COMMERCE ACT 1986: BUSINESS ACQUISITION
SECTION 66: NOTICE SEEKING CLEARANCE

Date: 3 November 2004

The Registrar
Business Acquisitions and Authorisations
Commerce Commission
PO Box 2351
WELLINGTON

Pursuant to s66(1) of the Commerce Act 1986 notice is hereby given seeking **clearance** of a proposed business acquisition.

OVERVIEW

Fonterra Co-operative Group Limited ("**Fonterra**") intends to issue a formal takeover offer for up to 100 per cent of the shares in National Foods Limited ("**NFL**"). From a New Zealand competition perspective, the only area of overlap between the two operations is in the wholesale supply of yoghurts and dairy desserts, undertaken in New Zealand by Fonterra's subsidiary, Mainland Products Limited ("**Mainland**"), and by NFL's subsidiary National Foods International Fine Foods Limited ("**NFIFF**").

The Commission last considered the wholesale market for yoghurts and dairy desserts in *Decision 459, National Foods/NZDF* (22 March 2002) ("***National Foods***"). Given the information available to it at the time, and the particular features of that transaction, the Commission concluded that there would be a substantial lessening of competition. Since then, new information has become available, particularly on the intentions of supermarkets. Equally importantly, the proposed transaction has fundamentally different characteristics to the one considered in *National Foods*. Hence, contrary to the ultimate conclusion in that decision, this proposed acquisition will not substantially lessen competition (it will, in fact, enhance it) and accordingly a clearance should be granted. There can be no doubt that New Zealand Dairy Foods ("**NZDF**"), as the largest competitor in the market, will materially constrain the merged entity. There is also no basis for concluding that effective and sustainable co-ordinated behaviour would be likely as a result of the acquisition. The three principal reasons why competition will not be substantially lessened are as follows.

First, the conclusion in *National Foods* that that acquisition would enhance the scope for the exercise of unilateral market power would not be justified in the context of the proposed acquisition. In *National Foods*, the proposal involved a merger of the market leader and a number two participant, to create a combined market share of approximately 80%. In contrast, the proposed acquisition involves the two secondary players combining to create a market share of just under approximately 40%, with the market leader, NZDF remaining as the leading player nearly half as large again.

Secondly, significant competitive constraint is provided by the countervailing power of the two supermarket chains. There has been considerable evidence over the last two years of the two supermarket chains exercising their power since the Progressive/Woolworths merger. That merger occurred after the *National Foods* decision, and there is now a very different competitive dynamic (recognised, even at early stages of its development, by the Commission in Decision 487, *Burns Philp/Goodman Fielder*, 21 February 2003) ("***Burns Philp***").

Evidence of the exercise of this power in New Zealand include strategies employed by the supermarket chains which are common overseas such as "category captaincy" described below, their entry through house brands (which is underway) and through their encouragement of new entrants.

Accordingly, for a number of reasons, including that the market and industry structure have moved on in the interim, critical assumptions in this respect which underlay *National Foods* do not accurately reflect the current competition dynamic. Two of those critical assumptions were:

(a) *Supermarkets would not enter this market with house brand products:* in fact, **[ ]**.

Foodstuffs is active in markets for milk, cream, cheese, and other cultured dairy products as they have progressively built their house brand position across the dairy category, and Foodstuffs Lower North Island has recently launched its own specific dairy brand, "Farmgate". Fonterra considers that supermarkets are in fact the most likely entrants and, if there were any attempt to increase price, supermarkets are in the best position to detect any such attempt and respond accordingly. Supermarkets in Australia (and there is now substantial Australian ownership of New Zealand grocery chains) have sought a goal of 30% house branded sales in stores; and

(b) *Branding is a significant barrier to entry*: Entry and expansion as a "premium" operator can be done without a pre-existing brand. To the extent that a brand is required, however, the two supermarket chains are most likely to leverage the growing strength of their existing house brands by extending them to yoghurts and dairy desserts. This could be achieved at a fraction of the cost of establishing a new brand. Product would be sourced from an existing small player or by requiring supply from the mainstream producers (in the latter case giving the chains access to scale economies in production). In addition, the supermarket chains could encourage entry by an offshore brand.

The Commission recognised the competition dynamic in markets constrained by the threat of, or actual entry by, house brand products in *Burns Philp*. Even when there is entry by the house brand product, where firm own-price elasticity is high (as it is here), any increase in average price shrinks total market size, resulting in a reduction in revenue for the supermarket. This overall effect retains competition at the wholesale level even where house brand entry has occurred.

It is by no means unusual in New Zealand to have two main suppliers in the fast moving consumer goods ("**FMCG**") area. There are a number of categories where this occurs, involving very significant participants and where competition is maintained (eg, laundry detergent, nappies, toothpaste). The competition dynamic in FMCG is heavily driven by the supermarkets. Yoghurts and dairy desserts are prime examples of this, where approximately 90% of sales occur through the two supermarket chains. Moreover, the Commission found in *National Foods* that 80% of yoghurts and dairy desserts are sold in supermarkets on promotion at low prices. Yoghurt is one of the core promoted products that signal the value proposition of the supermarket (a feature recognised by the Commission in *Decision 448*, *Progressive/Woolworths,* and in *Burns Philp*). As was recognised in *Burns Philp*, the supermarkets drive pricing promotions, they determine the supplier margins, and thus they determine the ability of suppliers to reinvest (against a backdrop of no incentive by the supermarkets to raise prices at retail but to secure the maximum share of the profit from the suppliers).

Structurally, the two supermarket chains discourage a proliferation of suppliers and brands. Instead, they prefer to have a supplier structure in which a strong market leader drives innovation and advertising promotion (to maintain consumer interest in the product category), with a second participant permits the supermarkets to play the two off against each other and to provide product variety for the consumer. Third and subsequent competitors often simply add complexity to the supermarkets' operation and it is often the case that the house brand is the preferred third player adding strength to the supermarket's own portfolio of products within its house brand range. This market structure is often referred to as the "category captain" phenomenon and behaviour designed to achieve this in a number of categories has increased over the last two years and has recently extended to yoghurts and dairy desserts.

Moreover, given the very real threat (**[ ]**) of entry by house brands, the market for wholesale supply of yoghurts and dairy desserts exhibits more competitive features than a number of other categories of FMCG in which there are only two main suppliers and little, if any, penetration by house brands.

Allowing Mainland and NFIFF to consolidate their operations will enhance competition, creating a number two with scale efficiencies to credibly challenge the market position of NZDF. In the battle among the suppliers, and between the suppliers and the two supermarket chains, the continued asymmetry of market share will mean that Mainland/NFIFF will have a real incentive to strive to capture market share, offering a better product value proposition for supermarkets, and ultimately consumers.

Finally, in *National Foods* the Commission considered that an acquisition by NFL of NZDF was not likely to materially increase the scope for coordinated market power. The same conclusion should apply here, because:

(a) The factors which led the Commission to that conclusion continue to apply, namely, asymmetrical market shares and the drive by Mainland to increase market share.

(b) Those factors are stronger in respect of the proposed acquisition. The asymmetry of shares will still result as a result of the acquisition. But this is the outcome of the two smaller participants merging to compete against NZDF with the largest market share (**[ ]**). Moreover, the proposed acquisition will enable Mainland/NFIFF to gain the scale needed to compete more effectively against NZDF. Not only is the asymmetry of shares itself conducive to ongoing competition but the scale which would be achieved from the acquisition will enhance the continuing competitive conduct in the market. NZDF is a sophisticated competitor with the ability, resources and incentive to defeat any attempt by the merged entity to pursue a unilateral strategy of price elevation.

In summary:

(a) In accordance with the Commission’s conclusions in *National Foods*, the proposed acquisition will not materially increase the scope for coordinated market power.

(b) However, in contrast to the Commission’s conclusions in *National Foods*, the proposed acquisition would not enhance the scope for the exercise of unilateral power. Distinguishing factors include:

- The merger of two minor players under the proposed acquisition would leave the merged entity with a **[ ]** market share, with NZDF remaining the leading player with a share almost half as large again, with the resources, ability and incentive to defeat any attempt to raise prices following the acquisition.

- Significant competitive constraint is provided by the countervailing power of supermarket chains which has strengthened since the *National Foods* decision with the merger of Progressive/Woolworths. Evidence of this power is the ‘category captains’ strategy adopted by the major chains.

