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COMMERCE COMMISSION

Decision No. 574

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

FONTERRA CO-OPERATIVE GROUP LIMITED

and

KAPITI FINE FOODS LIMITED AND UNITED MILK LIMITED

The Commission:	Paula Rebstock David Caygill Peter JM Taylor
Summary of Application:	An application by Fonterra Co-operative Group Limited for clearance for it, or any of its interconnected bodies corporate, to acquire 100 percent of the issued shares of Kapiti Fine Foods Limited and United Milk Limited.
Determination:	Pursuant to section 66(3) of the Commerce Act 1986, the Commission determines to give clearance to the proposed acquisition.
Date of Determination:	23 February 2006

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EXECUTIVE SUMMARY

The Proposal

1. On 18 November 2005, Fonterra Co-operative Group Limited (Fonterra) gave notice, pursuant to s66(1) of the Commerce Act 1986 (the Act), seeking clearance to acquire by itself, or through any of its interconnected bodies corporate, 100 percent of the issued shares in Kapiti Fine Foods Limited (KFF) and United Milk Limited (UML) from Foodstuffs (Wellington) Co-operative Society Limited (Foodstuffs LNI).

2. The proposed acquisition would result in an aggregation in respect of the acquisition of raw milk, and the manufacture and wholesale supply of town milk, premium ice cream and speciality cheeses.

Market Definition

3. The Commerce Commission (the Commission) has found that the relevant markets for the proposed acquisition are:
   - the supply and acquisition of raw milk in the Manawatu and Wairarapa region (raw milk market);
   - the processing and wholesale supply of town milk in the North Island (town milk market);
   - the national market for the import, manufacture and wholesale supply of specialty cheese (specialty cheese market); and
   - the national market for the import, manufacture and wholesale supply of ice cream (ice cream market).

Counterfactual

4. In the counterfactual, Foodstuffs LNI would retain KFF and UML. Foodstuffs LNI would continue to develop the market for its house brands through its supermarkets and the route trade.

Factual

5. In the factual, Fonterra would acquire KFF and UML and add the range of brands acquired to its current portfolio. Fonterra would also be assigned the obligation to take raw milk under contract from KFF's suppliers for the remaining terms of their contracts. On the expiry of these contracts, it is assumed that the KFF suppliers would switch to supply Fonterra directly.

6. Concurrent with the proposed acquisition, Fonterra would enter into a long term supply agreement with Foodstuffs LNI to manufacture and wholesale supply Foodstuffs LNI's house brand milk and cream. [ ].

Competition Analysis

The Raw Milk Market

7. The proposed acquisition would result in a reduction in the number of acquirers of raw milk from two to one. Fonterra's share of the Manawatu and Wairarapa raw milk market would increase from [ ] percent to [ ] percent. Goodman Fielder/NZDF, with its Longburn plant located in Palmerston North, would likely continue to acquire raw milk from Fonterra.

8. This is a highly concentrated market. The DIRA and Fonterra's co-operative structure constrain Fonterra's market power to some extent in the raw milk market. The impact of these constraints is unchanged in the factual and counterfactual. The proposed acquisition would remove a small competing acquirer of raw milk. KFF provided a limited competitive constraint in the counterfactual, and consequently, its removal in the factual is unlikely to significantly enhance Fonterra's market power in respect of prices paid to farmers. Consequently, the Commission considers that the proposed acquisition might lessen competition, but this lessening is unlikely to be substantial.

The Town Milk Market

9. Fonterra's market share would be likely to increase from [ ] percent to [ ] percent as a result of the proposed acquisition. Post-acquisition, Fonterra would contract manufacture Foodstuffs LNI's house brand milk [ ]. The resulting level of market concentration is outside the Commission's safe harbours.

10. The effects of the proposed acquisition are concentrated only in a portion of the North Island market. In the counterfactual, KFF would be a significant competitor in the lower North Island, but only a very minor competitor in the upper part of the North Island.

11. In the factual, there are a number of constraints that would continue to operate on Fonterra. In particular:
    - Goodman Fielder/NZDF would continue to exist as an alternative supplier of branded town milk on an island-wide basis;
    - the existence of smaller competitors, with the capacity to expand, facilitates competition at the regional level;
    - the potential for new entry, particularly at the regional level; and
    - some countervailing power by supermarkets and oil companies.

