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Determination

Fonterra Limited and New Zealand Dairies Limited (in receivership) [2012] NZCC 21

The Commission:	Dr Mark Berry Sue Begg Dr Stephen Gale
Summary of application:	An application by Fonterra Limited seeking clearance to acquire the dairy processing assets of New Zealand Dairies Limited (in receivership).
Determination:	Pursuant to s 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance to the proposed acquisition.
Date of determination:	6 September 2012

Confidential material in this report has been removed. Its location in the document is denoted by [ ].

Contents

The proposal

1. A notice under s 66(1) of the Commerce Act 1986 (the Act) was registered on 6 July 2012. The Notice sought clearance for Fonterra Ltd, a wholly-owned subsidiary of Fonterra Co-operative Group, or any of its interconnected bodies corporate (together Fonterra or the Applicant) to acquire the dairy processing assets of New Zealand Dairies Ltd (in receivership) (NZDL).

2. Three partners[1] of BDO New Zealand Ltd were appointed as receivers and managers of NZDL (the Receivers) on 17 May 2012 and they are the vendors in this case.

3. A competitive tender was conducted for the sale of the NZDL assets and Fonterra was the winning bidder.

4. The assets to be acquired by Fonterra are described in clause 2 of the sale and purchase agreement between Fonterra and the Receivers, dated 14 June 2012.[2] The sale and purchase agreement is conditional on the Commission clearing the proposed acquisition.

Procedure

5. Section 66(3) of the Act requires the Commission to either clear or 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 Fonterra. Accordingly, a decision on the application is required by 14 September 2012.

6. The Commission's approach to analysing the competition effects of the proposed acquisition is based on the principles set out in its Mergers and Acquisitions Guidelines.[3]

Statutory framework

7. Any person who proposes to acquire the assets or shares of a business and considers that the acquisition may breach s 47 of the Act can apply for clearance under s 66.

8. If the Commission is satisfied under s 66(3)(a) of the Act that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market, the Commission must give clearance for the proposed acquisition.

9. The Court of Appeal in *Port Nelson v Commerce Commission*[4] held that for something to be "likely" it must be "above the mere possibility but not so high as more likely than not and is best expressed as a real and substantial risk that the stated consequence will happen."

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1 Messrs Colin Gower, Stephen Tubbs and Brian Mayo-Smith.
2 Confidential Appendix A of Fonterra's application for clearance.
3 Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004.
4 (1996) 5 NZBLC 104, 150; (1996) 3 NZLR 562-563.

10. The High Court in *Woolworths & Ors v Commerce Commission*[5] observed that "…a substantial lessening of competition is one that is "real or of substance" as distinct from ephemeral or nominal. Accordingly a substantial lessening of competition occurs if it is likely that there will be a reduction in competition that is real or of substance."

11. If the Commission is not satisfied that the proposed acquisition will not have or would not be likely to have the effect of substantially lessening competition in a market or it is "in doubt" as to whether that is the case, it must decline the application under s 66(3)(b) of the Act.[6]

12. The burden of proof lies with Fonterra as the applicant, to satisfy the Commission on the balance of probabilities that the acquisition is not likely to substantially lessen competition.[7] The decision to grant or refuse clearance is to be made on the basis of all the evidence.[8] The Commission will sometimes have before it conflicting evidence from different market participants and must determine what weight to give to the evidence of each party.[9]

Analytical framework

13. The Commission's analytical framework for assessing whether an acquisition is likely to result in a substantial lessening of competition is described in the Commission's Mergers and Acquisitions Guidelines. The specific manner in which the Commission applies this framework depends on the facts in each case. In any assessment, the determination of the relevant market or markets may be an important tool. To define markets, the Commission identifies the areas of overlap between the businesses of the acquirer and the target, and then considers what, if any, products and geographic regions, constitute relevant close substitutes from both a customer's and a supplier's point of view.

14. The Commission uses a forward-looking analysis to assess whether a substantial lessening of competition is likely. This exercise "requires a comparison of the likely state of competition if the acquisition proceeds (the factual) against the likely state of competition if it does not (the counterfactual)."[10] That assessment is dependent on the facts revealed during the Commission's investigation of the application.

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5 *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 (HC).

6 *Commerce Commission v Woolworths Ltd* (2008) 8 NZBLC 102,336 (CA). At [105] the Court stated that the fact that the Commission is not satisfied does not require that the Commission be positively satisfied that a substantial lessening of competition is likely.

