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COMMERCE COMMISSION

Decision No. 542

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

FONTERRA CO-OPERATIVE GROUP LIMITED

and

NATIONAL FOODS LIMITED

The Commission:	Peter Taylor David Caygill Denese Bates QC
Summary of Application:	The acquisition by Fonterra Co-operative Group Limited of up to 100% of the shares in National Foods Limited
Determination:	Pursuant to section 66(3) (a) of the Commerce Act 1986, the Commission determines to give clearance to the proposed acquisition.
Date of Determination:	9 December 2004

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EXECUTIVE SUMMARY

The Proposal

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 4 November 2004. The notice sought clearance for the acquisition by Fonterra Co-operative Group Limited of 100% of the shares in National Foods Limited (National Foods).

Market Definition

2. The Commission has found that the relevant market for this acquisition is the market for the manufacture and wholesale supply of yoghurt and dairy food.

Counterfactual

3. The Commission considers the relevant counterfactual to be the status quo where National Foods International Fine Foods Limited, a wholly owned subsidiary of National Foods, would continue to operate and compete in the market for yoghurt and dairy food.

Previous Decision

4. In *Decision 459*[1] the Commission declined clearance for the acquisition of New Zealand Dairy Foods Limited by National Foods. The Commission concluded that the proposed acquisition would or would be likely to result in a substantial lessening of competition in the yoghurt and dairy dessert market.

Competition Analysis

5. The Commission notes that the key differences between the current proposed acquisition and that considered in *Decision 459* are:
   - that the combined entity would have had a considerably larger market share than its competitors after the proposed acquisition considered in *Decision 459*, whereas after the current proposed acquisition the combined entity would have a smaller market share than its main competitor, New Zealand Dairy Foods Ltd (NZDF); and
   - In the Factual considered in *Decision 459,* there would have been insufficient constraint from the existing competition whereas in the Factual being considered in the current matter, the combined entity would be faced with vigorous competition from NZDF.
6. The Commission concludes in the current matter that there would be sufficient existing competition post-acquisition to constrain the combined entity from unilaterally exercising market power.
7. For a lessening of competition resulting from a proposed acquisition to be regarded as substantial, a price increase that is predicted to arise as a result of the acquisition would have to be material. The Commission considers that the price increase of 2.7% predicted by the Commission's modelling is not sufficiently material to result in a substantial lessening of competition.
8. The Commission concludes that, because any price increase likely to result from the proposed acquisition is not sufficiently material to result in a substantial

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[1] Commerce Commission, *Decision 459: National Foods Limited / New Zealand Dairy Foods Limited* 22 March 2002

lessening of competition, and vigorous competition is likely to continue between NZDF and the combined entity post-acquisition, the type of non-coordinated market power that can occur in an oligopoly market is unlikely to occur, post-acquisition, to an extent that would result in a substantial lessening of competition.

9. The Commission also concludes that the scope for coordinated market power would not be enhanced by the proposed acquisition.

10. The Commission cannot be satisfied that entry, either by a supermarket company with a house brand product or by another supplier, would occur within sufficient time after an increase in price or other exercise of market power by the combined entity to prevent a substantial lessening of competition.

11. However, the Commission considers that the constraint provided by existing competition post-acquisition, together with the countervailing power of the supermarket companies, would be sufficient to constrain the combined entity from exercising sufficient market power to result in a substantial lessening of competition in the yoghurt and dairy food market.

Overall Conclusion

12. The Commission is satisfied that the proposed acquisition would not have, or be likely to have, the effect of substantially lessening competition in any market.

THE PROPOSAL

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 4 November 2004. The notice sought clearance for the acquisition by Fonterra Co-operative Group Limited (Fonterra) of 100% of the shares in National Foods Limited (National Foods).

PROCEDURE

2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear a notice under s 66(1) 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 10 December 2004.
3. The Applicant sought confidentiality for specific aspects of the Application. A confidentiality order was made in respect of the information for up to 20 working days from the Commission's determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply.
4. The Commission's approach to analysing this proposed acquisition is based on principles set out in the Commission's Merger and Acquisition Guidelines.[2]

STATUTORY FRAMEWORK

5. Under s 66 of the Act, the Commission may grant clearances for acquisitions where it is satisfied that the proposed acquisition would not have, or would not be likely to have, the effect of substantially lessening competition in a market. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.[3]
6. The Commission considers that it is necessary to identify a real lessening of competition that is 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 creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.
7. 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 able to be sustained for a period of at least two years.
8. Similarly, when the impact of market power is felt in terms of the non-price dimensions of competition such as reduced service, quality or innovation, for there to be a substantial lessening, or likely substantial lessening, of competition, these also have to be both material and sustainable for at least two years.

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[2] Commerce Commission, *Mergers and Acquisition Guidelines*, January 2004.
[3] Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission (1992) 4 TCLR 713-722.
[4] See Fisher & Paykel Limited v Commerce Commission (1996) 2 NZLR 731, 758 and also Port Nelson Limited v Commerce Commission (1996) 3 NZLR 554.

ANALYTICAL FRAMEWORK

9. The Commission applies a consistent analytical framework to all 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).
10. 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. The Commission analyses the extent of competition in each relevant market for both the factual and the counterfactual scenarios, in terms of:
    - existing competition;
    - potential competition; and
    - other competition factors, such as the countervailing market power of buyers or suppliers.

THE PARTIES

Fonterra

11. Fonterra is a New Zealand-headquartered co-operative dairy company. It comprises two main businesses:
    - Ingredients, which produces and internationally markets dairy commodities, such as milk powders, butter and cheese and value-added dairy ingredients. It also carries out the collection and processing of milk. The commodities and ingredients business accounts for approximately two thirds of Fonterra's revenue, and operates on 25 manufacturing sites in New Zealand. It is also involved in the research and development of new value-added ingredients.
    - Consumer Dairy Products, which operates in 40 countries internationally under the name New Zealand Milk. It has 35 manufacturing sites in New Zealand, Australia, the Americas, Asia and the Middle East.
12. In New Zealand, Fonterra has a subsidiary, Mainland, which produces yoghurts under the brands "Meadow Fresh", "Weight Watchers", and "Naturalea" and dairy desserts under the brands "Blue's Clues" and "Calci-Kids".
13. As a consequence of the industry structure in the Dairy Industry Restructuring Act 2001, Fonterra supplies raw milk, cream and other products to New Zealand Dairy Foods Ltd (NZDF), manufactures and packages butter and cheese on its behalf and licences NZDF the "Anchor" brand in New Zealand. NZDF supplies certain UHT products to Fonterra for export.

National Foods

14. National Foods is an Australian food company, with core activities in milk, fresh dairy food and specialty cheeses. It is listed on the Australian Stock

Exchange. National Foods' annual turnover is in excess of A$1.0 billion. It produces fresh milk, and full cream, flavoured and modified fresh and UHT milks, and yoghurt, dairy desserts, fromage frais, and cream cheese.