12. The Commission considers that the competitive constraint imposed by Goodman Fielder/NZDF, in combination with the other three factors, would constrain Fonterra post-acquisition. In comparing the factual and the counterfactual, there is unlikely to be a material increase in the ability of Fonterra to exercise market power post-acquisition.

13. Consequently, the Commission considers that there is unlikely to be a substantial lessening of competition in the town milk market.

The Specialty Cheese Market

14. Fonterra's market share post-acquisition would increase from [ ] percent to [ ] percent. The acquisition relates to a merger between the first and third largest suppliers of specialty cheese.

15. The Commission considers that there are a number of constraints that would continue to operate on Fonterra in the factual. In particular:

    - Goodman Fielder/NZDF would continue to exist as a major competitor for specialty cheese products;
    - there are a large number of smaller competitors at the national and regional level and, with a growing market, further entry is likely;
    - there is a high level of product innovation, meaning that new specialty cheese products are constantly under threat of being supplanted by newer products;
    - existing or potential imports impose some constraints on Fonterra's ability to raise prices; and
    - supermarkets would have some countervailing power.

16. The existing competition posed by Goodman Fielder and smaller competitors would likely constrain Fonterra. This is supplemented by the additional constraints posed by potential competition in the form of new product development and imports, as well as the countervailing power of supermarkets. Consequently, the Commission considers that the proposed acquisition is unlikely to substantially lessen competition in the specialty cheese market.

The Ice Cream Market

17. Taking a conservative estimate, Fonterra's market share would increase from [ ] percent to [ ] percent as a result of the proposed acquisition. In particular, Fonterra would increase its share of premium ice cream from [ ] percent to [ ] percent, and expand its presence into the foodservice (hospitality) sector.

18. The Commission considers that there are a number of constraints that would continue to operate on Fonterra in the factual. In particular:

    - Emerald Foods Limited would continue to exist as a major competitor for premium ice cream;
    - diversion of ice cream currently exported out of New Zealand by existing competitors, and new imports both provide competitive constraints;
    - there are a large number of smaller competitors in the ice cream market and, with a growing market, further entry is possible;
    - there is a high level of product innovation, meaning that any new ice cream product would be constantly under threat of being supplanted by newer products; and
    - supermarkets would have some countervailing power.

19. The existence of Emerald Foods Limited, which remains a major competitor for premium ice cream, as well as the potential for new imports and export diversion, the existence of smaller competitors and constant product innovation are factors which

would continue to pose a competitive threat to Fonterra. Consequently, the Commission considers that the proposed acquisition is unlikely to substantially lessen competition in the ice cream market.

Conclusion

20. The Commission concludes that the proposed acquisition is unlikely to substantially lessen competition in any of the affected markets.

THE PROPOSAL

21. On 18 November 2005, Fonterra Co-operative Group Limited (Fonterra) gave notice, pursuant to s 66(1) of the Commerce Act 1986 (the Act), seeking clearance to acquire by itself, or through any of its interconnected bodies corporate, 100 percent of the issued shares in Kapiti Fine Foods Limited (KFF) and United Milk Limited (UML) from Foodstuffs (Wellington) Co-operative Society Limited (Foodstuffs LNI).

22. The proposed acquisition would result in an aggregation in respect of the acquisition of raw milk, and the manufacture and wholesale supply of town milk, premium ice cream and speciality cheeses.

SUPPLY AGREEMENT

23. Concurrent with the proposed acquisition, Fonterra and Foodstuffs LNI entered into, or agreed to enter into, agreements relating to the supply of town milk and other specified dairy products. Key terms of the milk and cream supply agreements are:
    - [ ].
    - [ ].
    - [ ].
    - [ ].
    - [ ].
    - [ ].
    - [ ].
        - o [ ].
    - [ ].

24. The Commission received a terms sheet for the long term supply agreement as part of the notice of application for clearance of the acquisition of shares. The Commission considers that the long term supply agreement is distinct from the acquisition for which

clearance is sought. It includes a range of behavioural matters that are outside the scope of s 66. The terms of the agreement are simply matters to which the Commission can give such weight as it considers appropriate in considering the proposal.