- There is evidence that supermarkets are entering this market with house brand products. This includes the continued extension of house-branded dairy products across the category in the last few years, and more recent evidence of a major chain embarking on a tender for house-branded yoghurt. Branding is not a barrier to entry, since the supermarket chains can leverage their existing house-brands by extending them to yoghurt.

(c) Firm-price elasticity is high for this category. This provides an overall, and significant, competitive constraint because there will be no incentive for the two supermarket chains to co-ordinate with suppliers post acquisition to raise retail prices.

The market structure emerging in New Zealand after the proposed acquisition, with two main suppliers in an FMCG sector, is by no means unusual. There are a number of categories in which this occurs, involving very significant participants, but in which competition remains vigorous.

PART I: TRANSACTION DETAILS

1. THE BUSINESS ACQUISITION

1.1 Clearance is sought in respect of the proposed acquisition by Fonterra Co-operative Group Limited, or a wholly-owned subsidiary, (“**Fonterra**”) of up to 100% of the shares in National Foods Limited (“**NFL**”).

1.2 Fonterra currently holds 17.2% of the shares in NFL, and has an agreement to acquire a further 1.8%, conditional on approval of the Australian Foreign Investment Review Board.

1.3 A formal takeover offer has not yet been issued, but is expected to be on or about Thursday, 4 November 2004. Once issued, a copy will be provided to the Commission. A copy of the press release formally announcing the intended offer, and a document describing the conditions on which the offer will be made have been provided to the Commission in advance of this application.

1.4 This notice is given by:

Fonterra Co-operative Group Limited
Private Bag 92032
Auckland
New Zealand

Ph: (09) 374 9000
Fax: (09) 379 8284

(a) Attn: David Matthews, General Counsel

1.5 All correspondence and notices in respect of this application should be directed in the first instance to:

Matthew Dunning
Barrister
Park Chambers
PO Box 5844
Wellesley Street
Auckland

Ph: (09) 379 9780
Fax: (09) 377 0361

Russell McVeagh
Barristers & Solicitors
P O Box 8
Level 30, Vero Centre
48 Shortland Street
Auckland

Attn: Sarah Keene

Ph: (09) 367 8133
Fax: (09) 367 8596

2. CONFIDENTIALITY

2.1 Confidentiality is sought in respect of all items deleted from the public copy of this application ("**confidential information**"). The items are either indicated in the non-public version in square brackets ("**[ ]**"), or contained in **Appendix 1**, the entire contents of which are confidential.

2.2 In respect of the confidential information, a confidentiality order is sought under section 100 of the Commerce Act 1986 ("**Act**"), and confidentiality is claimed under section 9(2)(b)(ii) of the Official Information Act 1982, on the grounds that the information is commercially sensitive and valuable information which is confidential to the participants, and disclosure of it is likely to give unfair advantage to competitors of the participants and/or unreasonably to prejudice the commercial position of the persons involved.

2.3 Fonterra requests that it be notified of any request made to the Commission under the Official Information Act for release of the confidential information, and that the Commission seeks its views as to whether the information remains confidential and commercially sensitive, at the time responses to such requests are being considered. In particular, in respect of proprietary information from Aztec, arrangements with it require notification to Aztec in the event access is sought to the material by third parties.

3. DETAILS OF THE PARTICIPANTS

3.1 The proposed acquirer is Fonterra.

3.2 Fonterra is a co-operative company incorporated under the Companies Act 1993 and registered under the Co-operative Companies Act 1996. Shares in Fonterra are held by approximately 12,000 supplier shareholders. The most recent corporate structure diagrams for Fonterra are attached at **Appendix 1**.

3.3 The shares in any company acting as the purchasing vehicle for this transaction will be wholly owned by Fonterra or by one of Fonterra's wholly-owned subsidiaries. It is presently contemplated that the purchase will be completed by a new wholly-owned Australian subsidiary of New Zealand Milk (Australasia) Pty Ltd, which is in turn wholly-owned by Fonterra.

3.4 The proposed target is NFL.

3.5 NFL is an Australian registered company (ACN 004 486 631) listed on the Australian Stock Exchange. Its New Zealand operations are conducted by its subsidiary, National Foods International Fine Foods Limited ("**NFIFF**"). Contact details for NFIFF are:

National Foods International Fine Foods
100 Highbury Avenue
Palmerston North

Ph: 06 355 1155
Fax: 06 356 1293

Attn: Scott Pannell, General Manager

3.6 Further information concerning NFL, including a list of significant shareholders as at 6 August 2004 may be found at www.nationalfoods.com.au/investor_centre in the 2004 concise report. A significant change to the shareholdings since that report is the recent sale by Australian Co-operative Foods Ltd (a subsidiary of Dairy Farmers of Australia) of its 9.2% shareholding. Further information concerning NFL's New Zealand operations may be found at www.yoplait.co.nz.

4. INTERCONNECTED AND ASSOCIATED PARTIES

4.1 **Fonterra**:

(a) Please refer to the corporate structure diagram at **Appendix 1**.

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

4.2 **NFL**:

(a) A list of subsidiaries of NFL may be found at www.nationalfoods.com.au /investor_centre in note 28 to the 2004 Financial Report to Shareholders.

(b) No other relevant entity is expected to continue to own over 10% of the shares in NFL after the proposed acquisition.

5. BENEFICIAL INTERESTS

5.1 Neither Fonterra nor NFL holds any relevant beneficial interest except as set out in paragraph 4.1(b) above.

6. LINKS BETWEEN COMPETITORS

6.1 As a consequence of the industry structure in the Dairy Industry Restructuring Act 2001 and the formation of Fonterra, Fonterra supplies raw milk, cream and other products to NZDF, manufactures and packages butter and cheese on its behalf and licences the "Anchor" brand in New Zealand. NZDF supplies certain UHT products to Fonterra for export. Except as described above, Fonterra does not believe there to be any links, formal or informal, between the participants and its/their competitors.

6.2 No directors of Fonterra or its subsidiaries hold directorships in any other companies that are involved in any markets in New Zealand in which NFL operates.

7. BUSINESS ACTIVITIES OF EACH PARTICIPANT

Fonterra Co-Operative Group

7.1 Fonterra is a New Zealand-headquartered co-operative dairy company. It operates in New Zealand through its subsidiaries, as set out in the Fonterra corporate structure chart attached at **Appendix 1**, and in Australia through subsidiaries which include Peters & Brownes Foods and Bonland Dairies, and its joint venture, Bonlac Foods.

7.2 Fonterra comprises two main businesses:

(a) *Ingredients*, which produces and internationally markets dairy commodities, such as milk powders, butter, cheese and value-added dairy ingredients. It also carries out the collection and processing of milk. The ingredients business accounts for approximately two thirds of Fonterra's revenue, and operates 25 manufacturing sites in New Zealand. It is also involved in the research and development of new value-added ingredients.

(b) *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. Its major brands include "Anchor" (but not in New Zealand), "Anmum", "Anlene", "Soprole", "Brownes", "Bega", "Mainland", "Meadow Fresh" and "Western Star".

7.3 In New Zealand, Fonterra has a subsidiary, Mainland, which produces yoghurts and dairy desserts under the brands "Meadow Fresh", "Weight Watchers", "Blues Clues" and "Naturalea".

National Foods

7.4 NFL is an Australian food company, with core activities in milk, fresh dairy foods and specialty cheeses. It is listed on the Australian Stock Exchange. Its signature brand is "Pura".

7.5 NFL's annual turnover is in excess of A$1.0 billion. It produces fresh milk, and full cream, flavoured and modified fresh and UHT milks. Its milk brands include "Pura Light", "Start", "Masters", "Farmers Union" and "Classic" brands.

7.6 NFL also produces yoghurt, dairy desserts, fromage frais, and cream cheese under the "Yoplait", "Fruche", "Divine Classic", "YoGo" and "Farmers Union" brands. It also produces a range of specialty quality cheeses under the "King Island Dairy", "South Cape", "Tilba", "Timboon" and "Clover Creek" brands.

7.7 NFL has three New Zealand subsidiaries: National Foods International Fine Foods Ltd ("**NFIFF**"), National Foods New Zealand Holdings Ltd and National Foods Share Plans (NZ) Ltd. NFIFF sells yoghurt and dairy dessert products in New Zealand. It also acts as an agent for a range of non-dairy products which are not relevant to this application.