15. Fonterra, through its subsidiary Fonterra Investments Limited (formerly NZDG Investments Ltd), holds 17.2% of the shares in National Foods, with an agreement to acquire a further 1.8%, conditional on approval of the Australian Foreign Investment Review Board.

16. National Foods has three wholly-owned New Zealand subsidiaries: National Foods International Fine Foods Ltd (NFIFF), National Foods New Zealand Holdings Ltd and National Foods Share Plans (NZ) Ltd.

17. NFIFF sells yoghurt under the “Yoplait”, “Silhouette” and “Yoplus” brands, dairy food under the “Vigueur” and “YoGo” brands, “Petit Miam” fromage frais and “Le Rice” dairy dessert. Its annual turnover is [ ].

Other Relevant Parties

NZDF

18. NZDF manufactures, markets and distributes chilled dairy products in domestic and export markets. It has three divisions – Foods, Beverages and International. The Beverages division processes milk, cream and flavoured milk. The Foods Division produces speciality cheeses and cultured foods, including yoghurts, desserts, cottage cheese, sour cream and dips. It also markets butter and cheese.

19. NZDF sells yoghurt under the brand names of “Fresh n Fruity”, “Metchnikoff” and “De Winkel”, and dairy food under the brand of “Swiss Maid Calci-Yum”.

Other Yoghurt Producers

20. Serra Natural Foods Ltd (Serra) is a privately owned New Zealand company which sells yoghurt throughout New Zealand under the "Cyclops" brand, in 500gm and 250gm pots, and clotted cream. Its annual revenue is approximately [ ] of which yoghurt sold to supermarkets amounts to approximately [ ]. It also sells approximately [ ] and [ ] of bulk yoghurt to restaurants and takeaways.

21. Karikaas Natural Dairy Products Ltd (Karikaas) sells yoghurt under the "Supreme Flora" brand in 500gm and 1kg containers. Its yoghurt is sold in the South Island and in one outlet in Wellington. Karikaas’s total turnover for its last financial year was [ ] with yoghurt earning approximately [ ]

22. Independent Dairy Producers Ltd (IDP) has a range of cultured products including specialty cheeses, sour cream, cream cheese and yoghurt. It supplies yoghurt to the food service industry and has a contract to supply Auckland hospitals. It does not sell to supermarkets. Its revenue from all cultured products is approximately [ ] a year.

23. Biofarm Products Ltd (Biofarm) sells organic natural, acidophilus and low fat yoghurt under the "Biofarm" brand. There are small quantities of imported soy yoghurt.

24. The other dairy producers – Westland Milk Products, Tatua Co-operative Dairy Company Ltd (Tatua) and Gisborne Milk Co-operative Ltd are not involved in the production of yoghurt and dairy food.

Home Made Yoghurt

25. Home made yoghurt ingredients are supplied by EasiYo Products Ltd (EasiYo) and Hansells (NZ) Ltd. Neither of these companies makes fresh yoghurt.

Supermarkets

26. Progressive Enterprises Limited (Progressive) is owned by Foodland Associated Limited (Foodland), a public company incorporated in Australia. Foodland conducts wholesale and retail supermarket operations in Western Australia and New Zealand.

27. Progressive includes the Foodtown, Countdown, Woolworths, and Three Guys banner groups. Through its wholesale distribution operation, Progressive supplies the FreshChoice and SuperValue chains. Progressive's house brand labels are "Signature" and "Basic".

28. Foodstuffs is comprised of three separate co-operative companies based in Auckland, Wellington, and the South Island. Each Foodstuffs company is a co-operative, owned by the individual owners of the supermarkets within the chain. Foodstuff's house brand label is "Pams".

29. Each of the co-operatives runs independently, and there is no overlapping ownership or directorship. The three Foodstuffs companies share ownership of Foodstuffs (New Zealand) Limited, which has ownership of the brands "New World", "Pak 'N Save", and "4 Square" and leases them to the three Foodstuffs companies.

PREVIOUS DECISION

30. In *Decision 459*[5] the Commission declined clearance for the acquisition of NZDF by National Foods. The merged entity would have had a market share of 76.9% with the next nearest competitor, Mainland, having a market share of only 19.5%. The Commission considered that there would be insufficient constraint from existing competition, reasonably high barriers to entry and low likelihood of entry, and that the supermarkets were not likely to introduce house brand yoghurts and dairy desserts (dairy food) and that although the supermarkets might be able to exert some countervailing power against the ability of the merged entity to raise prices, this power may be limited. Accordingly, the Commission concluded that the proposed acquisition would or would be likely to result in a substantial lessening of competition in the yoghurt and dairy dessert market.

31. In *Decision 459* the Commission referred to the relevant products as being yoghurt and dairy desserts. However, in speaking with industry participants during the current investigation, the Commission has found it appropriate to use the term "dairy food" as opposed to term "dairy desserts".

INDUSTRY BACKGROUND

32. The products that would primarily be affected by the proposed acquisition are yoghurt and dairy food as these are the only products that both NFIFF and Mainland manufacture and supply. Dairy food is made from the same dairy

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[5] Commerce Commission, *Decision 459: National Foods Limited / New Zealand Dairy Foods Limited* 22 March 2002

ingredients as yoghurt but is not cultured. They are flavoured with similar flavourings as those used for ice cream. Yoghurt and dairy food are packaged as single units of between 100gm and 250gm, 6-packs of the units, and 1kg packs.

33. National annual yoghurt and dairy food production is approximately 34,100 tonnes retailing for approximately $148.5 million. The sales consist of approximately 90% yoghurt and 10% dairy food. 90% of yoghurt is either fruited, plain, diet or deluxe, and sold under one of three brands – Yoplait, Fresh n Fruity and Meadow Fresh.

34. The remaining 10% of yoghurt is generally referred to by industry participants as health yoghurt and includes Greek, organic, acidophilus and herbal yoghurt. Health yoghurts are produced by Mainland (Naturalea), NZDF (De Winkel and Metchnikoff), Serra (Cyclops), Karikaas and Biofarm.

35. In *Decision 459* the Commission included lite yoghurts in the health yoghurt category. Since that Decision, the growth of lite or diet yoghurt has been considerable and it is now considered by industry participants to be a mainstream product rather than a niche one.

36. 90% of yoghurt and dairy food is sold through supermarkets and between 70% and 80% of that volume is sold on promotion at discounted prices. There are various levels and frequencies of promotion. Progressive has annual promotional calendars where suppliers bid for promotional slots. Foodstuffs has advertised promotions which are organised every two to six months depending on which Foodstuffs company is organising it, and vary in length from one week SD1s (Super Deal 1s) to six weeks SD6s (Super Deal 6s). Suppliers pay for slots in the promotional calendars. Foodstuffs also has other levels of promotion e.g. Pak 'N Saves have TPRs (Temporary Price Reductions) which are organised centrally by Foodstuffs, and Bonus Buys which are organised by individual stores.