PROCEDURE

25. Subsection 66(3) of the Act requires the Commerce Commission (Commission) either to clear or to decline to clear a notice given under s 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. Extensions of time were agreed to by the Commission and the Applicant. Accordingly, a decision on the application was required by Friday 24 February 2006.

26. The Applicant sought confidentiality for specific information in the notice and this information was withheld during the course of the investigation in accordance with s 9(2)(b)(ii) of the Official Information Act 1982 (OIA).

27. The Commission received a submission that it should decline to give clearance for the proposed acquisition in accordance with s 68(2) of the Act on the basis that the proposed acquisition was unlikely to proceed. The Commission is satisfied that there is a real likelihood of the proposed acquisition being implemented.

28. The Commission received submissions and interviewed parties that the Commission considered could assist the Commission in making a determination.

29. The Commission's approach to analysing the proposed acquisition is based on the principles set out in the Commission's *Mergers and Acquisitions Guidelines*.[1]

STATUTORY FRAMEWORK

30. Under s 66 of the Act, the Commission is required to consider whether the proposal would have, or would be likely to have, the effect of substantially lessening competition in a market. If the Commission is satisfied that the proposal is not likely to substantially lessen competition, then it is required to grant clearance to the application. Conversely, if the Commission is not satisfied, it must decline. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.[2]

31. The substantial lessening of competition test was considered in *Air New Zealand & Qantas v Commerce Commission*, where the Court held:

> We accept that an absence of market power would suggest there had been no substantial lessening of competition in a market but do not see this as a reason to forsake an analysis of the counterfactual as well as the factual. A comparative 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, i.e. dominance has been attained. We consider, therefore, that a study of likely outcomes, with and without the proposed Alliance, provides a more rigorous framework for the comparative analysis required and is likely to lead to a more informed assessment of competitive conditions than would be permitted if the inquiry were limited to the existence or otherwise of market power in the factual.[3]

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[1] Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004.
[2] *Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission* (1992) 4 TCLR 713-722.
[3] *Air New Zealand & Qantas Airways Ltd v Commerce Commission*, unreported HC Auckland, CIV 2003 404 6590, Hansen J and K M Vautier, Para 42.

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

33. When the impact of market power is expected to be predominantly upon price, for the lessening, or likely lessening, of competition to be regarded as substantial, the difference between the anticipated level of prices expected without the acquisition has to be both material, and ordinarily able to be sustained for a period of at least two years, or such other time frame as may be appropriate in any given case.

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

ANALYTICAL FRAMEWORK

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

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

36. The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in the market between those two scenarios. The Commission analyses the extent of competition in each relevant market for both the factual and the counterfactual scenarios, in terms of:

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

THE PARTIES

Fonterra

37. Fonterra is a co-operative dairy company incorporated under the Companies Act 1993 and registered under the Co-operative Companies Act 1996. Shares in Fonterra are held

[4] See *Fisher & Paykel Limited v Commerce Commission* (1996) 2 NZLR 731, 758 and also *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554.

by approximately 12,000 supplier shareholders. Fonterra operates in New Zealand through its subsidiaries.

38. Fonterra's corporate structure reflects its different business activities. These business activities may be categorised in terms of:

- Ingredients – involving the manufacture and packaging of more than 1,000 products, such as milk powders, cheese and value-added dairy ingredients. This activity also relates to the collection and processing of milk, and research and development of new value-added ingredients.
- Consumer dairy products – Fonterra's dairy-based consumer and branded products business operates under the name Fonterra Brands. It has 35 manufacturing sites in New Zealand, Australia, the Americas, Asia and the Middle East. Its major brands include 'Anchor', 'Anmum', 'Anlene', 'Soprole', 'Brownes', 'Bega', 'Mainland' and 'Western Star'.