7 *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at [7] and *Commerce Commission v Woolworths Ltd* (CA) above n6 at [97].

8 *Commerce Commission v Woolworths Ltd* (CA) above n6 at [101].

9 *Brambles New Zealand Ltd v Commerce Commission* (2003) 10 TCLR 868 at [64].

10 *Commerce Commission v Woolworths Ltd* (CA) above n6 at [63].

15. In framing a suitable counterfactual, the Commission bases its view on a pragmatic and commercial assessment of what is likely to occur in the absence of the proposed acquisition.[11]

16. The High Court in *Air New Zealand v Commerce Commission (No.6)*[12] accepted that an absence of market power would suggest there had been no substantial lessening of competition in a market but did not see this as a reason to forsake an analysis of the counterfactual as well as the factual. Justice Rodney Hansen stated that "...a comparative judgment 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, that is, dominance has been attained."

17. In addition to existing competitors, the assessment may include an analysis of potential competitors. Potential competitors can act as a constraint on a business or businesses that might otherwise be able to exert market power. 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 actual, or threatened, market entry.

18. If entry is to act as an antidote to what otherwise might be a substantial lessening of competition in a market, that entry must be likely, timely and of sufficient extent to constrain market participants. However, the central question is simply whether or not a merged firm would be constrained in a timely way by likely market entry (or expansion) in the event it increased prices or reduced services.

Parties

Fonterra

19. Fonterra is a supplier-owned milk processor and marketer of dairy products. It has about 10,500 shareholders. Its constitution requires new suppliers who wish to become "share backed," to purchase one Fonterra share per kilogram of milk solids (kgMS) each produces per year. Fonterra's share price, currently set by its Board of Directors, is $4.52. Shareholder suppliers receive an annualised national milk price and a dividend on their shares. National pricing is discussed further below, but in general it means there is little or no scope for price negotiations between new suppliers and Fonterra. In 2011/2012 the milk price plus dividend was $7.89/kgMS.

20. Trading of Fonterra shares amongst farmers (TAF) is scheduled to be introduced in November 2012. TAF is a set of arrangements whose purpose is to stabilise and enlarge Fonterra's capital base by allowing external (non-farmer) investors to purchase the economic rights to non-voting shares while continuing to maintain farmer control of Fonterra. A consequence of TAF is that Fonterra's share price will be determined via a market price rather than through an administrative methodology as is the case today.

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[11] New Zealand Electricity Market (Commerce Commission Decision 277, 30 January 1996) at 16.
[12] *Air New Zealand v Commerce Commission (No.6)* (2004) 11 TCLR 347.

21. Entrant suppliers can fully "share up" to the level of their expected production or they can supply Fonterra on the basis of a Growth Contract. Under a Growth Contract, suppliers must purchase an initial 1,000 Fonterra shares followed by the purchase of sufficient shares to cover one third of their total milk supply at the start of the fifth, sixth and seventh milking seasons. This means suppliers on Growth Contracts will be fully share backed by the beginning of the seventh season. Fully share-backed suppliers receive the full Fonterra milk price and dividend. Growth Contract suppliers receive $0.05 per kgMS less than the Fonterra milk price for non share backed milk supply, together with a progressive share of the dividends. There are about [ ] suppliers currently supplying [ ]% of Fonterra's national milk solids purchases on the basis of a Growth Contract.

22. This acquisition relates to a raw milk processing factory in the South Island. Most relevant to the analysis of this application are those factories in South and mid-Canterbury, and North Otago.

23. Between 2001/2002 and 2005/2006, Fonterra processed approximately [ ]% of the South Island's milk production.[13] However, beginning in 2007/2008 this proportion began to decline, falling to 82% in 2010/2011, following the commissioning of the factories of Synlait Milk Ltd (Synlait), NZDL and Open Country Dairy Ltd together with Westland Milk Products (Westland) increasing its output. Table 1 shows the volumes and proportions of milk solids processed by Fonterra and its competitors in the South Island during the 2010/2011 milking season.[14]

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[13] Fonterra's application for clearance, figure 7.

[14] 1 June 2010 to 31 May 2012.