37. Yoghurt and dairy food have a short shelf-life of about 4 weeks, which, together with the constant promotion and, to some extent, a resulting uncertainty regarding volumes sold each week, means that stock management is particularly important.

MARKET DEFINITION

38. 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."[6]

39. For competition purposes, a market is defined to include all those suppliers, and all those buyers, between whom there is close competition, and to exclude all other suppliers and buyers. The focus is upon those goods or services that are close substitutes in the eyes of buyers, and upon those suppliers who produce, or could easily switch to produce, those goods or services. Within that broad approach, the Commission defines relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration,

[6] s 3(1) of the Commerce Act 1986.

bearing in mind the need for a commonsense, pragmatic approach to market definition.[7]

40. 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 is defined in terms of the dimensions of a 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 Market

41. Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. For each initial market so defined, the Commission considers whether the imposition of a SSNIP would be likely to be profitable for the hypothetical monopolist. If it were, then all of the relevant substitutes must be incorporated in the market.

42. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market. The degree of demand-side substitutability is influenced by the extent of product differentiation.

43. Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so by a small change in their relative prices.

44. Close substitute products on the supply-side are those between which suppliers can easily shift production, using largely unchanged production facilities and little or no additional investment in sunk costs, when they are given a profit incentive to do so by a small change to their relative prices.

45. The Applicant, while maintaining that the market can be defined as broader in scope, for the purposes of its application has proceeded on the basis that the relevant market is the manufacture and wholesale supply of yoghurt and dairy desserts (food) in New Zealand. This is based on the Commission's market definition in *Decision 459* which specifically excluded homemade yoghurts and other cultured dairy products.

46. However, the Applicant also submitted that there is a range of products that are manufactured by other suppliers that can be put to similar use and form part of the choices facing consumers. These include:

- drinkable yoghurt products and "smoothies";
- dairy and non-dairy snacks, such as cheese segments, cheese snacks, fruit jellies, yoghurt and muesli bars;
- sour cream, crème fraiche, fromage frais, cream cheese; and

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[7] Australian Trade Practices Tribunal, *Re Queensland Co-operative Milling Association*, above note 10; *Telecom Corporation of NZ Ltd v Commerce Commission & Ors* (1991) 3 NZBLC 102,340 (reversed on other grounds).

- other dairy and non-dairy desserts, such as frozen yoghurt, ice-cream, custard-based and similar desserts, and microwaveable desserts.

47. In light of this submission, the Commission revisited its market definition in *Decision 459*. The Commission again found that although there would be some substitutability from the supply-side between yoghurt and dairy food and some of the products listed in paragraph 46, for example drinking yoghurt, and some cultured products, such as sour cream and fromage frais which use similar manufacturing process, substitutability from the demand-side perspective would be weak and unlikely to satisfy the requirements of a SSNIP. Accordingly, the Commission considers that the products listed in paragraph 46 do not belong in the same market as yoghurt and dairy food.

Home Made Yoghurt

48. In *Decision 459* the Commission determined that home made yoghurt was not part of the same market as fresh yoghurt and dairy food. The Commission found that home made yoghurt exhibited different characteristics on both the demand-side and the supply-side.

49. EasiYo considered that home made yoghurt did compete with fresh yoghurt, particularly in the 1kg packs. As an example, it stated that its home made brands were the first suppliers into the one litre and low fat categories and the major fresh yoghurt manufacturers followed its lead in these categories. Further, EasiYo stated that [

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50. The Commission considers that although there is some substitution between homemade yoghurt and the 1kg range of fresh yoghurt, this substitutability is only at the margins. The Commission found insufficient evidence for it to reverse its previous assessment of home made yoghurt in *Decision 459*.

51. Accordingly, the Commission does not consider home made yoghurt to be part of the same market as fresh yoghurt.

Undifferentiated/Differentiated Products

52. Differentiated product markets are those in which the product offerings of suppliers vary to some degree and in which buyers make their purchase decisions on the basis of product characteristics as well as price. Suppliers' products are imperfect substitutes for one another and less close substitutes impose a lesser competitive constraint than others.

53. A "chain" of substitutes may be evident and, if there is no obvious break in the chain, there may be no obvious point where the boundary of the market can be drawn. If the competition analysis of an acquisition is sensitive to the market definition used, the Commission might not define the market precisely and instead focus on the competition analysis and the impact of the acquisition on prices.

54. In the words of the Commission's Merger and Acquisition Guidelines, "This approach recognises that in a differentiated product market, a structural analysis that takes into account market definition and market share may not be as helpful in judging market power as one that focuses on the degree of substitutability

between products, and on the amount of competitive constraint that each imposes upon the others."

55. The Commission has found the market for yoghurt and dairy food to be characterised by strong branding, packaging, price and product innovation. NZDF and NFIFF have traditionally used TV advertising and other means of advertising to create brand awareness and establish an image for their products whereas Mainland has relied on its lower price strategy to sell its products. For example, in terms of brand and image differentiation:

- NZDF uses an advertising slogan "Fresh n Fruity loves you" which it reports has been very successful;
- NZDF targets the adult market with its range of Lite and Deluxe products;
- Yoplait has developed its French image, although it has not had a TV campaign in the last two years;
- NZDF's Metchnikoff has been marketed as an organic yoghurt with casein, acidophilus and oligosaccharides;
- NZDF's De Winkel is known as a health yoghurt with extra added vitamins, minerals and natural plant extracts; and
- Mainland has invested in the "Blue's Clues" characters to promote its dairy food[8].

56. Packaging is also used to differentiate brands. For example, although Meadow Fresh multi-packs contain 125gm pottles, it also has a range of 150gm pottles which come with a spoon. Biofarm and Karikaas both have one litre containers which are designed to allow consumers to pour yoghurt directly from the container.

57. As is usually the case with differentiated products, prices differ between brands. All industry participants stated that Meadow Fresh is consistently the lowest priced yoghurt in the market and has the lowest non-promotion retail price,. It should be noted, however, that Meadow Fresh is not always cheaper than the other manufacturers' brands when the latter are on promotion and Meadow Fresh is not.

58. Industry participants also attempt to differentiate their products by means of product innovation. For example:

- NZDF has launched a new 'Deluxe' range for Fresh n Fruity which is positioned as an indulgent treat with flavours such as Dreamy Lemon and Passionfruit Cheese Cake; and
- Serra has recently launched two flavours, Banana and Licorice, and it also has a coffee flavoured yoghurt.