39. Relevant interconnected bodies corporate of Fonterra are:

- Fonterra Brands (New Zealand) Limited (Fonterra Brands) – a wholly-owned subsidiary, and Fonterra's main consumer dairy products company in New Zealand. Fonterra Brands manufactures, distributes and supplies 'Anchor' milk and milk variants, cream, butter, 'Fresh'n Fruity' yoghurt, and 'Mainland' cheese. It also manufactures other processed goods under those and other brands, and contract manufactures products for various house brands. Fonterra Brands manufactures specialty cheese under the brands 'Ferndale', 'Galaxy', 'Mainland' and 'Perfect Italiano'.
- Fonterra Brands (Tip Top) Limited – a wholly-owned subsidiary that manufactures, distributes and supplies ice cream products under the 'Tip Top' and 'Peters New American' brands.

Foodstuffs LNI

40. Foodstuffs LNI is a co-operative society registered under the Industrial and Provident Societies Act 1908. Foodstuffs LNI specialises in grocery distribution in the lower North Island through the 'New World', 'Pak 'N' Save' and 'Four Square' supermarkets. It also owns and manages warehousing and transport operations, and operates cash and carry operations (through Toops Wholesale Limited (Toops)) to service the needs of dairies, service stations, catering and institutional customers.

KFF and UML

41. KFF and UML are both 100 percent owned by Foodstuffs LNI.

42. KFF produces a range of high-value speciality cheeses and ice creams under the 'Kapiti' brand for the domestic and export markets. It also operates a raw milk processing facility at Palmerston North, producing milk and cream under the 'Farmgate' and 'Kapiti' brands (including 'Circulait' and 'Classic' brands), flavoured milk under the 'SUP' brand, and milk and cream for Foodstuffs LNI's under the 'Pam's' (including 'Calci-Smart') brands. This processing facility was recently expanded to incorporate an ice cream manufacturing plant, which manufactures 'Kapiti' and 'Pam's' ice cream brands.

43. KFF started its operations four years ago with 17 staff, producing [ ] litres of milk a day. It now produces in excess of [ ] litres a day, and is a 24-seven operation that employs over 40 staff. Approximately [ ] percent of KFF's milk is supplied by 15 contracted farmers (relating to 17 farm units), and the remainder is sourced from Fonterra under the Dairy Industry Restructuring Act 2001 (DIRA).

44. UML began as a joint venture between KFF and North Island Dairy Company for the purposes of milk processing. Under Foodstuffs LNI's ownership, the milk processing business was amalgamated with KFF, but in April 2005 UML was re-registered and is used as a manufacturing name for the manufacture of 'Farmgate' and 'Calci-smart' milk.

Other Relevant Parties

KFF Suppliers Committee

45. The KFF Suppliers Committee consists of four suppliers representing a majority of the suppliers to KFF. The KFF suppliers represented supply approximately 25.55 million litres of milk per annum to KFF (or approximately 2.1 million kgMS). The farms represented stock in excess of 5,000 cows and employ over 20 workers (excluding the owners).

Goodman Fielder Limited (Goodman Fielder/NZDF)

46. Goodman Fielder is an Australian company listed on the Australian and New Zealand stock exchanges. Goodman Fielder is one of Australasia's leading food companies operating in both the retail grocery and commercial food service channels. Goodman Fielder carries on business within New Zealand through its Retail New Zealand division, being the largest consumer food supplier in New Zealand.

47. On 15 November 2005, Goodman Fielder acquired New Zealand Dairy Foods Limited (NZDF). Following the dairy brand swap with Fonterra in August 2005, NZDF manufactures, distributes and supplies 'Meadow Fresh' milk, milk variants, cream, and yoghurt, and 'Anchor' block cheese. Goodman Fielder's specialty cheese brands include 'Anchor', 'Bouton D'Or', 'Ornelle', 'Puhoi', 'Aakronia' and 'Royal Tasman'.

Open Country Cheese Limited (Open Country Cheese)

48. Open Country Cheese was incorporated on 30 November 2001, and commenced cheese production on 1 October 2004. In its first season, Open Country Cheese produced 6,000 tonnes of hard cheeses. The company's cheese plant is located at Waharoa (seven kilometres north of Matamata). In addition, Open Country Cheese is constructing a drying plant to convert its whey by-product into milk powder, which is due to come into production in March 2006.