Table 1: Distribution of South Island milk between processors

Milk Processor	Millions of kilograms of milk solids in 2010/2011	Proportion of total South Island production
Fonterra upper South Island	[ ]	[ ]%
Fonterra central South Island	[ ]	[ ]%
Fonterra lower South Island	[ ]	[ ]%
South Island total Fonterra	**[ ]**	**82**%
Westland	[ ]	[ ]%
Synlait	[ ]	[ ]%
NZDL	[ ]	[ ]%
Open Country Dairy	[ ]	[ ]%
Total South Island Production	**[ ]**	**100%**

Source: Fonterra[15]

24. As shown in Table 1, during the 2010/2011 season, Fonterra processed 82% of the milk produced in the South Island in its factories, most notably at Clandeboye and Edendale. Fonterra has advised that it intends to open a new large capacity factory at Darfield at the beginning of the 2012/2013 milking season.

25. Two important issues to consider when analysing the dairy industry are first, Fonterra's co-operative structure and second, the industry specific regulation which applies to Fonterra.

26. As a supplier-owned co-operative, Fonterra, like other co-operatives exists to further the interests of its shareholder suppliers. As such, its Board of Directors and its management are influenced in their raw milk pricing strategies by the views of its farmer shareholders. In this respect, fairness and equity to all its shareholders are important considerations to Fonterra. In the past Fonterra has engaged in tactical pricing whereby it set a higher raw milk price in certain regions where it was faced with strong competition for milk supply. This resulted in farmer discontent and Fonterra has advised that it currently does not engage in tactical pricing. Similarly, differing raw milk prices depending on differing transport distances to factory has not found favour amongst Fonterra's shareholders. It was from these kinds of farmer pressures that Fonterra's national pricing strategy evolved.

27. While all co-operatives share this feature, the Commission's view is that it is particularly strong for Fonterra. This is because there is a very tight link between Fonterra's shareholders and its suppliers. Indeed, Fonterra's suppliers become shareholders of the co-operative.

15 Fonterra letter of 24 July 2012.

28. In terms of industry specific regulation, under the Dairy Industry Restructuring Act 2001 (DIRA):

    28.1 Fonterra cannot discriminate between existing shareholder suppliers and new entrant suppliers in the same circumstances.

    28.2 Farmer suppliers may enter and leave Fonterra without penalty;

    28.3 Fonterra is obliged to supply 250 million litres per year to Goodman Fielder's milk, cheese, butter and yoghurt factory and up to 50 million litres per year to each other independent milk processor (DIRA milk). It may charge those processors the reasonable cost of transporting the milk to their factories.

    28.4 Fonterra must ensure that 33% or a greater percentage of the milk solids produced within a 160 kilometre radius of any point in New Zealand:

        28.4.1 Is supplied under contracts with independent processors; or

        28.4.2 Is supplied under contracts with Fonterra that expire or may be terminated by the supplier at the end of the current season without penalty to the supplier.

    28.5 Fonterra's suppliers can supply up to 20% of their milk output to a competing processor without having to exit Fonterra (the 20% rule); and

    28.6 Fonterra will shortly be required to disclose information in relation to its milk price setting.

NZDL (in receivership)

29. NZDL currently processes raw milk into standard milk powders at its factory at Studholme near Waimate but [ ] It produces milk powder solely for export.

30. NZDL is in receivership. [ ]:

    30.1 [ ]

    30.2 [ ]

    30.3 [ ]

    30.4 [ ].

31. The Receivers advised [

], they had entered into an "Operational Agreement" with Fonterra.

32. Under this Agreement there are 31 farms [ ] contracted to the factory for the duration of the current milking season. NZDL's suppliers are generally grouped in an area close to the Studholme factory on either bank of the Waitaki River. The Operation Agreement provides that:

32.1 [ ]

32.2 [ ]

32.3 [ ]

32.4 [ ]

33. [ ]

Westland Milk Products

34. Westland, like Fonterra, is also a supplier-owned milk processor and marketer of dairy products. It has over 330 shareholders. Similarly to Fonterra, under its constitution it obliges its suppliers to purchase one of its shares per kgMS produced per year. The share price is currently $1.50. Shareholders receive an annualised total payout. There is no scope for price negotiations between suppliers and Westland. In 2011/2012 its total payout (milk price and dividend) was $7.70/kgMS.

35. Westland's factory is located at Hokitika where it receives milk from its various suppliers, mostly located on the West Coast between Karamea and Fox Glacier. It also receives:

35.1 DIRA milk from Fonterra’s Canterbury-based suppliers which is transported by road tanker over Arthur’s Pass; and

35.2 Milk from [ ]farmer suppliers located in mid Canterbury close to its reverse osmosis factory at Rolleston. Reverse osmosis is a process used to remove water from raw milk to reduce transport volumes and transport costs. The concentrated milk is then transported to Westland’s Hokitika factory by rail.

