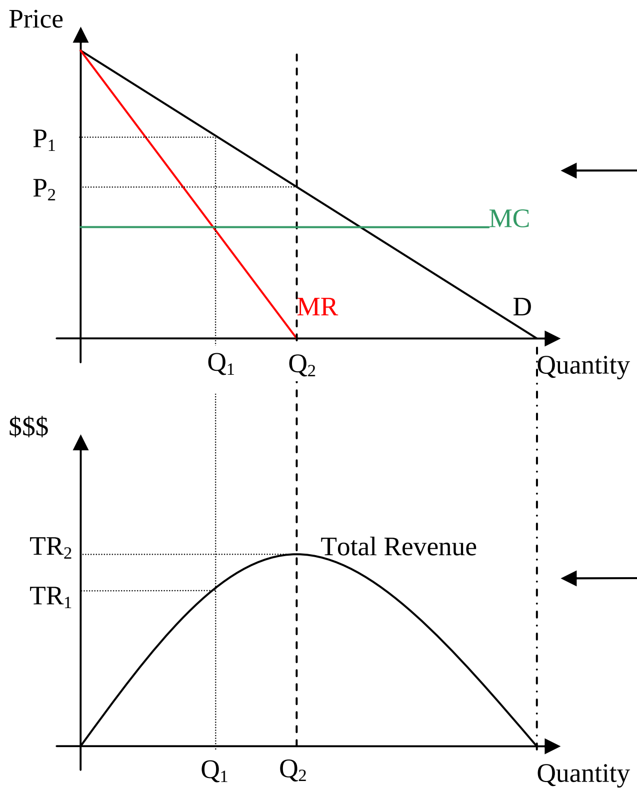

Figure A2.1

Figure A2.2

345. The firm will then maximize profit by setting output at the level where marginal revenue (MR) equals marginal cost (MC) and taking the price of the demand curve. In this case the profit maximizing level of price and output are given by P_1 and Q_1 respectively. At any amount of output produced less than Q_1 the additional revenue the firm would generate from selling another unit of output would be greater than the additional costs it would incur so the firm should produce more. Similarly, at any amount of output produced greater than Q_1 the additional cost the firm would incur from selling another unit of output would be greater than the additional revenue it would earn and so the firm should produce less.

346. The relationship between the firm's total revenue and output is shown in Figure A2.2. When the firm sets prices and quantities to maximize profit its total revenue will be equal to (TR_1). Revenue continues to increase with output so long as marginal revenue is positive. Total revenue is therefore maximised at an output of (Q_2) with price (P_2) and is equal to (TR_2). Notice that (P_2), the revenue maximizing price, is less than (P_1) the profit maximizing price.