49. Open Country Cheese was supplied with approximately 30 million litres of raw milk by 26 contracted suppliers in the 2005/06 season. It also acquires 50 million litres of raw milk from Fonterra under the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (raw milk regulations).

Whitestone Cheese Limited (Whitestone Cheese)

50. Whitestone Cheese is a specialty cheese manufacturer located in Oamaru. Whitestone Cheese produces over 16 varieties of specialty cheese, including organic and sheep milk cheeses. Approximately [ ] percent of production is exported, with domestic sales [ ] between retail and foodservice. In 2005/06, Whitestone Cheese will produce [ ] tonnes of cheese, including exports, with total revenue between [ ] million.

51. Whitestone Cheese sources its raw milk from Fonterra under the raw milk regulations.

Emerald Foods Limited (Emerald Foods)

52. Emerald Foods is a wholly-owned subsidiary of Emerald Group Holdings Limited (Emerald Group), a private investment company 100 percent owned by Bill and Diane Foreman. Emerald Foods manufactures premium ice cream and desserts for the supermarket, route trade and foodservice channels, and for export. Its brands include 'Chateau', 'Heavenly Treats', 'Killinchy Gold' and 'Mövenpick' ice cream, and 'Lite Licks' frozen desserts. Currently, Emerald Foods also manufactures 'Pam's' house brand ice cream (2 litre) in the upper North Island and South Island, and 'Signature' premium house brand ice cream.

53. In April 2004, the Emerald Group purchased a controlling interest in New Zealand Natural Pty Limited. New Zealand Natural ice cream is sold in more than 200 franchised ice cream parlours throughout Australasia and the United Kingdom. Emerald Group also owns 50 percent share of Klondyke Milk.

Kiwi Ice Cream Company Limited (Kiwi Ice Cream)

54. Kiwi Ice Cream is a family business that has been operating for approximately 20 years. Kiwi Ice Cream manufactures everyday (non-premium) ice cream and novelty ice cream predominately for the supermarket and route trade, with some exports. Kiwi Ice Cream's brands include 'Kiwi', 'Mel-O-Rich Supreme', 'Mel-O-Rich Everyday', 'Calci-Lite', and 'Mel-O-Pop' for ice cream, and 'Much Moore', 'Ca-zoom', 'Vive', and 'Ice Licks' for novelties. [ ].

Crean Foodservice Limited (Crean)

55. Crean is the largest specialist foodservice distributor in New Zealand. Crean is a wholly-owned subsidiary of Bidvest Plc, a leading foodservice products distributor in the United Kingdom, Australia, South Africa and New Zealand.

56. Crean services the foodservice, hospitality and leisure channels with a comprehensive range of products covering all three major food categories – frozen, dry and chilled goods. It operates nationwide, purchasing or importing goods for sale to over 10,000 customers.

Progressive Enterprises

57. Progressive Enterprises operates the 'Woolworths', 'Foodtown', and 'Countdown' supermarket banner groups and the two franchises 'SuperValue' and 'FreshChoice'. It

has 150 supermarkets, 43 franchise stores and 22 convenience stores, which together account for approximately 45 percent of sales in the retail grocery sector.

58. Progressive Enterprises was recently acquired by Woolworths Limited (Woolworths Australia), the largest food and grocery retailer in Australasia. In Australia, Woolworths Australia operations include the 'Woolworths', 'Safeway', 'Big W', and 'Dan Murphy's' stores.

59. Progressive Enterprises markets house branded products under the 'Basic' and 'Signature Range' brands. It currently acquires its house branded:

- town milk from Fonterra and, in 31 stores in the upper North Island, Fresha Valley;
- ice cream from Emerald Foods and Fonterra (for its 'Signature' brand), and [ ] (for its 'Basics' brand); and
- specialty cheese from [ ].

PREVIOUS COMMISSION DECISIONS

60. The Commission has on a number of occasions considered acquisitions relating to raw milk, town milk, ice cream and cheese. Those relevant to this Decision are outlined below. It is important to note that the Commission considers every decision based on its particular circumstances.