36. Westland produces milk powder mostly for export, bulk butter for processed food manufacture in New Zealand, butter for retail sale as house brands, and yoghurt in sachet form.

37. [ ]

Synlait Milk Ltd

38. Synlait’s factory is located at Dunsandel between Christchurch and Ashburton and produces milk powder for export.[16] Synlait receives milk from about [ ] suppliers mostly within a [ ] kilometre distance by road from its factory.[17] About [ ]% of the farms that supply Synlait are owned by the Company.

39. Unlike Fonterra and Westland, Synlait does not require its suppliers to purchase shares in Synlait, rather it has a simple supply contract with them.

Previous decisions

40. In its most recent merger decision involving the milk industry, the Commission gave clearance to Fonterra to acquire Kapiti Fine Foods and United Milk Ltd (KFF).[18] The market most relevant to the present case was that for the supply and acquisition of raw milk in the Manawatu and Wairarapa regions. In that market Fonterra purchased [ ]% of the available raw milk and KFF purchased the balance.

41. The Commission decided in relation to that market, that in the factual, Fonterra would become the sole acquirer of raw milk from farmers in the Manawatu and Wairarapa regions. In the status quo counterfactual KFF would provide an alternative for some farmers and this ability to switch between acquirers of milk would provide some constraint on Fonterra’s farm gate pricing.

16 [ ].

17 [ ]

18 *Fonterra Co-operative Group Ltd and Kapiti Fine Foods and United Milk Ltd* (Commerce Commission Decision 574, 23 February 2006).

42. However, the Commission concluded that because of the small volume of milk it purchased, KFF provided only a limited constraint on the prices paid by Fonterra to its suppliers in the counterfactual. Consequently the removal of that limited constraint in the factual was unlikely to significantly enhance Fonterra's market power. The Commission decided that the acquisition would be unlikely to substantially lessen competition in the relevant market.

Market definition

43. The Commission considers it sufficient for the purposes of this decision, to analyse the effects of the merger in the South Canterbury and North Otago regions. It was not necessary to more precisely define the relevant geographic market (to the exact kilometre) as the competition analysis below would not significantly vary with either a narrower, or wider, geographic market.

Fonterra's view of the relevant markets

44. Fonterra submitted that the markets affected by the proposed acquisition are the:

    44.1 South Island market for the supply and collection of raw milk; and

    44.2 South Island market for raw milk processing assets.

45. In respect of the delineation of the relevant geographic market, Fonterra submitted that the economic catchment area for milk transport of 100-150 kilometres from a milk processing factory[19] was too limited in scope. Fonterra stated that raw milk is regularly transported for much longer distances and submitted that the relevant geographic market encompassed the entire South Island.

46. In support of that submission, Fonterra pointed to:

    46.1 The size of farms in the lower South Island being large with relatively flat milk production curves, and connected by relatively flat, straight roads to factories allowing longer than normal raw milk transport distances by road;

    46.2 Synlait collecting milk from a group of former Oceania Dairy farmers located just north of the Waitaki River who are a considerable distance from Synlait's Dunsandel factory;

    46.3 Westland collecting milk from [ ];

    46.4 Westland transporting milk from a distance of over 200 kilometres from Karamea to Hokitika and by railway tankers from Rolleston to Hokitika; and

    46.5 Fonterra, itself, transporting milk by rail from its collection station in Oamaru to its Edendale factory in Southland.

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19 Adopted by the Commission in the KFF Decision.

The Commission's view of the relevant markets

Introduction

47. As to Fonterra's suggestion of a South Island market for raw milk processing assets, the Commission has assumed that it should read additional words into the description so it becomes the South Island market for *the acquisition* of raw milk processing assets.

48. The Commission does not consider that the one off acquisition of NZDL would result in more than minimal business overlap in the acquisition of the factory machinery and land and buildings which comprise milk processing assets. There would be many international and national suppliers of these types of assets and many national purchasers of factory machinery and industrial land and buildings. The Commission considers that there is unlikely to be any prospect of a substantial lessening of competition in the sale and purchase of these types of assets resulting from this merger. It has carried out no further analysis of same.