8. THE REASONS FOR THE PROPOSAL

8.1 The proposed transaction is Australia-focussed and is the premier strategic opportunity for Fonterra to:

(a) Take advantage of projected growth in dairy markets around the world, particularly in Asia, by building on Australasia's unique competitive advantage which is based on its co-operative heritage, open competitive markets, low cost structures, efficiency, and a subsidy-free environment;

(b) Utilise any available synergies across the businesses to produce the best products, in the most efficient way, utilising the latest thinking on consumer trends and product innovation;

(c) Utilise Fonterra's research and development and innovation businesses to capture opportunities to create the highest quality, leading dairy products at competitive prices; and

(d) Permit Fonterra to expand into the national yoghurt and national milk market in Australia. These are categories with good growth prospects and they complement Fonterra's existing businesses in cheese and spreads. Through this acquisition, Fonterra seeks to create an even better and more efficient trans-Tasman consumer dairy business that can build on Fonterra's dairy brands, product innovation and existing export base. In New Zealand, this will be derived through additional efficiencies in Mainland's plant utilisation and transportation costs arising from the consolidation of NFIFF and Mainland operations in New Zealand.

PART II: IDENTIFICATION OF MARKETS AFFECTED

9. HORIZONTAL AGGREGATION

Market Definition

Product Dimension

9.1 Yoghurts and dairy desserts are the only products sold in New Zealand that are manufactured by both Fonterra and by NFL, through its subsidiary NFIFF. Accordingly, these are the only products affected by this acquisition.

9.2 In Decision 459*, National Foods Ltd / New Zealand Dairy Foods Ltd* (*"**National Foods**"*), the Commission defined a narrow market for the manufacture and wholesale supply of yoghurts and dairy desserts in New Zealand. This market definition excluded homemade yoghurts and other cultured dairy products.

9.3 At the manufacturing level, yoghurt is one of the oldest and simplest products to produce. The manufacturing technology and know-how is readily available internationally. Owners of brands have to be of sufficient scale to be able to invest in product development and promotion. Owners of significant non-yoghurt brands (such as supermarkets with their house brand ranges of related products) would have no difficulty contracting for the manufacture of yoghurt.

9.4 In addition, there are ranges of products which are manufactured by other suppliers which fall outside the market for yoghurts and dairy desserts as defined, but which can be put to similar use and form part of the choices facing consumers. These include:

(a) Drinkable yoghurt products and "smoothies" (substitutable for yoghurts and dairy desserts eaten as a healthy light snack);

(b) Dairy and non-dairy snacks, such as cheese segments, cheese snacks, fruit jellies, yoghurt and muesli bars (substitutable for yoghurts and dairy desserts eaten as a dairy snack or in lunch boxes);

(c) Sour cream, crème fraiche, fromage frais, cream cheese (used in substitution for yoghurt in cooking); and

(d) Other dairy and non-dairy desserts, such as frozen yoghurt, ice-cream, custard-based and similar desserts, and microwaveable desserts (used in substitution for yoghurts and dairy desserts eaten as a dessert).

9.5 For reasons elaborated below, Fonterra does not consider it feasible that there could be a significant increase in the price of yoghurts and dairy desserts post-acquisition, given the existing forces of competition operating in this market. Fonterra also does not consider that this application will give rise to competition concerns on a market definition which either includes or excludes homemade yoghurt (or other products). Accordingly, while maintaining that the market can properly be defined as broader in scope, for the purposes of this application only this application proceeds on the narrower basis that the relevant market is that defined in *National Foods*, being the market for the manufacture and wholesale supply of yoghurts and dairy desserts in New Zealand.

Functional Dimension

9.6 The market operates at the wholesale level, between manufacturers and retailers in the grocery sector. Over 90% of yoghurts and dairy desserts are sold in major supermarkets, with the balance sold directly into the convenience channel (e.g. small supermarkets, corner dairies, service stations) and to the food service channel (e.g. restaurants, hotels, cafés) variously either direct or via distributors. Fonterra estimates that such sales would comprise less than 10% of the market.

9.7 The major supermarkets in New Zealand are highly concentrated into two chains, Progressive and Foodstuffs. Those entities constitute powerful buyers of grocery items.

Geographic Dimension

9.8 The geographic market is New Zealand, given the national purchasing regimes of the major supermarkets. In many grocery lines, the supermarkets may seek suppliers outside New Zealand (mainly Australia). However, due to the fresh nature of most yoghurt and dairy desserts and air transport costs, procurement of these products has remained New Zealand based, except for small volumes of imported soy yoghurt.

Current competitors in the market

9.9 Current suppliers of yoghurts and dairy desserts are (all market shares below are for sales in major supermarkets by value):

(a) *New Zealand Dairy Foods Limited* ("**NZDF**")

NZDF is a 100% subsidiary of Rank Group Ltd. NZDF has a market share of **[ ].** NZDF sells yoghurt and dairy dessert products under the "Fresh 'n Fruity", "Swiss Maid", "Calci-Yum", "Symbio", "Metchnikoff", "De Winkel", "Simply Organics" and "Slimmers' Choice" brands.

(b) *Mainland Products Ltd* ("**Mainland**")

Mainland is a 100% subsidiary of New Zealand Milk Ltd, which is itself a 100% subsidiary of Fonterra. Mainland sells yoghurt and dairy dessert products under the "Meadow Fresh", "Weight Watchers", "Blues Clues" and "Naturalea" brands. Mainland has a market share of **[ ].**

(c) *National Foods International Fine Foods Ltd* ("**NFIFF**")

NFIFF is a 100% subsidiary of NFL and New Zealand licensee of the "Yoplait", "Vigeur", "Yogo", "Petit Miam" and "Le Rice" brands. NFIFF has a market share of **[ ].**

(d) *Serra Natural Foods Ltd* ("**Serra**")

Serra is a privately owned New Zealand company. Serra sells products under the "Cyclops" brand. Since *National Foods*, Serra has nearly doubled its share of the yoghurt segment from approximately **[ ]** to over **[ ].** This has moved it from **[ ]** of the total market for yoghurts and dairy desserts. The growth of the "Cyclops" brand is described in more detail in paragraph 14.1 below.

(e) *Others*

Other competitors in this market include Biofarm Products Ltd ("**Biofarm**"), which sells products under the "Biofarm" brand and has a market share of **[ ]**; and Karikaas Natural Dairy Products Ltd ("**Karikaas**") which sells products under the "Supreme Flora" brand and has a market share of **[ ]**. In addition, there are small quantities of imported soy yoghurt and gourmet dairy desserts.

(f) *Home made yoghurt*

The main supplier of home made yoghurt equipment and product is EasiYo Products Ltd ("**EasiYo**"). Home made yoghurt sales account for **[ ]** of total yoghurt sales. More information about EasiYo can be found at www.easiyo.co.nz.

The total market share of the participants listed in (d) – (e) above in the market for yoghurt and dairy desserts is in the vicinity of **[ ]**, having grown from approximately **[ ]** in December 2002.

9.10 Fonterra is not aware of any ownership, contractual or other relationship between any of these other industry participants.

Effect of acquisition in terms of horizontal aggregation

9.11 The horizontal effect of the acquisition will be to combine the operations of Mainland with those of NFIFF, with a combined market share of **[ ]**. The market leader, nearly half as large again, will remain NZDF, with **[ ]** of the market.

10. DIFFERENTIATED PRODUCT MARKETS

Extent Of Product Differentiation

10.1 As the Commerce Commission acknowledged in *National Foods*, while yoghurt and dairy dessert products are differentiated from one another to some extent, this differentiation is insufficient to prevent the different brands from being substitutable with one another (para 100). Yoghurts and dairy desserts vary between products in terms of flavours, levels of fruit content, taste and texture, fat content and packaging, branding and image differences.

10.2 Yoghurts and dairy desserts are heavily price-promoted in supermarkets through specials brochures, in-store advertising, and other promotional material. As the Commission is aware (*Decision 448, Progressive Enterprises Ltd / Woolworths (NZ) Ltd* ("***Progressive***"), paragraph 214), one key way in which supermarkets compete is by reference to certain regularly promoted staples, such as soft drinks and washing powder. The Commission last considered this phenomenon in *Decision 487, Burns Philp & Company Ltd / Goodman Fielder Limited* ("***Burns Philp***") regarding the wholesale market for consumer yellow spreads. In that determination, the Commission observed (para 95):

> Consumer yellow spreads are one of a limited basket of headline products which supermarket operators use to attract shoppers to their supermarket. Further examples are other dairy products and bread. Supermarket operators are particularly price-sensitive in respect of these products.