Raw Milk and Town Milk

61. The most recent decisions in relation to raw milk and town milk are Decision 396: *Mainland Products and Nelson Milk Company* (7 June 2000) and Decisions 428/454: *Mainland Products and Southern Fresh Milk Company Ltd* (18 May 2001/14 February 2002). These decisions relate to the supply and acquisition of raw milk in the South Island and the processing and wholesale supply of town milk in the South Island.

62. In all three decisions, the Commission considered that the small change in concentration in the raw milk market resulting from the proposed acquisitions would have a minimal affect on competition. The proposed acquisitions related to 17 and 21 suppliers (respectively) who would switch to supply milk to the merged entity following the acquisition.

63. In the case of town milk, in Decision 396 Southern Fresh would be the main competitor to Mainland Products post-acquisition. In the South Island, NZDF relied upon franchise arrangements with Nelson Milk and Southern Fresh to process and package its milk and it held a relatively small market share. The Commission considered that these existing competitors were unlikely to constrain the merged entity. However, the Commission considered that market entry by a particular independent processor of milk was likely within the Commission's timeframe. This imminent new entry was considered likely to constrain Mainland Products post-acquisition and, consequently, clearance was given.

64. In Decision 428, the Commission noted that the previously anticipated market entry had not yet occurred and such entry was now considered unlikely within the Commission's timeframe. NZDF was reliant upon Southern Fresh, and to a lesser extent, Marlborough Milk, to process and package its milk in order to compete in the South Island market. In the event that Southern Fresh was acquired, NZDF would not have sufficient alternative

options for the supply and processing of its milk. In addition, the Commission considered that acquirers of town milk, being supermarkets, oil companies and milk vendors, did not have sufficient countervailing market power over the merged entity. Consequently the Commission declined clearance.

65. In Decision 454, the Commission considered that Southern Fresh was a failing firm, and after applying the new substantial lessening competition threshold, the Commission gave clearance.

Raw Milk, Town Milk and Cheese

66. The Commission considered a wide range of dairy markets in the *'NewCo' Draft Determination* dated 27 August 1999 (this Application was subsequently withdrawn). Of relevance to this proposed acquisition, the Commission defined the following markets:

- the supply and acquisition of unprocessed milk in the North and South Island markets;
- the secondary markets for the wholesale supply and acquisition of unprocessed and near milk in the North and South Island markets;
- the processing and wholesale supply of town milk in the North and South Island markets; and
- the manufacture and wholesale supply of cheese in New Zealand, with block cheese and specialty cheese being segments of this market. This is the most recent previous decision in respect of cheese.

67. The 'NewCo' Draft Determination related to the proposed merger of the New Zealand Dairy Board, eight co-operative dairy companies and Tasman Milk Products. The merger would have resulted in the merged entity acquiring virtually 100 percent of the unprocessed milk in New Zealand.

68. In defining the geographic dimension of the unprocessed milk market, the Commission considered the likelihood of suppliers switching from one dairy co-operative to another in response to a significant reduction in payout by one of the co-operatives. Relevant factors included:

- Due to the cost and practicalities of transport, most milk is transported less than 100 kilometres;
- the presence of potential substitute acquirers; and
- the willingness of substitute acquirers to accept additional milk supplies.

69. The Commission considered that, as NewCo would control virtually 100 percent of the market regardless of definition, there was little advantage to be gained from an attempt to accurately define the geographic dimension of the market. Consequently, the Commission determined that markets were for the North and South Islands.

70. The Commission also defined a separate market for the wholesale supply and acquisition of unprocessed and near-milk[5] in the North and South Islands, being a

[5] Near-milk includes milk derivatives such as whey, milk fat and colostrum.

'secondary milk market'. The Commission considered that this market was distinguishable from the primary market by its functional level, being a wholesale market which operates between dairy co-operatives.

> Farmers require regular, generally daily milk collections throughout the season, and hence effectively enter season-long contracts with their dairy co-operatives. In exchange, the dairy co-operative requires an equivalent commitment from the supplier, meaning that the farmer is generally unable to switch within a season, nor to take advantage of opportunistic spot trading. In contrast, the secondary market involves trading opportunities which arise on an irregular basis, or at particular times of the season. It also involves trade in products other than unprocessed milk.[6]

71. The Commission's draft determination was that the merger would result in a strengthening of a dominant position in each of the relevant markets.