59. Industry participants agree that price is a significant driver in the buying decision, but it is not clear the degree to which consumers switch brands to buy the brand on promotion rather than bring forward purchases of their favoured

[8] Blue's Clues is an animated children's television programme.

brand when it is on promotion[9]. Nevertheless, Fresh n Fruity was described as having strong brand equity so that when it is on special, it captures sales from all the other suppliers. Yoplait has some brand equity and, when on special, captures sales from Meadow Fresh and a small percentage from Fresh n Fruity. Meadow Fresh was described as having very little brand equity and because of this, it is sold almost entirely on promotion.

60. The Commission considers that although the brands are differentiated to some extent, the differentiation is not sufficient to prevent the different brands from being substitutable for each other. Accordingly, the various brands are not so differentiated as to affect the market definition.

61. The Commission in *Decision 459* considered that yoghurt and dairy food were substitutable from a demand-side perspective. The scanner data supplied during the current investigation provided the Commission with an opportunity to verify whether this is the case. Statistical tests were performed on the data to determine what economic substitutability exists between dairy food and yoghurt.[10] In general, the results showed there to be no statistically significant increase in the quantity of yoghurt purchased in response to an increase in the price of dairy food or in the quantity of dairy food purchased in response to an increase in the price of yoghurt. Such results indicate that, at least on the demand-side, yoghurt and dairy food are not substitutes and accordingly they could be considered as being in separate markets. However, because of the high supply-side substitutability that is evident, the Commission considers it is appropriate for the purposes of the current competition analysis to treat them as being in one market.

Conclusion on Product Markets

62. The Commission concludes that for the purpose of assessing the competition implications of the proposed acquisition, the appropriate product market is the market for yoghurt and dairy food.

Functional Markets

63. The production, distribution and sale of a product typically occur through a series of functional levels, conventionally arranged vertically in descending order. Generally, the Commission identifies separate relevant markets at each functional level affected by an acquisition, and assesses the impact of the acquisition on each.

64. Mainland and NFIFF both manufacture and distribute yoghurt and dairy food to retailers. Accordingly, the Commission concludes that the appropriate

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[9] The Applicant submitted that due to the short shelf life of the product and the need for the product to be refrigerated, there is limited opportunity for "investment" buying by consumers (shifting purchases between periods).

[10] Prices of dairy food and yoghurt multi-packs were regressed onto quantities of brands of yoghurt and dairy food purchased. This involved positing a relationship between, for example, the quantity of a brand of yoghurt and the prices of all yoghurt brands and all dairy food brands in the following form:

$$\ln(y_1) = c_1 + \beta_{1,1}\ln(p_{y1}) + \beta_{1,2}\ln(p_{y2}) + \beta_{1,3}\ln(p_{y3}) + \beta_{1,4}\ln(p_{df1}) + \beta_{1,5}\ln(p_{df2}) + \beta_{1,6}\ln(p_{df3})$$

Note that this is a more general formulation of the regression equations that appear in Appendix A for the merger simulation modelling.

functional level is the manufacture and wholesale supply of yoghurt and dairy food.

Geographic Markets

65. 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.

66. All the major suppliers of yoghurt supply yoghurt nationally. The Commission therefore concludes that the geographic market is a national one.

Conclusion on Market Definition

67. The Commission concludes that the relevant market is the market for the manufacture and wholesale supply of yoghurt and dairy food in New Zealand (the yoghurt and dairy food market).

COUNTERFACTUAL AND FACTUAL

68. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a "with" and "without" comparison rather than a "before" and "after" comparison. The comparison is between two hypothetical future situations, one with the acquisition (the factual) and one without (the counterfactual).[11] The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

Factual

69. In the factual scenario there would be two major suppliers of yoghurt and dairy food, Fonterra through its subsidiaries and NZDF.

70. The Commission was informed that the current nature of the market has meant that there are extreme brand demand fluctuations which are the result of the regular specialling of the products. The Applicant said that despite careful practices to smooth the peaks and troughs in demand, in periods of high demand the volume of output is twice the level of the low demand periods. Consequently, all factories have excess capacity and consolidation of plants could therefore result in synergies for the merged entity.

71. The Commission understands that the NFIFF and NZDF plants both use a form fill seal machine for packaging yoghurt and dairy food. A flat sheet of plastic is fed into the machine which forms the required pottle, fills it with product and then seals it. Industry participants have informed the Commission that this is the most efficient method for yoghurt packaging. This packaging technology has a higher capital cost, of approximately [ ], but enables significant savings in variable costs.

72. The existing Mainland factory uses a different form of packaging. It purchases pre-formed pots which are filled with product and sealed. As the merged entity would have two different packaging machines, and each plant has excess capacity, the Commission considers it is likely that some form of consolidation would occur.

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[11] Commerce Commission, *Decision 410: Ruapehu Alpine Lifts/Turoa Ski Resorts Ltd (in receivership),* 14 November 2000, paragraph 240, p 44.

Counterfactual

73. In its submission to the Commission NFIFF stated that it manufactures and imports (dairy desserts only) approximately [ ] of combined production per annum and had a turnover of [ ] for the fiscal year ending June 2004. NFIFF's moving annual total in October 2004 shows growth of [ ]

74. National Foods views the proposed acquisition as a hostile takeover and has responded to the unsolicited bid by Fonterra by recommending that its shareholders reject the offer.

75. Although the Applicant states that neither Mainland nor NFIFF has been able to obtain sufficient returns to warrant additional investment to materially impact on NZDF's leading market position, the Commission has found no evidence to question the on-going viability of NFIFF, or Mainland, in New Zealand.

76. Therefore the Commission considers the relevant counterfactual to be the status quo where NFIFF would continue to operate and compete in the market for yoghurt and dairy food.

COMPETITION ANALYSIS

Existing Competition

77. 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). Supply-side substitution by near competitors arises either from redeployment of existing capacity, or from expansion involving minimal investment, in both cases involving a delay of no more than one year.

78. 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.

79. The Commission identifies market shares for all significant participants in the relevant market. Market shares can be measured in terms of revenues, volumes of goods sold, production capacities or inputs (such as labour or capital) used.

80. An aggregation that would result in a low concentration level is unlikely to be associated with a substantial lessening of competition in a market. On this basis, indicative safe harbours may be specified.

81. A business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

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

82. 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. Specifically, the Commission seeks to understand the dynamics of the competition that would exist between the remaining firms in the market, compared to what would exist in the absence of the merger.

83. The major participants in the yoghurt and dairy food market are NZDF, Mainland and NFIFF with Serra, Karikaas and Biofarm having considerably smaller market shares. The total yoghurt and dairy food market is approximately $148.5 million in value and 34,100 tonnes in volume. 90% of yoghurt and dairy food is sold through supermarkets. Market shares by value and volume in yoghurt and dairy food sold through supermarkets are set out in Table 1.