49. [ ] there would be no business overlap between NZDL and Fonterra in downstream markets in New Zealand[20] and, therefore, no prospect of a substantial lessening of competition in downstream markets in New Zealand. Therefore, the Commission has not analysed any such market in these reasons. However, the Commission notes that this will not necessarily be the case in respect of any future proposed acquisitions by Fonterra of other dairy processors. If the target processor competed with Fonterra in other markets in New Zealand, those markets would require analysis by the Commission.

Product dimension

50. This case concerns the production by suppliers, and the acquisition by processors, of raw milk. Consistent with previous decisions, the Commission considers that there is limited differentiation in raw milk supplied by farmers and that there are no close substitutes for raw milk.

51. Fonterra submitted that the relevant product in this case was raw milk and the Commission agrees.

Geographic dimension

52. In the Commission's KFF Decision, the Commission found that the geographic market for raw milk collection was the area within 100-150km from the KFF factory.

53. The relevant market is typically identified by the Commission in order to analyse the competitive constraints acting upon the merged entity. The competition analysis below does not rely on an exact delineation to the kilometre of the relevant

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[20] In respect of the counterfactual, [ ].

geographic market to identify competitive constraints acting on the merged entity. It is, therefore, unnecessary in this instance, for the Commission to reach a conclusion on the precise geographic scope of the market. The Commission considers it sufficient for the purposes of this decision, to analyse the merger in the South Canterbury and North Otago regions.

Factual and counterfactual

Factual

54. In the factual Fonterra would acquire the dairy processing assets of NZDL and would contract with [ ] of the former suppliers of NZDL (representing [ ] farms) to supply the factory. [ ][21] [ ]:

    54.1 [ ]

    54.2 [ ][22]

    54.3 [ ][23] [ ]

    54.4 [ ]

55. Under Fonterra's bid for NZDL's assets, the relevant farmers would receive the full value of the retrospective payments owed to them by NZDL for raw milk supplied during the 2011/2012 season.

56. [ ][24] [ ]

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21 [ ].
22 [ ].
23 [ ]
24 [ ].

Counterfactual

57. The Receivers conducted an open bidding process to sell the NZDL business and assets. The Receivers advertised for expressions of interest and made direct approaches to the most likely prospective purchasers.

58. The Commission has interviewed the Receivers and has been provided with their analysis of the [ ] bids received.[25] That analysis showed that while the Receivers concluded that Fonterra's bid was significantly higher at [ ], they also considered that [ ] was a credible bid. [ ] was the Receivers' preferred under bidder. [ ] was interviewed by the Commission and confirmed that it was very interested in purchasing NZDL [ ]

59. [ ]

60. [ ] the NZDL farmers endorsed the Fonterra offer.

61. [ ].

62. The Receivers did not consider [ ].

63. Fonterra submitted that NZDL is a failed firm and that should be factored into the counterfactual. The Commission has published a guideline on failing firms[26] in which it outlines factors to be taken into account when assessing claims of a failing firm counterfactual. One factor is whether there is any prospect of a credible third party acquiring the assets of the failing firm and using them to compete (where this would not lead to a substantial lessening of competition). If that is the case, a failing firm analysis is not appropriate.

64. The Commission concludes that because there were [ ] credible bids to purchase the NZDL business and assets, the counterfactual is not one of a failing firm.

65. Rather, the Commission concludes that in the counterfactual it is likely that the under bidder, [ ] would purchase the assets and use them to

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25 Buddle Findlay letter to BDO Christchurch Ltd, 20 July 2012.

26 *Mergers and Acquisitions: Supplementary Guidelines on Failing Firms* (October 2009).

produce infant formula. In this scenario, Fonterra would continue to be the largest milk purchaser in the region.

Competition analysis

Introduction

66. The Commission's analysis compares the likely state of competition if the acquisition proceeds against the likely state of competition if it does not. Put another way, the Commission's analysis compares Fonterra's buyer side market power if the acquisition proceeds with Fonterra's buyer side market power if the acquisition does not proceed.

67. The Commission's analysis below discusses:

    67.1 The impact of any loss of choice for farmer suppliers that would occur in the factual;

    67.2 Theories of potential harm arising from the merger; and

    67.3 The constraints Fonterra would continue to face in the factual and the counterfactual arising from Fonterra's farmer ownership, its national raw milk price strategy, and the DIRA.