Ice Cream

72. The most recent decisions in relation to ice cream are Decisions 313/313A *Tip Top Ice Cream Company Limited and United Dairy Foods Limited* (September 1996 / December 1997). These decisions relate to the national markets for the manufacture and wholesale supply of take home ice cream, frozen novelties / scoop ice cream and frozen desserts.

73. In terms of product dimension, take home ice cream consists of one, two and five litre containers of ice cream, sold for consumption at home and often served as a dessert or an accompaniment to a dessert. Frozen novelties and scoop ice cream are the range of frozen ice cream bars, ice blocks and ice cream cones, which are predominately sold for immediate consumption as a snack or refreshment. Multi-pack frozen novelties were included in the frozen novelties and scoop ice cream market as they are also generally consumed as snacks or refreshments. Frozen desserts (eg Viennetta, cheese cake) were not considered to be substitutes for take home ice cream, and were defined as a separate market.

74. The Commission initially declined, but subsequently approved, clearance for the acquisition (as modified in the second application).

MARKET DEFINITION

75. The Act defines a market as:

> … a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.[7]

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

[6] *'NewCo' Draft Determination* (27 August 1999), para. 172.
[7] Section 3(1) of the Commerce Act 1986.

acquisition under consideration, bearing in mind the need for a commonsense, pragmatic approach to market definition.

77. For the purpose of competition analysis, the internationally accepted approach is to assume the relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power might be exercised is defined in terms of five dimensions, namely the product type, the class or classes of acquirer, the functional level, the geographical extent, and (not relevant to this determination) a particular time period. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

Product Dimension

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

79. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market.

80. Two products might be technical substitutes, in that they might be utilised for essentially the same function, but still be sufficiently differentiated that they are not considered close substitutes by consumers. For example, two products having similar uses might not be close substitutes if the price of one of the products is much higher, or the performance of one of the products is significantly inferior, that it might be a poor substitute in an economic sense, at least for the great majority of buyers.

81. There may be a chain of substitution between products and, so long as there is no break in the chain of close substitution possibilities such that each adjacent pair of products are close substitutes, all of these products might be included in the same market. However, the more widely spaced are any two products in that chain, the less close they might be as substitutes to each other, and the more likely is there to be a break in the chain such that the products should be grouped into two or more markets.

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

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

Raw Milk

84. The proposed acquisition of KFF would result in Fonterra being assigned the obligation to take raw milk under contract from KFF's suppliers. Currently, three of these suppliers also supply milk to Fonterra.

85. Consistent with previous Commission decisions, the Applicant submits that the relevant product market for considering this acquisition is that for raw (or unprocessed) milk.

86. The KFF Suppliers' Committee submits there is a continuum of products in the raw milk market that may be differentiated based on quality and pricing considerations. The KFF suppliers produce specialty milk, which is differentiated from other raw milk on the basis of lower somatic cell counts, more rapid cooling properties, improved protein yields and reduced variation in milk composition over the year (milk fat/protein ratios) due to flat line production. This specialty milk is valued for use as fresh milk for the domestic market, as:

   - milk composition is an important determinant of milk flavour; and
   - grading standards and temperature requirements relate to bacteria levels, which in turn will determine fitness for purpose and length of shelf life.

87. Flat line production also means that KFF does not have to manage significant seasonal variations in milk supply and the associated demands on processing capacity.

88. KFF suppliers receive a price premium for this specialty milk relative to a Fonterra supplier receiving the annualised payout for normal raw milk supply. The KFF payment formula is [ ]. The KFF Suppliers' Committee estimates that it receives a premium of [ ] cents per litre relative to a Fonterra supplier receiving the annualised payout. It is important to realise that embedded in this premium is a reduction taking account of savings due to the suppliers not having to own shares in Fonterra.