Table 1: Market shares (by volume and value) in yoghurt and dairy food sold through supermarkets (as at 3 October 2004)

Supplier (Owner)	Market share % (value)	Market share % (volume)
Mainland	[ ]	[ ]
NFIFF	[ ]	[ ]
Combined Entity	**[ ]**	**[ ]**
NZDF	[ ]	[ ]
Serra	[ ]	[ ]
Biofarm	[ ]	[ ]
Karikaas	[ ]	[ ]
Other	[ ]	[ ]
Total	**100.0**	**100.0**
Total market	$135 million	31,000 tonnes

Source: [ ]

84. Table 1 indicates that the merged entity would have a market share of [ ] by value and [ ] by volume and that the three-firm concentration would be [ ] by value and [ ] by volume. This is outside the Commission's safe harbour guidelines.

Analysis of Existing Competition

85. The Applicant submitted that the proposed acquisition is fundamentally different from that which the Commission considered in *Decision 459*, in respect of the issue of unilateral market power. It said that the proposed acquisition involves a merger of the two smaller players in the market, and that the resulting entity will still be considerably smaller than NZDF, and will not possess market power of itself. The Applicant submitted that if it were to seek to act unilaterally to increase prices or restrict output in the yoghurt and dairy food market, competitors such as NZDF would be able to and would respond to render any such attempt ineffective. For the same reasons, the new market structure is unlikely to lead to the kind of non-coordinated unilateral market power referred to in the Commission's Mergers and Acquisitions Guidelines.

86. The Applicant said that the proposed acquisition would have a pro-competitive effect in that a combined Mainland/NFIFF would be better able to justify further investment in product improvement, advertising and promotion to act as a more effective competitor to NZDF.

87. The Applicant also submitted that the industry structure that would result from the transaction is not uncommon in consumer product markets in New Zealand, where the products are sold predominantly through supermarkets. It also submitted that, given the countervailing role of supermarkets, an "FMCG (Fast Moving Consumer Goods) market structure consisting of two players with sufficient scale to challenge each other in terms of product innovation and promotion, coupled with the tangible threat of entry by strong house brands (discussed below), is more competitive than a structure with a single "category captain" and two or more small-scale followers."

88. Yoghurt and dairy food market participants compete with each other by means of advertising campaigns, packaging innovation, product innovation, and in-store price promotions. All industry participants were of the view that the current market is very competitive. Peter McClure, the CEO of NZDF, when asked if this was likely to change post-acquisition, said [ ] and that he encourages a culture of competitiveness.

89. Foodstuffs Wellington said that the more players there are in a market, the harder it is for them to increase prices. Accordingly, going from three major suppliers to two was likely to result in an increase in prices as if one put its prices up, the other would be expected to follow. Foodstuffs Auckland said that it preferred three suppliers to two as three were more competitive.

90. Foodstuffs South Island, however, said that because of the low penetration of Yoplait yoghurt in the South Island, the proposed acquisition would be unlikely to have much impact there. It pointed out that there are only two major suppliers of bread and that market is competitive and prices have not increased.

91. Progressive said that Mainland was unlikely to be able to increase prices for Meadow Fresh as it sells because of its low prices and that though it preferred three suppliers, because of the ability to play them off against each other, the strength of the NZDF Fresh n Fruity brand would keep the market competitive. Progressive also pointed out that the bread market, for example, has only two major suppliers and was competitive.

92. Non-coordinated market power can arise in oligopoly markets in which there are a small number of fairly evenly-matched businesses. Although the firms may independently seek to maximise profits, they cannot ignore the pricing responses and initiatives of the other businesses. Depending upon the assumptions they make about others' responses, the vigour of competition between them, and other factors, prices can stabilise at levels above the competitive level. In these types of markets, when seller concentration is already relatively high, a merger may result in a further price increase that might amount to a substantial lessening of competition.

93. It is this type of market power that Foodstuffs Auckland and Wellington are referring to. The likelihood of price increases resulting from such market power was tested in modelling undertaken by the Applicant and the Commission. The results of this modelling are described below.

<u>Modelling Results</u>

94. In *Decision 511*[12] at paragraph 909 the Commission noted that:

> With respect to the use of models, the Commission considers that these are useful to the degree that they focus the parties' attentions on key assumptions regarding characteristics of the market. The Commission's view is that the value of a model is in its ability not to produce 'proof' of a substantial lessening of competition, nor to supplant the Commission's exercise of judgement, but rather in providing support to the Commission's deliberations by:
>
> - focusing parties' attentions on verifiable economic arguments;
> - making transparent the values of the key parameters and assumptions in the analysis; and
> - producing quantitative estimates of the results of a given transaction or arrangement.

95. Economists from Castalia on behalf of the Applicants, submitted a report outlining what they saw might be the effect of the merger. In it they briefly set out the results of an analysis of market volume and price data. On the basis of the results of this analysis they had also done modelling work to derive possible price effects resulting from the merger. The analysis used supermarket scanner data to identify the relationship between the quantity sold of a given brand of yoghurt and the price of that brand and others in the market. Castalia used figures from this analysis and revenue market shares in a version of the PCAIDS merger simulation model[13] to derive a predicted price increase of about 2%.

96. The Commission conducted further simulations of its own in which it chose, for some inputs, different assumptions to those adduced by Castalia. In particular the Commission i) found evidence in the data that the revenue market shares, on their own, did not lead to an adequate approximation of the cross price effects between brands; ii) considered that it was appropriate to anticipate some cost efficiencies, due to the transaction, in the simulation; and iii) adopted a lower elasticity for the market as a whole. The price increase generated by the Commissions modelling was higher than that adduced by Castalia but was still relatively modest at 2.7%.

97. The Commission has found Castalia's work on the unilateral effects of this transaction, and discussions with Commission staff, to be helpful both in

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[12] Commerce Commission*, Decision 511:Qantas Airways Limited / Air New Zealand Limited* 23 October 2003.

[13] Roy Epstein and Daniel Rubinfeld, "Merger Simulation: A Simplified Approach With New Applications", *Antitrust Law Journal*, vol. 69, pp. 883-919. See also Commission decisions 500, 482.

clarifying issues and advancing the Commission's own thinking on the case. Further details of the modelling work can be found in Appendix A.

98. As explained above in paragraph 7, for a lessening of competition resulting from a proposed acquisition to be regarded as substantial, a price increase that is predicted to arise as a result of the acquisition would have to be material. The Commission considers that a price increase of 2.7% is not sufficiently material to result in a substantial lessening of competition.

Conclusion on Existing Competition

99. The Commission concludes that the information received from industry participants indicates that there would be sufficient existing competition post-acquisition to constrain the combined entity from unilaterally exercising market power.

100. The Commission also concludes that, because any price increase likely to result from the proposed acquisition is not sufficiently material to result in a substantial lessening of competition, and vigorous competition is likely to continue between NZDF and the combined entity post-acquisition, the type of non-coordinated market power that can occur in an oligopoly market is unlikely to occur, post-acquisition, to an extent that would result in a substantial lessening of competition.