10.3 Yoghurts and dairy desserts are in this category of "core promoted" products that signal the value proposition of the supermarket. The Commission observed in *National Foods* (para 28) that over 80% (by volume) of yoghurts and dairy desserts sold are on some kind of promotion. These promotions are funded by the suppliers, through pressure from the supermarkets.

11. VERTICAL INTEGRATION

11.1 The proposal will not result in any material vertical integration effects.

11.2 Fonterra is the primary manufacturer of raw milk in New Zealand.

11.3 Under the Dairy Industry Restructuring (Raw Milk) Regulations 2001 ("**Raw Milk Regulations**"), Fonterra is required to supply raw milk to any independent processors who seek it, including competitors, up to a maximum total of 400 million litres per year (r 11(2)). Unless otherwise agreed, Fonterra must under the Raw Milk Regulations (r 8) supply milk to competitors at the "default milk price". This means that the price of raw milk is set at a competitive level.

11.4 The effect and, indeed, legislative intention, of these regulations is that there is no ability or incentive for Fonterra to leverage market power in this supply market. Indeed, the regulations create an environment specifically designed to facilitate entry and expansion in dairy produce markets in New Zealand.

11.5 While NFIFF does not purchase raw milk directly from Fonterra, but rather processed milk from an independent processor, Fonterra estimates that NFIFF uses the equivalent of **[ ]** million litres of raw milk (in processed milk) to produce its current volumes. The assimilation of NFIFF into the Fonterra group would effectively free up NFIFF's current use of processed milk, which would then become available to other third parties.

12. PREVIOUS ACQUISITION AND COMMISSION NOTIFICATIONS

12.1 Set out in **Table 1** is a list of the previous acquisitions involving either Fonterra or NFL (or any interconnected body corporate or predecessor thereof) as applicant or target notified to the Commission in the last three years:

Table 1

Commerce Commission Notifications in the last three years involving Fonterra or NFL

Dec'n No	Date	Applicant	Target	Determination	End Result
454	14/02/2002	Mainland Products Ltd	Southern Fresh Milk Company Ltd	Cleared	proceeded
459	22/03/2002	National Foods Ltd	New Zealand Dairy Foods Ltd	Declined	Did not proceed
459A	26/09/2002	National Foods Ltd	New Zealand Dairy Foods Ltd	Parties not associated	Did not proceed
462	29/04/2002	Anchor Investments Ltd	Grated Cheese Company Ltd	Cleared	proceeded

12.2 In addition, Fonterra is a party to the Commission's determinations under the Dairy Industry Restructuring Act 2001, copies of which are located at http://www.comcom.govt.nz/dairy/decisions.cfm.

12.3 Fonterra has not undertaken any other acquisition of assets of a business or shares in any markets material to the Commission's present investigation in the last three years.

PART III: CONSTRAINTS ON MARKET POWER BY EXISTING COMPETITION

13. EXISTING COMPETITORS IN MARKET

13.1 The leader in the market for yoghurts and dairy desserts is NZDF. Mainland and NFIFF are smaller competitors in this market. In addition, there are a number of competitors on a smaller scale again, of which Serra in particular, with its "Cyclops" brand of yoghurt, is a rapidly expanding example. More detail on each of the market participants is described in paragraph 9.9 above. Approximate market shares are set out in **Table 2** below.

Table 2

Market shares (by volume and value) in yoghurts and dairy desserts sold through supermarkets
(as at 3 October 2004)

Supplier (Owner)	Market share % (value)	Market share % (volume)
NZDF (Rank Group)	[ ]	[ ]
Mainland (Fonterra)	*[ ]*	*[ ]*
NFIFF (NFL)	*[ ]*	*[ ]*
[Combined]	[ ]	[ ]
Serra	[ ]	[ ]
Biofarm	[ ]	[ ]
Karikaas	[ ]	[ ]
Other	[ ]	[ ]
Total	**100.0%**	**100.0%**
Total market	[ ]	[ ]

Source: [ ]

13.2 Fonterra will provide the Commission with further information relating to historical market share trends shortly.

14. CONDITIONS TO EXPANSION BY EXISTING COMPETITORS

14.1 Entry costs are low and the regulatory framework is designed to facilitate entry. It is relatively easy to set up a yoghurt producing operation on a small scale and then grow it incrementally. The only relevant regulatory requirements are sanitary requirements, and these are easily complied with. The significant presence of home yoghurt makers indicates the ease with which the product can be manufactured.

14.2 While the Commission observed in *National Foods* that brand perception was a barrier to entry and expansion, this does not appear to be the case. First, the prime threat from new entry comes not from the introduction of new brands by independent suppliers, but (as elaborated in section 23 below) from the supermarket chains choosing to introduce yoghurt house brands. A house brand can be launched at the necessary scale to compete effectively with NZDF. During its analysis in *National Foods*, the Commission expressed the view that supermarkets were unlikely to launch yoghurt house brands. As Fonterra demonstrates with the example of **[ ]**, new information indicates that **[ ]**.

14.3 Branding would not be a problem for either supermarket chain. Even if they did not acquire an existing established brand from an existing operator, or a brand such as Nestlé's "Ski" brand, which had a presence in New Zealand in the past but is not currently licensed, their own "Pam's", "Basics" and "Signature Range" have significant market penetration and are already used in milk, cheese and cultured dairy product ranges. As noted in paragraph 23.2 below, Foodstuffs Lower North Island ("**Foodstuffs LNI**") has recently launched a new dairy brand, "Farmgate", committing significant resources in advertising and marketing to achieve sales not only in the Foodstuffs chain but also to the convenience channel.

14.4 Secondly, in less than a year, Serra has obtained distribution arrangements with supermarkets for its "Cyclops" product, which have seen its share of total supermarkets' key accounts in yoghurt grow from **[ ]** to **[ ]**. In the neighbouring market for fresh milk, Fonterra has entirely re-branded its "Tararua" brand milk to "Meadow Fresh", with barely any impact on its product's market share.

14.5 Supermarkets have a strong incentive to discipline the “category captain”. Any attempt by the major yoghurt and dairy dessert manufacturers to increase average price would be immediately detected, and would encourage the supermarkets either to grow a smaller competitor's share, or (which is more likely) to enter the market themselves.

15. EXAMPLES OF EXPANSION BY EXISTING COMPETITORS

15.1 Fonterra believes that its competitors in the yoghurts and dairy desserts market (and, in particular, NZDF) have significant excess plant capacity. Indeed, Fonterra understands that the economies of scale involved in operating the NZDF plant mean that, if its market share in the yoghurt and dairy foods market falls significantly below its current levels, NZDF loses the benefit of low average operating costs because of the type of packaging technology in use, and so discounts aggressively to ensure that it achieves sufficient throughput of yoghurt and dairy food products.

15.2 Fonterra considers that the supermarket chains, in particular, Foodstuffs, would be the most likely near-entrant to expand into this market in response to a significant price increase. Foodstuffs has contracts with NZDF and Mainland for the supply of house branded milk, cream, cheese and cultured dairy products for supply throughout New Zealand, and Foodstuffs LNI has commenced its own "greenfields" milk processing operation producing milk and cream. In addition, in around September 2003, Foodstuffs LNI purchased the Kapiti Cheese Company, which produces a range of high value cheeses and ice creams, showing its willingness to own and operate a branded dairy products business in addition to its drinking milk operations. It would be a small step for Foodstuffs to similarly acquire its own yoghurt production facility, either by purchasing the plant and expertise, or by purchasing new or second-hand plant, which is freely available on the international market, or a combination of both.

15.3 In summary, the threat of expansion into the market for yoghurts and dairy desserts by a supermarket chain (or potentially a new entrant supported by a supermarket chain) will continue to act as a considerable constraint on the pricing of the incumbent operators.

15.4 In addition, raised prices would encourage the further growth of the smaller players such as Serra, Biofarm and Karikaas, as well as potentially other new entrants.