Loss of choice for farmer suppliers

68. The Commission acknowledges that farmers in the South Canterbury/North Otago region would lose the option of supplying NZDL (owned in the counterfactual by the under bidder [ ]) if the acquisition proceeds.

69. However, the Commission does not consider that the removal of this option equates to a substantial increase in Fonterra's buyer side market power in the factual compared to the counterfactual. In other words, the Commission considers it unlikely that Fonterra would have a greater ability or incentive to reduce prices to suppliers. This is discussed in more detail in the competition analysis below.

70. Further, while NZDL (owned by the under bidder in the counterfactual) would be the largest buyer of raw milk apart from Fonterra in the South Canterbury/North Otago region, the Commission is not aware of any evidence that would suggest that the under bidder would be able to sustainably offer a higher payout to farmers than Fonterra:

    70.1 Fonterra's total payout for the last season was [ ];

    70.2 [ ] intend to use the Studholme plant to produce the same processed product [ ]; and

    70.3 One of the reasons NZDL's business failed was [ ]

71. Thus the Commission concludes that the loss of the option to supply NZDL (owned in the counterfactual by [ ]) does not result in any additional potential competitive harm (in addition to the concerns about Fonterra's buyer power noted in the paragraph above and discussed in more detail below).

Two theories of potential harm in this case

72. The Commission has identified two potential theories of harm, namely:

    72.1 Fonterra gaining increased buyer side market power; and

    72.2 Fonterra gaining an ability to foreclose other processors and/or new entrant suppliers.

Fonterra gains increased buyer market power

73. The substantial lessening of competition test focuses on changes in market power. In this context, buyer side market power is the converse of selling side market power. On the supply side, market power exists when a firm can price above workably competitive levels. Likewise, market power on the buying side exists when a firm can depress prices below workably competitive levels.

Other processors and new entrant suppliers are foreclosed

74. Under the proposed acquisition Fonterra would enter [ ]. As a result, these suppliers would be foreclosed to any other processor in the NZDL catchment area (approximately 100km from the NZDL plant) for [ ] years, and other farmers would only be able to supply Fonterra.[27] In this case the other processor would be an entrant (such as Oceania Dairies), as there would be no other existing processors (apart from Fonterra) in that catchment area post acquisition.

75. The Commission does not consider that this potential foreclosure would lead to a substantial lessening of competition for the following reasons:

    75.1 First, NZDL, which obtained its raw milk supply within the catchment area, reported no difficulty in attracting suppliers when it was operating. It said that certain suppliers were attracted to it by the absence of a need to provide capital to purchase Fonterra shares. Certain suppliers preferred to use that capital instead, to invest in increased production from their own farms. In any event, as shown in Table 2, the NZDL factory requires only about [ ]

    75.2 Secondly, concerns over access to raw milk by independent processors are alleviated by the DIRA which requires Fonterra to:

[27] In respect of the under bidder counterfactual, the Commission has been advised by [ ]

75.2.1 Supply up to 50 million litres of milk per annum in response to each request from independent processors subject only to a cap of 5% of the total raw milk supplied to Fonterra;[28]

75.2.2 Ensure that at all times a minimum of one third of milk solids produced in any region (within a radius of 160 kilometres from any point in New Zealand), is supplied to an independent processor. Alternatively, a minimum of one third of milk solids must be available to be supplied. That is, supply contracts providing an equivalent volume of milk solids to Fonterra must expire or be able to be terminated by the supplier at the end of the current season;[29] and

75.2.3 Comply with the 20% rule.

76. Finally, evidence from [ ] has established that about 50% of the irrigated land in the catchment area is yet to be converted to dairy farming and that new dairy conversions are occurring regularly. New conversions are an ideal source of raw milk for independent processors as these suppliers often struggle to find capital to purchase Fonterra shares in the early years of the life of their farm.

77. As a result the remainder of these reasons focus on whether Fonterra would gain increased buyer side market power as a result of the acquisition.

Fonterra's submissions

78. Fonterra submitted that it would be constrained from reducing the milk price paid to suppliers in the relevant market post-acquisition by:

78.1 Existing competitors in the market for raw milk supply in the South Island and the extent to which they could expand. In this respect Fonterra submitted that:

78.1.1 Westland already purchases milk in competition with Fonterra in Canterbury and plans to build an infant formula factory at its Rolleston site;

78.1.2 Synlait purchases raw milk from other suppliers previously contracted to Oceania Dairy and from other suppliers in South Canterbury, and has expanded its production into infant formula and other specialty milks; and

78.1.3 The raw milk acquired to supply the NZDL factory is only a very small proportion of the milk supplied in the relevant market.