Potential Competition

101. Although the Commission considers that existing competition post-acquisition is likely to be sufficient to constrain the combined entity from exercising market power, for the purposes of a thorough analysis of the competition factors that would affect the yoghurt and dairy food market post-acquisition, the Commission has also considered whether potential competition would be likely to constrain the combined entity.

102. 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.

103. 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 barriers they might encounter should they try. Where barriers to entry in a market are clearly low, it may be unnecessary for the Commission to identify specific businesses that might enter. In other markets, where barriers are higher, the Commission may seek to identify possible new entrants as a way of testing the assessed entry barriers.

Barriers to Entry

104. 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. The Commission is of the view that a barrier to entry is best defined as anything that amounts to a cost or disadvantage that a business has to face to enter a market that an established incumbent does not face.

105. The Applicant submitted that entry costs are low and the regulatory framework is designed to facilitate entry. It said that it is relatively easy to set up a yoghurt

producing operation on a small scale and then grow it incrementally. It said that the only relevant regulatory requirements are sanitary requirements, and these are easily complied with. The Applicants also submitted that the significant presence of home yoghurt makers indicates the ease with which the product can be manufactured.

106. Other industry participants advised the Commission that yoghurt and dairy food categories are driven by price, innovation and brand loyalty and that the main factors affecting entry into the yoghurt and dairy food market are:

- ability to get access to shelf space in supermarkets;
- machinery;
- brand;
- supply chain management capability; and
- the small size of the New Zealand market and the entrenched competitors with strong market positions.

107. As 90% of yoghurt and dairy food is sold by supermarkets, if a new entrant is to be competitive, it must be able to have its products sold by at least one of the supermarket chains. Progressive and Foodstuffs advised the Commission that because of the limited space in the chillers, if a new product is introduced, an existing product has to be removed from the chillers. Accordingly, for them to accept a new yoghurt or dairy food supplier, it would have to have:

- a quality product;
- competitive prices that offer margins to the supermarket equal to or better than current products;
- a full promotional programme including TV and other media advertising (estimated by one supermarket chain to cost at least $1.5 million), in-store tasting – Foodstuffs Wellington, for example, emphasised the need to have aggressive marketing to get supermarket slots;
- full merchandising support and daily deliveries;
- an effective launch of the product;
- a full sales representative force; and
- a point of difference from existing products e.g. a new break-through product that boosts interest in the category as a whole.

108. Progressive and Foodstuffs both advised the Commission that it would be very difficult for a small supplier to meet all their requirements, particularly without brand awareness, although Foodstuffs said that it may be possible to trial a new product in some of their smaller stores.

109. An additional factor increasing the difficulty in gaining entry to Pak ‘N Save supermarkets is the current range review by Pak ‘N Save which is reducing the number of ranges of products carried.

110. NZDF advised the Commission that it would cost at least $10 million to set up a yoghurt and dairy food plant that could compete with the combined entity and NZDF. National Foods said that it would cost between $10 million and $30

million for a plant such as that operated by NFIFF to substantially expand capacity.

111. Industry participants said that it is possible to set up a small operation reasonably cheaply. Serra, for example, said that if an entrant already had a milk plant it would already have pasteurising machinery but would need to adapt it, could lease a packaging machine for approximately $250,000, and purchase culturing tanks and cleaning systems and pumps for approximately $100,000. Such an operation, however, is unlikely to be able to produce sufficient volume of sufficient quality to be competitive.

112. Industry participants advised the Commission that although price is a key determinant in the majority of purchases by consumers, a new entrant would need to have brand awareness to obtain initial sales, let alone be competitive. NZDF said that if price was the only determinant of sales, it would not have the market share it does as the average price for Fresh n Fruity is higher than both Yoplait and Meadow Fresh and yet NZDF has a [ ] market share.

113. As discussed above with respect to access to supermarkets, establishing a brand and supporting it is crucial to getting access to shelf space in supermarkets. Both Progressive and Foodstuffs advised that a new entrant would have to have an effective launch of its new brand and a continuing promotional programme. As stated above, the initial launch could cost at least $1.5 million.

114. All industry participants advised the Commission that, due to the short shelf life of yoghurt and dairy food and the considerable variations in demand due to promotional activity, supply chain management is crucial to profitability. Both Progressive and Foodstuffs pointed to the risk of wastage as being one of the key factors that makes the introduction of house brands difficult.

115. NZDF, Foodstuffs Auckland and Foodstuffs Wellington stated that the small size of the New Zealand market with entrenched competitors with strong market positions would discourage new entry. Nestle advised the Commission that although it is currently a potential entrant into the New Zealand market, it would be highly unlikely to enter if the proposed acquisition proceeded as a move from three to two suppliers would make it almost impossible for another major player like Nestle to enter.

<u>Conclusion to Barriers to Entry</u>

116. As the Commission stated in *Decision 459*, the barriers to entry faced by potential new entrants in the market can differ significantly and are dependent on the size of the entrant. The main barriers to entry for a small start-up would be capital investment in plant, brand establishment, and access to supermarket shelf space, whereas a large company with well-established brands would consider that the size and nature of the market and access to supermarket shelf space are the main barriers to entry. Even though the barriers to entry listed above are not all applicable to all potential new entrants, the Commission considers that each new entrant would face at least the cumulative effect of some of them, which would result in reasonably high barriers to entry.

The "LET" Test

117. 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, sufficient in Extent and Timely (the LET test).

118. The mere possibility of entry is, in the Commission's view, an insufficient constraint on the exercise of market power, and would not alleviate concerns about a substantial lessening of competition. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational business would be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on its investment, including allowance for any risks involved.

119. If it is to constrain market participants, the threat of entry must be at a level and spread of sales that is likely to cause market participants to react in a significant manner.

120. If it is to alleviate concerns about a substantial lessening of competition, entry must be feasible within a reasonably short timeframe, considered to be two years, from the point at which market power is first exercised.

121. The Applicant submitted that there are a number of potential entrants in the market for yoghurt and dairy food, such as supermarket chains and international licensors of well established global dairy brands. It submitted that the prime threat from entry comes from the supermarket chains, either through the purchase of a processing facility, or by introducing house brands produced under contract, and that a house brand could be launched at the necessary scale to compete effectively.

<u>Supermarkets</u>

122. The Applicant advised the Commission that [

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123. Nestle advised the Commission that it would not consider producing house brands as it has no reason to do so as Nestle would take all the risk for no real benefits as it would not be able to use its own brand.

124. Foodstuffs Wellington owns United Milk which has a milk processing plant. It advised the Commission, however, that it would not produce yoghurt and does not see it as being a future opportunity. It said that the Australian experience of house brand yoghurt shows that it does not sell and that New Zealand supermarkets' trends in house brands follow Australia and not the UK or other markets where house brand yoghurt has been more successful.