16. CONCLUSIONS ON CONSTRAINT BY EXISTING COMPETITION ON EXERCISE OF UNILATERAL MARKET POWER

16.1 The proposed acquisition is fundamentally different from that which the Commission considered in *National Foods*, in respect of the issue of unilateral market power. It involves a merger of the two smaller players, the resulting entity will still be considerably smaller than NZDF, and will not possess market power of itself. If it were to seek to act unilaterally to increase prices or restrict output in the wholesale yoghurts and dairy desserts market, competitors such as NZDF, and near-entrants such as Foodstuffs, are 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*.

16.2 As a result, the acquisition will not substantially lessen competition in this market. To the contrary, the acquisition would have a pro-competitive effect. As pointed out above, 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.

16.3 The ultimate industry structure that will result from this transaction is not uncommon in consumer product markets in New Zealand, where the products are sold predominantly through supermarkets. In fact, given the countervailing role of supermarkets, a FMCG 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, is more competitive than a structure with a single "category captain" and two or more small scale followers. Hence, we consider the proposed transaction to be pro-competitive.

16.4 Table 3 sets out some heavily promoted, "core promoted" products sold by supermarkets. What these markets have in common is that the two largest suppliers together have in excess of 80% market share, and individually each has more than a 30% share. Moreover, as **Table 3** reveals, the suppliers are not 'minnows' in the New Zealand market. Nevertheless, their scale appears to have been used to best advantage by the supermarket to obtain a regular flow of discounts.

Table 3

Two-supplier markets - "core promoted" product ranges

PRODUCT	Largest	%	Second	%	Total 1&2 %	House brand %	Other %
Laundry Detergent	Unilever	[ ]	Colgate Palmolive	[ ]	[ ]	[ ]	[ ]
Toothpaste	Colgate Palmolive	[ ]	GlaxoSmithKline	[ ]	[ ]	[ ]	[ ]
Nappies	Kimberley Clark	[ ]	Sca P/L	[ ]	[ ]	[ ]	[ ]

Source: [ ]

16.5 In deciding on their competition strategy, supermarkets tend to designate a "category captain" – a lead firm whose products headline promotional activity. In a competitive market, one would expect different supermarkets to identify different suppliers as "category captains". This is the case with many other FMCG categories, where the products are manufactured by two strong competitors. For example, some supermarkets anchor their promotions on Treasures nappies, while others lead with the Huggies brand. By contrast, in this market, NZDF brands serve as "category captains" for all supermarkets. Given their current scale, neither Mainland nor NFIFF is able to secure this cornerstone role.

16.6 The net result of this is that Mainland is unable to obtain sufficient returns to warrant additional investment to materially impact NZDF's leading market position (by way of product quality improvement, innovation, new product development, advertising and promotion). For example, Mainland can only justify its television advertising promotion of the "Meadow Fresh" brand in yoghurts and dairy desserts by the scale achieved through spreading the promotional cost over its similarly branded milk products. In the year ending 30 June 2003, NFIFF made only 3.8% return on equity (see NFIFF Annual Report to June 2003, attached at **Appendix 2**) and it has not run a television advertising campaign for its "Yoplait" brand in nearly two years.

16.7 This does not mean that Mainland and NFIFF do not innovate at all, or that NZDF does not compete on price. Frequent product re-launches are necessary simply to maintain share in this dynamic market, and frequent price promotions are demanded by the supermarket chains in order to attract customers to their supermarkets. Steps taken by supermarket chains here in New Zealand, and evidenced in countries such as the UK and Australia, to rationalise the number of suppliers in each category (described in more detail below) will exacerbate this effect.

16.8 There is strong firm-price elasticity for these products and so no incentive for the two supermarket chains to co-ordinate with suppliers post-acquisition and raise prices at retail. Accordingly, there will continue to be the competitive tension between supermarkets and suppliers for margin, and this transaction will not alter the level of price promotion in this market (being driven by the two supermarket chains). However, as a result of the synergies arising from the transaction, a combined Mainland/NFIFF would be better able to justify further investment in product improvement and advertising promotion to act as a more effective competitor to NZDF, thereby providing a better value product offering for the ultimate benefit of consumers.

17. MARKET CHARACTERISTICS FACILITATING OR IMPEDING COORDINATION

17.1 The proposed acquisition will not increase scope for the exercise of coordinated market power:

(a) Mainland and NFIFF will have a greater ability to compete strongly against NZDF, with better efficiencies arising out of the combination of their operations.

(b) In *National Foods*, the Commission did not consider that there would be scope for coordinated market power. That conclusion must be even more robust here, where:

(i) the two smaller players only would merge; and

(ii) Fonterra (Mainland) would continue to be driven to compete aggressively, as the Commission accepted it was then against NZDF.

(c) While the transaction will reduce the level of asymmetry from that in *National Foods*, it will still be significant. NZDF will be half the size again of a combined Mainland/NFIFF, providing the merged entity with an incentive to try to grow market share. The remaining asymmetry in size will, therefore, make coordination very unlikely. The post transaction market structure will no longer be characterized by the leader-follower dynamics of the current market, and hence is likely to be even less conducive to coordination, not more.

(d) There is significant firm-price elasticity such that there is no incentive for the two supermarket chains to participate in oligopolistic behaviour with its suppliers post-acquisition by raising prices.

(e) The competitive tension which already exists in the market by virtue of the contest between two actively powerful supermarket chains and the pressure they put on suppliers for margin, will continue. As discussed in paragraph 23 below, the supermarket chains have and will continue to have significant countervailing buyer power, both because over 90% of product is sold via supermarkets and through the threat of house brand/self supply by supermarkets, which is an impending reality.

(f) As yoghurts and dairy desserts are "core promoted" products, regularly promoted via discounting, the supermarkets will be quickly able to detect any price increase and to discipline such attempts by diverting demand from the major suppliers by the threat of de-listing, or by production of house brand product.

(g) Consistent with the approach taken by the High Court in *Brambles New Zealand Ltd v Commerce Commission* (2003) 10 TCLR 868 (HC), the conditions for concluding that there would be effective and sustainable coordinated behaviour as a result of the acquisition simply do not exist.

17.2 **Tables 4**, **5** and **6** below comment on the market characteristics set out in the Commission's *Mergers and Acquisitions Guidelines*:

Table 4

Scope for co-ordinated market power in market for yoghurts and dairy desserts

Feature	**Comment**
High seller concentration	Reasonably high. However, significant asymmetry of market shares remains.
Differentiated product	Yes. Product differentiated by brand perception and product characteristics.
Static production technology	No. Innovation still high and encouraged by supermarkets.
Speed of new entry	High. New/near-entrants identifiable.
Fringe competitors	Yes, some local producers.
Acquisition of a maverick	No. NFIFF not a disproportionately vigorous or effective competitor.
Price elastic market demand	Reasonably elastic demand, subject to product differentiation as described above.
History of co-ordinated conduct	No. See *National Foods* para 182.
Countervailing power of acquirers	High.
Existence of excess capacity	Yes. NZDF. See also *National Foods*, para 182.
Industry associations/fora	Dairy Companies Association of New Zealand (representation on regulatory and other matters affecting the dairy industry)

Table 5

Detection of deviation from co-ordination

Feature	Comment
Seller concentration	Reasonably high; however, not significantly different to other leading categories.
Frequent sales	Yes. Frequent, small orders, and negotiated promotions.
Vertical integration	No. Except for Fonterra/Mainland. No ability to take advantage of any vertical integration – statutory scheme of Raw Milk Regulations means acquisition pro-competitive in this respect.
Growth in demand	Yes. Demand for yoghurts and dairy desserts is growing somewhat rapidly, at the rate of over 9% last year.
Cost similarities	No. NZDF has greater economies of scale and, therefore, its production costs are lower.
Multi market contact	Each of Mainland and NZDF sell a variety of dairy product categories, and there are production, supply and packaging arrangements in place.
Price transparency	Retail price information is available to competitors via Aztec or AC Neilsen, collected by the major supermarket chains.

Table 6

Ability to retaliate

Feature	Comment
Credibility of threats to abandon collusion	Without participation of supermarkets, retaliation threats would not be credible.
Availability of excess capacity	Yes.
Profit incentive from collusion	Limited by supermarkets' agenda for a "core promoted" product.
Ability to disadvantage by dumping in deviator's allocated section of market	Only with co-operation of supermarkets.