78.2 Potential competition for milk supply such as that from the new entrant Gardians which is producing for the first time during the 2012/2013 season;

[28] Dairy Industry Restructuring (Raw Milk) Regulations 2001 promulgated under s 115 of the DIRA.
[29] Section 107(3) of the DIRA.

78.3 The impact of the DIRA on Fonterra's operations; and

78.4 The constraining power of Fonterra's shareholder suppliers.

79. As such, Fonterra submitted there would be no substantial lessening of competition as a result of the proposed acquisition.

Existing competition

80. There are a number of factors which would constrain Fonterra in both the factual and the counterfactual, the most significant of which is Fonterra's particular co-operative structure. It is in light of these constraints that the Commission must view the potential loss of farmer choice in the counterfactual, and the impact of that loss of choice on Fonterra's buyer side market power.

The co-operative incentives of Fonterra

81. The members of the Fonterra co-operative are both shareholders as well as suppliers. This overlap of supply and ownership means that, in both the factual and the counterfactual, Fonterra's management have the incentive to maximise the returns on shareholders' funds as well as to purchase raw milk from farmers at a competitive price. Co-operative members will take account of both the price they receive for upstream milk production as well as the dividend paid on their shareholder funds when exercising their voting rights and making decisions around entry and exit from Fonterra.

82. Fonterra submitted it is significantly constrained in its ability to pay its supplier shareholders a price for their milk that differs materially from the national milk price, which provides a transparent benchmark that leads to significant supplier pressure if Fonterra deviates from this price. For example, Fonterra [

]

83. In previous decisions the Commission[30] and the High Court[31] have examined the extent to which the ownership structure in co-operative companies can provide a constraint on the exercise of market power. The High Court has accepted that suppliers to a co-operative can be in a position through their ownership of the company to prevent, or at least curtail, the exercise of their market power.

84. In *New Zealand Co-op Dairy Ltd v Commerce Commission* [32] the High Court said:

> …we are quite satisfied on the evidence that was before the Commission that by a system of committees, meetings and the appointment of directors, the suppliers have a very effective day to day influence on the decision-making processes of their dairy company co-operatives and would have just such a strong influence on the merged company. When the constraints

[30] See Ruapehu Alpine Lifts Limited and Turoa Ski Resorts Limited (in receivership) (Commerce Commission Decision 410, 14 November 2000).

[31] See *Ravensdown Corporation Limited v Commerce Commission* AP168/96, 16 December 1996.

[32] *New Zealand Co-op Dairy Ltd v Commerce Commission* [1992] 1 NZLR 601 at 629.

> of the Dairy Board Act and the Milk Act are added to that situation our view is that, despite the cost advantages it will acquire, the merged company will still be somewhat constrained by its co-operative structure from behaving “to an appreciable extent in a discretionary manner without suffering detrimental effects” in the raw milk market.

85. On balance the High Court in *NZ Co-op Dairy* considered that the merged entity’s co-operative structure represented a degree of constraint.

86. Fonterra’s particular co-operative structure and the regulatory regime it faces are different to those which applied at the time of the *NZ Co-op Dairy* case and, in the Commission’s view, impose a materially greater constraint than that which the High Court found.

87. For these reasons, in the present case and with the present regulatory environment, the Commission considers that the evidence suggests that Fonterra’s buyer side market power is constrained by its co-operative structure such that Fonterra would have no incentive to pay below competitive prices. Paying a raw milk price below competitive levels would be against the ethos of Fonterra as a co-operative.

88. Furthermore, the Commission considers that Fonterra’s co-operative structure constrains its commercial ability and incentive to discriminate against its shareholder suppliers in the South Canterbury and North Otago regions (or any other region) in favour of its shareholders in other regions. That too would be against the ethos of Fonterra as a co-operative venture and would be difficult in light of the transparency around Fonterra’s national pricing (as discussed below). The Commission considers that Fonterra’s particular co-operative structure will constrain it from such discrimination.