125. Foodstuffs Wellington said that the price for a house brand yoghurt or dairy food would need to be 5% to 10% lower than the promotional prices of the incumbent brands and that there were issues with the supply chain due to the peaks and troughs in sales resulting from promotions and that if you got this wrong you could lose money on wastage.

126. Foodstuffs Auckland advised that it had looked at the possibility of having house brand yoghurt and dairy food but that it would be very difficult because of the distribution, product management and servicing issues. It said it had house brand cultured products – sour cream, cream cheese and cultured cheese – and that it was not confident about their success.

127. Foodstuffs South Island made the same comments as the other Foodstuffs companies and added that it believed it would not make money on house brand yoghurt and dairy food and could lose a lot of money on wastage as yoghurt was one of the most difficult products it manages.

128. The Commission considers that it is unlikely that any of the Foodstuffs companies would introduce house brand yoghurt and dairy food within sufficient time to constrain the combined entity from exercising market power.

129. [

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Other Potential Entrants

130. All the supermarket companies and dairy industry participants spoken to considered that entry in the yoghurt and dairy food market by anyone other than a supermarket company was unlikely. Foodstuffs Wellington said that entry by a small supplier was not likely at all and queried why an international company would want to enter such a small market. Foodstuffs Auckland said that it would be very difficult for a new supplier to enter and Foodstuffs South Island felt that entry by an overseas company was unlikely.

131. Nestle advised the Commission that although it has considered entry into the New Zealand market, it would be far less likely to enter if the proposed acquisition proceeded as a move from two to three suppliers would make it almost impossible for another major player like Nestle to enter given the strength of the existing parties.

132. The only dairy industry participant that expressed any interest in entering the market was IDP which said that it had considered the market as a potential area of growth. However, it has no current plans to do so.

133. Furthermore, the smaller yoghurt suppliers advised the Commission that they did not intend to expand their operations to an extent that would make them competitive with the combined entity and NZDF.

Conclusion on Potential Competition

134. The Commission cannot be satisfied that entry, either by a supermarket company with a house brand product or by another supplier, will occur within sufficient time after an increase in price or other exercise of market power by the combined entity to prevent a substantial lessening of competition.

Co-ordinated Market Power

135. An acquisition may lead to a change in market circumstances such that either co-ordination between the remaining businesses is made more likely, or the effectiveness of pre-acquisition co-ordination is enhanced. The Commission is of the view that where an acquisition materially enhances the prospects for any form of co-ordination between businesses in the market, the result is likely to be a substantial lessening of competition.

136. The Commission evaluates the likely post-acquisition structural and behavioural characteristics of the relevant market or markets to test whether the potential for co-ordination would be materially enhanced by the acquisition. In broad terms, effective co-ordination can be thought of as requiring three ingredients: collusion, detection and retaliation.

137. The Applicant pointed out that in *Decision 459* the Commission did not consider that there would be scope for coordinated market power and that this would be even more so with the proposed acquisition where:

- the two smaller player would merge; and
- Mainland would continue to be driven to compete aggressively.

138. In *Decision 459* the Commission considered that the reduction from three competitors to two would be outweighed by the fact that the combined entity would have a considerable market share and Mainland a much smaller market share, and by Mainland's drive to increase market share. The market shares that would result from the proposed acquisition would be more similar than in *Decision 459* (39.5% and 54.6% as against 19.5% and 76.9%). However, the following factors are likely to reduce the likelihood of the exercise of coordinated market power.

- as discussed in the section on market definition, the products are quite differentiated, making it more difficult to reach agreement on price;
- the production technology is constantly evolving with the result that over time the differences between the businesses and their products might increase;
- there is no history of anti-competitive behaviour and in fact the market is very competitive; and
- the countervailing power of the supermarkets would undermine any attempt at coordinated market power.

139. The Commission concludes that the scope for coordinated market power would not be enhanced by the proposed acquisition.

Countervailing Power

140. The potential for a business to wield market power may be constrained by countervailing power in the hands of its customers, or when considering buyer market power (oligopsony or monopsony), its suppliers. In some circumstances, this constraint may be sufficient to eliminate concerns that an acquisition would be likely to lead to a substantial lessening of competition.

141. The Applicant claimed that the supermarket chains derived countervailing power from the way they purchase from suppliers. The key factors were:

- 90% of yoghurt and dairy food is sold through supermarkets;
- between 60 and 80% of yoghurt and dairy food[14] sold in supermarkets is sold on promotion;
- threat of entry from a house brand; and
- aggressive conduct of supermarkets towards wholesalers of yoghurts and dairy food.

142. Supermarket sales are crucial for yoghurt and dairy food. Promotions are managed by supermarkets with supermarket category managers choosing amongst the best discounts offered by suppliers for their promotion calendar. They play suppliers off against each other to get the best deals before confirming the promotion calendar.

143. In *Decision 459* the Commission found that supermarkets maintain a certain degree of uncertainty for the suppliers regarding access to promotion slots because if a large supplier knows that it will get a certain percentage of the promotion slots because of its size, it would have less incentive to offer low

[14] The Commission's own findings estimate this figure to be between 70 to 80%.

promotion prices. The Applicant argued that this factor operates to increase competition in the factual where there is an even greater ability for supermarkets to play NZDF off against the merged entity in the allocation of promotional slots, given that their market shares in the factual would be more closely aligned.

144. The supermarket companies themselves stressed the importance of yoghurt in attracting consumers. Yoghurt is classed as a core product by supermarkets and one that must be stocked. Foodstuffs Wellington stated that yoghurt was one of the supermarkets' key drivers. As an example, when Fresh n Fruity (the market leader) went on special, it got the customers "off the buses".

145. The Commission estimates that approximately 70 to 80% of yoghurt is sold on promotion. The Applicant informed the Commission that consumers are actively aware of this and that they have been 'trained' to only buy yoghurt when it is on special.

146. Due to the large amount of product bought on promotion, suppliers actively compete to secure the best promotional slots. In turn, these promotional slots affect the volume sold in the supermarkets and the whole category is characterised by high-low sales. [ ]

147. Both the supermarket chains have standard trading terms with the yoghurt manufacturers. Neither has any fixed contract with manufacturers for the supply of product to, or for the positioning of product in, stores. They could therefore stop stocking a supplier's products or stop promoting it at any time.

148. All suppliers, both large and small, stressed the necessity for the suppliers of supermarkets to stock their products and in turn the supermarket's ability to delete a product range or individual SKU (Stock Keeping Unit) from their shelves. [ ]

149. The Foodstuffs companies are in the process of completing a 'Range Review' for their Pak 'N Save stores. This review focuses on returning these stores to their original format of 'barns' with cardboard dump-stacks and a limited number of SKUs as opposed to a full range supermarket. As a result of this review, Mainland sees the potential for its products to be significantly reduced in the supermarket chain that it deems the market leader. However, Foodstuffs Auckland stated that if Mainland's products were to be affected by the range review, [ ]

150. The Commission found that if there was a unilateral increase in price by a supplier, the supermarket chains would act to counter this. Foodstuffs Auckland stated that it had a number of options in this scenario. It would bring pressure on the company by either refusing to accept the price rise, or it could refuse to promote the product or refuse to put in new product lines. Further it might go to the opposition supplier and organise some other form of promotional activity. It would favour this method as this would avoid the perception that the supermarkets themselves were putting their prices up. This was especially important for the Pak 'N Save stores which are marketed as a discounter and price leader.