18. EVIDENCE OF PAST OR CURRENT COORDINATION

18.1 The wholesale yoghurt and dairy desserts market does not show any evidence of price coordination, price matching or price following behaviour by market participants.

19. CONCLUSIONS RE CONSTRAINT BY EXISTING COMPETITION ON CO-ORDINATION

19.1 The Commission has recognised that Mainland seeks to be an aggressive competitor. The acquisition of NFIFF will not alter that behavioural characteristic and a significant asymmetry of market share vis-à-vis NZDF will exist. Mainland/NFIFF will necessarily continue to strive to become the market leader in the segments in which it competes, by providing consumers with the best product at the best price.

19.2 To do this in the market for yoghurts and dairy desserts, Mainland will benefit from the ability to leverage NFIFF's brands through additional scale economies, to provide it with a sufficiently cost-effective platform to efficiently compete with NZDF's "Fresh 'n Fruity" and "Swiss Maid" products, on marketing and promotion, product innovation, quality and price.

19.3 For all the reasons set out above, the application of the tests in the Commission's Guidelines reveal that there would not be scope for the exercise of co-ordinated market power in this market.

PART IV: CONSTRAINTS ON MARKET POWER BY POTENTIAL COMPETITION

20. CONDITIONS OF ENTRY

20.1 As discussed in the section relating to conditions for expansion, there are no relevant regulatory or legislative conditions to entry. Facilities for the production of yoghurts and dairy desserts are readily able to be purchased, second hand or new, to varying sizes and specifications, on the international market. There are economies of scale, both with respect to manufacturing and marketing, but these do not represent barriers to entry in the sense used in competition analysis. A new entrant wishing to operate at significant scale would not incur additional expense over and above what had been required of the incumbents.

20.2 There are a number of potential entrants in the market for yoghurts and dairy desserts, such as supermarket chains and international licensors of well-established global dairy brands. However, the recent initiatives by both major supermarket chains is evidence that they will be creating house brands in this category. Fonterra considers that the most likely new/near-entrant in own production would be Foodstuffs starting its own house brand or other brand production, as it has done in milk, cream and soon will have in cheese and ice cream (since its purchase of Kapiti).

21. POTENTIAL NEW ENTRANTS:

21.1 As described in paragraphs 20.2 above and 23.10 below, potential new entrants include supermarket chains and international licensors of well-established global dairy brands.

21.2 A new entrant could start up operations and compete almost immediately, provided it obtains the required supermarket listing arrangements to give it the scale to compete effectively. This would not be a problem for Foodstuffs, which has a proven track record of precisely this behaviour in competing in fresh milk, cream and cheese through a combination of own production (lower North Island) and house brand production under contract (throughout New Zealand).

22. CONCLUSION ON POTENTIAL ENTRY

22.1 The actual current threat of entry by the supermarket chains, either through the purchase of a processing facility, or by house brands produced under contract, is and will continue to be a significant constraint on competitive conduct in this market.

22.2 In addition, the ease of entry and expansion by small-scale producers will ensure that these competitors continue to be a feature of this market.

PART V: OTHER POTENTIAL CONSTRAINTS

23. CONSTRAINTS ON MARKET POWER BY THE CONDUCT OF ACQUIRERS

23.1 In the market for yoghurts and dairy desserts, 90% of sales are through supermarkets.

23.2 As the Commission will be aware, there are two major supermarket chains in New Zealand:

(a) Progressive Enterprises Ltd ("**Progressive**"), which is owned by Foodland Associates Ltd (Foodland), an Australian public company. Progressive operates supermarkets under the "Woolworths", "Big Fresh", "Price Chopper", "Foodtown", "Countdown" and "Supervalue" names and has a **[ ]** demand-side market share in the wholesale yoghurts and dairy foods market.

(b) Progressive markets house brand products under the brands "Basic" and "Signature Range". These ranges include milk, cream and cheese. **[**

.]

(c) "**Foodstuffs**", which consists of three co-operative companies based in Auckland, Wellington and the South Island operating under the names "New World", "Pak 'N Save" and "Four Square". Foodstuffs has a **[ ]** demand-side market share in the wholesale yoghurts and dairy foods market.

Foodstuffs' house brand is "Pam's", in which it is currently investing significant promotional expenditure, including the Jamie Oliver series of endorsements. The "Pam's" product range already includes milk, butter, cheese, and other cultured dairy products such as cottage cheese, cream cheese, sour cream, including flavoured and 'lite' versions of those products. It also has a variety of ice cream products in the "Pam's" range. The cultured dairy product ranges have been introduced subsequent to the Commission's decision in *National Foods*.

Foodstuffs LNI also owns the Kapiti Cheese Company, producing a range of high-value cheeses and ice creams under the Kapiti brand, and a raw milk processing facility, producing milk and cream under the "Pam's" and "Farmgate" brands. "Farmgate" was launched in March 2004 as a competing dairy brand, rather than a house brand, with newspaper, radio and television advertising to support the launch. Foodstuffs LNI is also marketing this brand to the convenience and food service channels.

23.3 The Commission early last year considered the countervailing power of the two supermarket chains in *Burns Philp* regarding the wholesale market for consumer yellow spreads. 95% of consumer yellow spreads were sold at wholesale to the two supermarket chains.

23.4 The Commission noted in that decision that, on the basis of its market inquiries (para 124):

> [a]ll persons spoken to during the Commission's investigation of the proposed merger affirmed the very high countervailing power of the two major supermarket

> chains in the … market[,]

and concluded that:

> supermarkets will be able to exert a large degree of countervailing power against the ability of the merged entity to raise prices.

23.5 Similar considerations apply to the wholesale yoghurts and dairy desserts market. Sales to the two supermarket chains are at similar levels. Both are "core promoted" products. Both are constrained by the threat of house brand competition.

23.6 The observation in *Burns Philp* was made not long after the merger between Progressive and Woolworths had been implemented. Since then, there has been considerable evidence of the exercise of countervailing market power, as the concentration into two supermarket chains has bedded down.

Price Promotion competition

23.7 The Commission noted in *Burns Philp* that:

> [s]uppliers submit a three monthly promotion calendar. This calendar is reviewed by supermarkets' category managers, who choose the best offers (discounts) for each week or attempt to persuade suppliers to offer greater discounts. Supermarkets play off suppliers against one another for promotions to get the best deals, and then confirm the promotion calendar.

This discounting policy applies equally to the market for yoghurts and dairy desserts. Between 60-80% of yoghurts and dairy desserts sold in supermarkets are sold on promotion.

23.8 In *National Foods*, the Commission was not convinced that the process of tendering for promotion slots would continue to significantly countervail the market power of the merged entity. That was because the supermarkets:

> have to maintain a certain degree of uncertainty for the suppliers to access promotion slots. For example, if the merged entity knows that it will get 70% of promotion slots (in proportion to its market share) in a month because it is bigger, it would have less incentive to offer low promotion prices.

This factor operates to increase competition in this case, where there is arguably an even greater ability to play NZDF off against Mainland/NFIFF in the allocation of promotion slots, given their closer, albeit still asymmetrical market shares.

23.9 As noted in section 10 and the Overview, management of suppliers through a "category captain" strategy is common overseas and also features in New Zealand. The observations set out in the EC's Green Paper on Vertical Restraints, derived from the supermarkets inquiry in the UK, are relevant here (emphasis added):

> Although the balance of power has clearly shifted towards retailers in the course of the last years, the question of whether it is the manufacturer or the retailer who can determine the terms and conditions of their mutual relation seems to depend very much on the position of a specific brand in a given market segment. Manufacturers are more and more dependent on distributors and grocery retail for getting their products to the consumers. Since the shelve space for new products is limited, conflicts arise between the increasing number of new product launches and the retailers' objective for profit optimization. This conflict has resulted in retailers asking for listing fees (key money) or for discounts schemes which sometimes go beyond possible cost savings of the manufacturers. **Given the pressure on shelve space, products which are not in a number one or two**

> **position increasingly run the risk of being delisted and replaced by large retailers' own brands. As a consequence, in many market segments, the position of the number one and two suppliers, has in many instances been copperfastened**. Market access for other suppliers is becoming increasingly difficult.
>
> Some interlocutors were of the opinion that basically three types of companies have a chance to survive in the long run : large manufacturers with a broad area of products who invest in R&D and new launches of product leaders, 'own label producers' (i.e. manufacturers who produce products for sale by retailers under their respective brand names), and niche operators. On the other hand, **second tier manufacturers (i.e. those with brands in third and fourth position) are increasingly 'sandwiched' between brand leaders and downmarket own brands of big retailers and often have no choice other than to become a subcontractor and to produce under a retailer's brand**.