National pricing strategy

89. Fonterra has advised that its milk price method, which is set out in detail in its Milk Price Manual, is used to calculate a minimum aggregate sum of money to be set aside to pay for raw milk supplied to it during a particular season, for instance [ ] in its 2011/2012 financial year. This amount is then expressed as a price per kgMS, for example $5.50/kgMS (the current forecast for 2012/2013), in which sense the milk price is a national price to all dairy farmers supplying Fonterra.[33]

90. As such, were Fonterra to drop its prices in the South Canterbury/North Otago region, its national pricing strategy would require an equivalent price reduction throughout the country. In this case, Fonterra may lose suppliers to other processors across New Zealand (in spite of a likely increase in their dividends as a result of Fonterra’s lower raw milk purchase costs). It is unlikely that this consequent loss of milk supply volumes in other parts of the country would be offset by its increase in profits in the small catchment area around the NZDL plant.

[33] Fonterra advised that the national price can be varied in respect of certain raw milk quality and quantity parameters but that these variations are applied, or available, to farmers on a non-discriminatory basis.

91. Fonterra advised that it has in the past offered certain suppliers Tactical Contracts which included raw milk prices above the national price, in those regions where there was particularly strong competition with other processors for raw milk supply. [

]

92. The Commission considers that the incentives that Fonterra faced as a result of its co-operative ownership moved it towards an (initially voluntary) national pricing regime, as any form of regional or transport price discrimination would have created conflict amongst supplier shareholders [
]

93. While national pricing has been and remains a voluntary regime, the Dairy Industry Restructuring Amendment Act 2012 will require Fonterra (amongst other things), to maintain and transparently disclose a “milk price manual” that details how the base milk price is calculated.

94. While Fonterra could, in theory, abandon the national pricing approach, any alternative would not only be likely to face opposition from disadvantaged farmer suppliers, but that alternative would need to be monitored against the relevant purpose statement in the DIRA[34] which is to promote the setting of a base milk price that provides an incentive for Fonterra to operate efficiently while providing for contestability in the raw milk market.

95. Therefore, the Commission considers that given the new transparency as to the calculation of the national pricing of raw milk as purchased by Fonterra it would be even more difficult for Fonterra to retreat from national pricing. There would be significant barriers to Fonterra altering its national pricing strategy.

96. Given Fonterra sets the raw milk price that it pays to its suppliers on a national basis, and which strategy, in the Commission’s view, is unlikely to change, the Commission concludes that Fonterra would have little incentive or ability to lower its raw milk price to farmers in only the NZDL catchment area. The evidence points to the likelihood of such a strategy leading to significant conflict amongst Fonterra’s shareholders.

97. Therefore, it does not appear to the Commission that Fonterra could price discriminate on a local or regional basis. The Commission considers that this would be a strong constraint on Fonterra reducing its prices below the national price in both the factual and the counterfactual.

98. As a final matter, the Commission notes that [

]. The Commission considers that this is not an exercise of market power, [

[34] Section 150A of the DIRA.

]to the relevant suppliers, corresponding to the money owed to them as unsecured creditors of NZDL. [

] The Commission does not consider this is at variance to national pricing or discriminatory because it only applies to this small group of farmers who are in a unique situation.

Conclusion on substantial lessening of competition

99. The Commission considers that Fonterra's co-operative structure removes the incentive and ability of Fonterra to depress raw milk prices below competitive levels in both the factual and counterfactual. This is reinforced by the national raw milk pricing strategy. The combination of the strong incentives created by farmer ownership of Fonterra and the new pricing transparency, soon to be introduced, create significant barriers to the potential removal of the national pricing strategy. That strategy provides a significant constraint on Fonterra.

100. In light of these strong constraints, the Commission concludes that it is unlikely that the acquisition would increase Fonterra's buyer side market power and, therefore, it is unlikely that the acquisition would have the effect of substantially lessening competition in any relevant market.

101. Further, the Commission considers that there is no proper basis upon which to conclude that, under the counterfactual, the under bidder [ ] may be able to sustainably offer a higher payout to farmers than Fonterra.

102. In this case, the Commission has not had to consider downstream markets in New Zealand for products such as butter and cheese. If such an acquisition arose in the future, further analysis of such downstream markets would be necessary and it is possible there would be more significant competitive effects in such markets.

Determination on notice of clearance

103. The Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition.

104. Pursuant to section 66(3)(a), the Commission gives clearance for Fonterra Ltd, a wholly-owned subsidiary of Fonterra Co-operative Group Ltd, or any of its interconnected bodies corporate, to acquire the dairy processing assets of New Zealand Dairies Ltd (in receivership).

Dated this 6th day of September 2012

Dr Mark Berry
Chair