151. Foodstuffs Wellington advised that it recently [

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152. Foodstuffs Wellington and Auckland, and Progressive said that they would have less countervailing power with the move from three major suppliers to two. The Commission acknowledges that there may be a reduction in the supermarket companies' countervailing power post acquisition, but considers that this countervailing power would still be considerable..

153. It should be noted that the Commission has previously considered the countervailing power of supermarkets in other consumer good categories with an equally high percentage of sales in supermarkets as yoghurt and dairy food[15] In both these investigations the supermarket chains were found to have significant countervailing power over the ability of the combined entity to raise prices.

Conclusion on Countervailing Power

154. The Commission concludes that the supermarket companies would have sufficient countervailing power to constrain the combined entity from exercising market power.

OVERALL CONCLUSION

155. The Commission has considered the probable nature and extent of competition that would exist, subsequent to the proposed acquisition, in the yoghurt and dairy food market.

156. The Commission considers that the counterfactual is the status quo.

157. The Commission concludes that there would be sufficient existing competition post-acquisition to constrain the combined entity from unilaterally exercising market power.

158. The Commission also concludes that, because any price increase likely to result from the proposed acquisition is not sufficiently material to result in a substantial lessening of competition, and vigorous competition is likely to continue between NZDF and the combined entity post-acquisition, the type of non-coordinated market power that can occur in an oligopoly market is unlikely to occur, post-acquisition, to an extent that would result in a substantial lessening of competition.

159. The Commission concludes that the scope for coordinated market power would not be enhanced by the proposed acquisition.

160. The Commission also concludes that the supermarket companies would have sufficient countervailing power to constrain the combined entity from exercising market power.

161. The Commission cannot be satisfied that entry, either by a supermarket company with a house brand product or by another supplier, would occur within

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[15] *Decision 487* considered the market for consumer yellow spreads of which 95% is sold in supermarkets. *Decision 529* considered the market for fabric softener of which at least 95% is sold in supermarkets.

sufficient time after an increase in price or other exercise of market power by the combined entity to prevent a substantial lessening of competition.

162. However, the Commission considers that the constraint provided by existing competition post-acquisition, together with the countervailing power of the supermarket companies, would be sufficient to constrain the combined entity from exercising sufficient market power to result in a substantial lessening of competition in the yoghurt and dairy food market.

163. The Commission is therefore satisfied that the proposed acquisition would not have, or be likely to have, the effect of substantially lessening competition in any market.

DETERMINATION ON NOTICE OF CLEARANCE

164. Pursuant to section 66(3) (a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by Fonterra Co-operative Group Limited of 100% of the shares in National Foods Limited

Dated this 9th day of December 2004

Peter JM Taylor

Division Chair

Commerce Commission

APPENDIX A

165. Castalia's derivation of price elasticities used supermarket scanner data in a series of statistical regressions. These were designed to identify the relationships between the quantity sold of a given brand of yoghurt, and the price of that brand and others in the market. More specifically these relationships are known as, respectively, the own and cross price elasticities of demand.

166. The regressions posited relationships between the proportional change in prices and the proportional change in quantity in the following terms:

$$\begin{aligned}
\ln(y_1) &= c_1 + \beta_{1,1}\ln(p_1) + \beta_{1,2}\ln(p_2) + \beta_{1,3}\ln(p_3) \\
\ln(y_2) &= c_2 + \beta_{2,1}\ln(p_1) + \beta_{2,2}\ln(p_2) + \beta_{2,3}\ln(p_3) \\
\ln(y_3) &= c_3 + \beta_{3,1}\ln(p_1) + \beta_{3,2}\ln(p_2) + \beta_{3,3}\ln(p_3)
\end{aligned}$$

167. Where the yi are quantities of different yoghurt brands and the pj are prices of different brands. In this form, estimates of the coefficient βi,j are own and cross price elasticities of quantity demanded for the respective brands.

168. In discussions with the Commission Castalia made the observation that the weighted average of the sums of each equation's βs can be interpreted as a market elasticity. The intuition behind this is that market price elasticity of demand is the proportional change in market quantity for a given proportional change in prices of all products in the market.

169. On the basis of its regression estimates, Castalia found the own price elasticity for Meadow Fresh yoghurt to be about [ ] and the market elasticity to be approximately -2. Castalia used these figures and revenue market shares in an implementation of the PCAIDS merger simulation model16 to derive a predicted price increase of about 2%. Their simulations did not allow for any cost efficiencies due to the transaction.

170. However, the Commission considered that a market elasticity of -2 is quite high (in absolute value). Its view is that the analysis as conducted will tend to produce a high elasticity of demand if not all relevant substitutes are included; accordingly the Commission, in its own modelling, took a more conservative approach and adopted a market elasticity of -1.5.

171. Additionally, the Commission's own regression analysis indicated that [ ] suggesting that the proportionality assumption in an unadjusted PCAIDS model might be inappropriate. The proportionality assumption in PCAIDS can be relaxed through the use of "nests" in which brands are grouped together according to observed common characteristics (or other evidence of close substitutability) and a nest's members' substitutability for the members of another nest, otherwise based on brand market share, can be reduced by an appropriate factor.17

172. Concerning cost efficiencies resulting from the merger, although none were modelled, the Applicant submitted that it anticipated efficiencies

[16] Roy Epstein and Daniel Rubinfeld, "Merger Simulation: A Simplified Approach With New Applications", *Antitrust Law Journal*, vol. 69, pp 883-919. See also *Commission Decisions 500, 482*.
[17] ibid p 895.

post-transaction to be in the order of 2-3%. The Commission accepted that there are likely to be some cost efficiencies but took the view that a more conservative figure was more appropriate for the current analysis.

173. Accordingly, the Commission's own run of the PCAIDS model used the same parameters as those used by Castalia but with the following changes: i) the market elasticity was set to -1.5; ii) Fresh n Fruity and Yoplait were nested separately from Meadow Fresh, and the substitutability implied by market shares (i.e. the proportionality assumption) between these nests was reduced by 25% (other brands - Cyclops etc - were put into an additional nest with proportionality reduced by 50% reflecting that they are even less substitutable for the main brands); and iii) a 1% cost efficiency was assumed for all brands owned by the merged entity. The price increase generated by the Commission's modelling using these assumptions was a weighted average of 2.7%.