Supermarket house brands

23.10 At present, there are no supermarket house brands for yoghurts or dairy desserts. In *National Foods,* the Commission stated that it was unlikely that the supermarket chains would seek to introduce house brands in the foreseeable future. Fonterra does not consider this conclusion is accurate today. The behaviour of the supermarket chains has revealed that they will enter markets with very similar characteristics, such as milk, cheese, ice cream and other cultured dairy product markets.

23.11 The supermarkets are increasing the range of house brands, no longer limited to long-life goods, for which inventory control is important. Foodstuffs' "Pam's" brand milk has been on the market for a number of years and Foodstuffs LNI has acquired a raw milk processing facility and farmer supply arrangements. As noted above, **[** **]**, and Foodstuffs has a number of "Pam's" house brand cultured dairy products (cream cheese, sour cream, cottage cheese). These products are similar in shelf life and product characteristics to yoghurts and dairy desserts.

Other conduct

23.12 **[** .**]**

Conclusion

23.13 The competition for promotion slots, the threat of entry of house brands, and the otherwise aggressive conduct of supermarkets towards wholesalers of yoghurts and dairy desserts leads Fonterra to conclude that the countervailing power of the two large supermarket chains acts to reduce the market power possessed by the merged entity.

24. CONSTRAINTS ON MARKET POWER BY THE CONDUCT OF SUPPLIERS

24.1 As noted in paragraph 11 above, this acquisition will be competitively neutral in the upstream market for raw/processed milk.

This Notice is given by:

Fonterra Co-operative Group Limited

The company hereby confirms that:

- all information specified by the Commission has been supplied;
- all information known to the applicant/s which is relevant to the consideration of this application/notice has been supplied; and
- all information supplied is correct as at the date of this application/notice.

The company undertakes to advise the Commission immediately of any material change in circumstances relating to the application/notice.

Dated this 3rd day of November 2004.

Signed by Fonterra Co-operative Group Limited

David Matthews

David Matthews
General Counsel, Fonterra

I am a director/officer of the company and am duly authorised to make this application/notice.

APPENDIX 1

CORPORATE STRUCTURE DIAGRAMS FOR FONTERRA

[CONFIDENTIAL]

APPENDIX 2

NFIFF ANNUAL REPORT TO JUNE 2003

10045371263

NATIONAL FOODS INTERNATIONAL FINE FOODS LIMITED

ANNUAL REPORT
June 2OO3

Table of Contents

Directory
as at 30 June 2003

DIRECTORS
M.G Ould
C.A Hooke
M.J Read
D.A Lambert

AUDITORS
Ernst & Young

BANKERS
ANZ Banking Group (New Zealand) Limited

SOLICITORS
Simpson Grierson
Auckland

REGISTERED OFFICE
100 Highbury Avenue
Palmerston North

REGISTERED UNDER THE COMPANIES ACT 1993

ANNUAL REPORT - ADDITIONAL STATUTORY INFORMATION

For the Year Ended 30 June 2003

The board of directors present their Annual Report including the financial statements of the Company for the year ended 30 June 2003.

The shareholder of the Company has exercised its right under Section 211 (3) of the Companies Act 1993, and agreed that this annual report need not comply with any of paragraphs (a) and (e)-(j) of Section 211(1) of the Act.

For and on behalf of the board:

Peter Margin — Date: 2/09/03

Clive Hooke — Date: 2.9.03

Michael Read — Date: 29/8/03

David Lambert — Date: 2.9.03

Auditor's Report

To the Shareholders of National Foods International Fine Foods Limited.

We have audited the financial statements on pages 7 to 20. The financial statements provide information about the past financial performance of the company and its financial position as at 30 June 2003. This information is stated in accordance with the accounting policies set out on pages 7 to 10.

Directors' Responsibilities

The directors are responsible for the preparation of financial statements which comply with generally accepted accounting practice in New Zealand and give a true and fair view of the financial position of the company as at 30 June 2003 and of its financial performance for the year ended on that date.

Auditor's Responsibilities

It is our responsibility to express an independent opinion on the financial statements presented by the directors and report our opinion to you.

Basis of Opinion

An audit includes examining, on a test basis, evidence relevant to the amounts and disclosures in the financial statements. It also includes assessing:

- the significant estimates and judgements made by the directors in the preparation of the financial statements; and

- whether the accounting policies are appropriate to the circumstances of the company, consistently applied and adequately disclosed.

We conducted our audit in accordance with generally accepted auditing standards in New Zealand. We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatements, whether caused by fraud or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Other than in our capacity as auditor we have no relationship with, or interest in, the company.

Unqualified Opinion

We have obtained all the information and explanations we have required.

In our opinion:

- proper accounting records have been kept by the company as far as appears from our examination of those records; and

- the financial statements on pages 7 to 20:
  - comply with generally accepted accounting practice in New Zealand; and
  - give a true and fair view of the financial position of the company as at 30 June 2003 and its financial performance for the year ended on that date.

Our audit was completed on 8 October 2003 and our unqualified opinion is expressed as at that date.

Ernst & Young

Wellington

STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

For the Year Ended 30 June 2003

1. Statement of Accounting Policies

The reporting entity is National Foods International Fine Foods Limited. These financial statements have been prepared under the requirements of the Companies Act 1993 and the Financial Reporting Act 1993. The measurement base adopted is that of historical cost.

The Company is reliant on the continued support of National Foods Limited. National Foods Limited has undertaken to provide the support necessary to enable the Company to pay its liabilities as they fall due, including funding through intercompany accounts as necessary until the assets of the Company, fairly valued, exceed its liabilities and all payments can be made in the normal course of business.

a) Property, Plant and Equipment

The company has six classes of Property, Plant and Equipment:

- Land
- Improvements
- Freehold Buildings
- Plant & Equipment
- Office Furniture and Equipment
- Motor Vehicles

Property, plant and equipment are initially stated at cost and depreciated as outlined below.

STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

For the Year Ended 30 June 2003

b) **Depreciation**

Depreciation is provided on a straight line basis on all tangible property, plant and equipment, other than freehold land, at rates calculated to allocate the assets' cost or valuation less estimated residual value, if any, over their estimated useful lives.

Major asset classes are depreciated as follows:

• Freehold Buildings	7-25 years
• Improvements	10 years
• Plant & Equipment	10 years
• Office Furniture & Equipment	3-10 years
• Motor Vehicles	4 years

c) **Receivables**

Receivables are stated at their estimated net realisable value

d) **Income Tax**

The income tax expense charged to the statement of financial performance includes both the current year's provision and the income tax effects of timing differences calculated using the liability method.

Tax effect accounting is applied on a comprehensive basis to all timing differences. A debit balance in the deferred tax account, arising from timing differences or income tax benefits from income tax losses, is only recognised if there is virtual certainty of realisation.

e) **Goods and Services Tax**

All amounts are shown exclusive of Goods and Services Tax (GST), except for receivables and payables that are stated inclusive of GST.

STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

For the Year Ended 30 June 2003

f) Inventories

Inventories are stated at the lower of cost, determined on a first-in first-out basis, and net realisable value.

Cost of finished goods includes the cost of direct material, direct labour and a proportion of the manufacturing overhead, based on the normal capacity of the facilities, expended in putting the inventories in their present location and condition.

g) Leases

The Company leases certain plant, equipment, and buildings.

The company does not currently hold any Finance Leases.

Operating lease payments, where the lessors effectively retain substantially all the risks and benefits of ownership of the leased items, are included in the determination of the net surplus in equal instalments over the lease term.

h) Foreign Currencies

Transactions in foreign currencies are converted at the New Zealand rate of exchange ruling at the date of the transaction.

Short term transactions covered by forward exchange contracts are measured and reported at the forward rates specified in those contracts.

At balance date foreign monetary assets and liabilities are translated at the closing rate of exchange and exchange variations arising from these transactions are included in the statement of financial performance as operating items.

STATEMENT OF SIGNIFICANT ACCOUNTING POLICIES

For the Year Ended 30 June 2003

i) Differential Reporting

The Company qualifies for differential reporting exemptions, as it is not publicly accountable, and there is no separation between the owners and the governing body.

The Company has elected to apply all differential reporting exemptions.

j) Amortisation of Goodwill

Goodwill is amortised by the straight line method over the period during which benefits are expected to be received. This is taken as being 15 years.

k) Cut off date

In accordance with the Company's policy of reporting at the end of cycles ending on a Sunday, the financial statements include transactions only up until and including 29 June 2003.

l) Changes in Accounting Policies

There have been no changes in accounting policies during the year. All policies have been applied on a consistent basis with the prior year.

STATEMENT OF FINANCIAL PERFORMANCE
For the Year Ended 30 June 2003

	Notes	2003 $'000	2002 $'000
OPERATING REVENUE	1	37,362	32,811
OPERATING SURPLUS / (DEFICIT) BEFORE TAXATION	2	694	(316)
Taxation expense		513	179
NET SURPLUS / (DEFICIT) AFTER TAXATION		181	(495)

The accompanying notes form an integral part of these financial statements.

STATEMENT OF MOVEMENTS IN EQUITY
For the Year Ended 30 June 2003

	Notes	2003 $'000	2002 $'000
EQUITY AT BEGINNING OF PERIOD		4,596	5,091
Net Surplus / (Deficit)		181	(495)
Total Recognised Revenues and Expenses for the Year		181	(495)
EQUITY AT END OF PERIOD		4,777	4,596

The accompanying notes form an integral part of these financial statements.

STATEMENT OF FINANCIAL POSITION
As at 30 June 2003

	Notes	2003 $'000	2002 $'000
EQUITY			
Share Capital	3	5,000	5,000
Retained Earnings	4	(223)	(404)
Total Equity		4,777	4,596
CURRENT LIABILITIES			
Accounts Payable		4,810	2,762
Accruals and other Creditors		983	906
Related Party Loan	5	12,448	12,999
		18,241	16,667
TOTAL LIABILITIES AND EQUITY		23,018	21,263

The accompanying notes form an integral part of these financial statements.

National Foods International Fine Foods Ltd

STATEMENT OF FINANCIAL POSITION

As at 30 June 2003

	Notes	2003 $'000	2002 $'000
NON CURRENT ASSETS			
Property, Plant and Equipment	6	4,011	4,240
Future Income Tax Benefit		30	-
Intangibles	9	10,400	11,252
		14,441	15,492
CURRENT ASSETS			
Cash		493	482
Receivables and Prepayments	7	6,008	2,618
Inventories	8	2,022	2,503
Taxation		54	168
		8,577	5,771
TOTAL ASSETS		23,018	21,263

For and on behalf of the Board of Directors who authorised the issue of the Financial Report on

M.J. Read
Director

Date 29 August 2003

C.A. Hooke
Director

Date 2.9.03

The accompanying notes form an integral part of these financial statements.

NOTES TO FINANCIAL STATEMENTS

For the Year Ended 30 June 2003

	Notes	2003 $'000	2002 $'000
1. OPERATING REVENUE			
Operating Revenue Comprises:			
Sales		37,313	32,800
Interest Revenue		49	11
		37,362	32,811

	Notes	2003 $'000	2002 $'000
2. OPERATING SURPLUS / (DEFICIT) BEFORE TAXATION			
After Deducting			
Auditors' Remuneration	12	-	-
Amortisation of Goodwill		852	852
Bad & Doubtful Debts		13	69
Directors fees		-	-
Interest		880	990
Rental and Operating Lease Expenses		186	158
Depreciation of Property Plant & Equipment:			
Freehold Buildings		91	88
Improvements		1	1
Plant and Equipment		222	230
Office Furniture and Equipment		58	46
Motor Vehicles		17	24
Gain on Disposal of Assets		-	(1)

NOTES TO FINANCIAL STATEMENTS

For the Year Ended 30 June 2003

	2003 $'000	2002 $'000
3. SHARE CAPITAL		
5,000,000 Ordinary shares of one dollar each	5,000	5,000

All ordinary shares have equal voting rights and share equally in dividends and surplus on winding up.

	2003 $'000	2002 $'000
4. RETAINED EARNINGS		
Balance at beginning of period	(404)	91
	(404)	91
Net Surplus / (Deficit)	181	(495)
Balance at end of period	(223)	(404)

	2003 $'000	2002 $'000
5. RELATED PARTY LOAN		
This loan is from National Foods Finance Limited, a company in the National Foods Limited Group. The loan is at call and bears interest at current market rates.	12,448	12,999

NOTES TO FINANCIAL STATEMENTS

For the Year Ended 30 June 2003

	2003 $'000	2002 $'000
6. PROPERTY, PLANT AND EQUIPMENT		
Land at cost	300	300
Freehold buildings (at cost)	2,015	2,015
Accumulated Depreciation	268	178
	1,747	1,837
Improvements	13	13
Accumulated depreciation	3	2
	10	11
Plant and Equipment (at cost)	2,516	2,359
Accumulated depreciation	700	435
	1,816	1,924
Motor Vehicles (at cost)	53	87
Accumulated depreciation	40	44
	13	43
Office furniture and equipment (at cost)	223	216
Accumulated depreciation	98	91
	125	125
TOTAL PROPERTY, PLANT AND EQUIPMENT	4,011	4,240

NOTES TO FINANCIAL STATEMENTS

For the Year Ended 30 June 2003

	2003 $'000	2002 $'000
7. RECEIVABLES AND PREPAYMENTS		
Trade Debtors	5,902	2,596
Prepayments	106	22
	6,008	2,618

	2003 $'000	2002 $'000
8. INVENTORIES		
Raw materials	927	837
Finished Goods	1,095	1,666
	2,022	2,503

Inventories are subject to a retention of title clause.

	2003 $'000	2002 $'000
9. INTANGIBLES		
Goodwill	12,956	12,956
Less Accumulated Amortisation	2,556	1,704
	10,400	11,252

NOTES TO FINANCIAL STATEMENTS

For the Year Ended 30 June 2003

	2003 $'000	2002 $'000
10. COMMITMENTS		
Capital Commitments		
Purchase of Raw Materials under Supply contract	NIL	105

Operating Lease commitments

Lease commitments under non-cancellable operating leases:

	2003 $'000	2002 $'000
Current	162	167
Non-current	231	138
	393	305

NOTES TO FINANCIAL STATEMENTS

For the Year Ended 30 June 2003

11. SIGNIFICANT EVENTS AFTER BALANCE DATE

There have been no significant events after balance date.

12. AUDITORS' REMUNERATION

The audit fee for the Company is encompassed by the remuneration paid by National Foods Limited to Ernst & Young in Australia.

13. RELATED PARTY TRANSACTIONS

The Company is a wholly owned subsidiary of National Foods New Zealand Holdings Limited, which in turn is a wholly owned subsidiary of National Foods Holdings Limited. All members of the National Foods Group are considered to be a related party. The Company has a loan of $12,448,000 from a Group company. During the year, repayments of $1,344,000 were made and $794,440 interest was charged.

14. CONTINGENT LIABILITIES - UNSECURED

The parent, National Foods Limited along with other material entities in the consolidated entity including this Company, has guaranteed the obligations of any other borrower within the consolidated entity, under a A$170 million Facility Agreement. The obligations of the parent are contingent only upon the event that a default is made by a borrower under the Facility Agreement and a demand is made on the parent as the guarantor.

Bank guarantees provided to third parties at 30 June 2003 are $12,793,000 (2002: $12,583,000).

INTERNATIONAL Fine Foods

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Fax: 06 356 1293

Auckland Office
National Sales office
1st floor, Stanway House
644 Great South Road
Penrose, Auckland
P.O. Box 13757
Onehunga, Auckland
Phone: 09 571 0170
Fax: 09 571 0174

17th December 2003

The Registrar of Companies
C/- Companies Office
Northern Business Centre
Private Bag 92061
Auckland Mail Centre
Auckland

Dear Sir

We enclose our cheque for $200 being the filing fee for the Audited Financial Statements of the following Companies:

- National Foods International Fine Foods Ltd
- National Foods New Zealand Holdings Ltd

We enclose also, copies of the audited Financial Statements.

Yours faithfully
National Foods International Fine Foods Limited

Catherine Parsons
Commercial Manager

22 DEC 2003
RECEIVED