89. Consequently, the KFF Suppliers' Committee submits that a narrower product dimension is appropriate to analyse the competition implications of this acquisition. The Committee considers that the relevant product market is 'specialty milk for use as fresh milk in the domestic market'. The Committee submits that Fonterra also discriminates between milks of varying content when acquiring raw milk for use in the domestic market (in particular, Fonterra sets higher quality standards for winter milk contracts, which are exclusively for use as fresh milk in the domestic market). Consequently, the Committee's product market definition includes a small portion of the raw milk acquired by Fonterra, being that raw milk used for producing fresh products for domestic use.

90. The Commission considers that raw milk may vary in its composition and quality, and consequently, is differentiated to some extent. The market recognises this product variation through pricing premiums and penalties based on compliance and non-compliance with standards. Further differentiation may relate to seasonal or flat line supply patterns, cow breeds and farming methods (eg organic milk). However, Fonterra and NZDF/Goodman Fielder are the main acquirers of milk for use as fresh milk in the domestic market, and the Commission did not find evidence that these acquirers

demand an all year round supply of speciality milk for this use. For example, the raw milk acquired by NZDF/Goodman Fielder from Fonterra predominately for use as fresh milk for the domestic market has quality and composition standards that are consistent with Fonterra's normal milk standards.

91. The KFF Suppliers' Committee advised that 'Pam's' and 'Farmgate' brands of town milk produced from its specialty milk are claimed to have a longer shelf life than the competing brands due to the higher quality standards and rapid cooling technologies applied by KFF suppliers. This suggests that KFF suppliers produce premium raw milk for use in the town milk market, but that other raw milk (supplied to generic standards and acquired by competing suppliers of town milk) is a close substitute.

92. The exact price differential between the KFF rate and Fonterra's payout is difficult to determine with accuracy. This is due to differences in the methods used by the two companies to calculate payouts and some uncertainty as to what payout KFF suppliers' would receive in the future under the counterfactual and factual scenarios. For example, the average supplier to KFF has a lower milk fat content than the average Fonterra supplier and this affects the conversion rates used to compare payouts, as KFF's payout is based on litres and Fonterra's payout is based on milk solids. [ ]. Consequently, the Commission considers that the extent of the price differential may be less than that claimed by the KFF suppliers.

93. Furthermore, evidence that KFF pays its suppliers a premium for raw milk relative to Fonterra's payout does not necessarily indicate that the KFF suppliers' milk is in a separate market. Similar products may have different attributes causing a price differential, and yet still be close enough in attributes to be a substitute product.

94. The Commission considers that the milk supplied by the KFF suppliers is a close substitute for the milk generally supplied by Fonterra suppliers for domestic and export uses, and thus whilst there may be some differentiation within the raw milk market, the market comprises milk supplied both to KFF and to Fonterra.

Town Milk

95. The proposed acquisition would result in an aggregation in respect of a range of milk and cream products. KFF currently processes and supplies milk and cream under the 'Farmgate' and 'Kapiti' brands (including the 'Circulait' fibre enriched and 'Classic' brands), flavoured milk under the 'SUP' brand, and milk and cream for Foodstuffs LNI under the 'Pam's' (including 'Calci-Smart') brands. Fonterra supplies a wide range of town milks (including full cream, homogenised, reduced fat and calcium enriched varieties), fresh flavoured milks, fresh soy milks and cream. Fonterra supplies this milk under the 'Anchor' brand and also contract manufactures house brand milk.

96. The Applicant notes the increasing rate of product innovation and differentiation, but submits that the relevant product market is that for town milk.

97. Previous Commission decisions have noted studies both in New Zealand and overseas that indicate the price elasticity of demand for town milk is low, which suggests that

there are no close substitutes for town milk.[8] Anecdotal evidence indicates that an increase in the price of milk results in consumers making smaller but more frequent purchases, with no significant change in overall quantities demanded.

98. There is evidence that the town milk market is becoming increasingly differentiated in response to consumer demand for value-added and healthier alternatives. Fonterra submits this product differentiation is reflected in the default colour-coding system for labels/caps as outlined in Table 1 below.

Table 1: Differentiated Town Milk Products

Product attribute	Colour	Anchor	Meadow Fresh	House brand
Calcium Enriched milk	Yellow	Xtra	Calci-Trim	Calci-Smart
Kids milk	Orange/Blue & Yellow	Mega	Calci-Kids	-
Reduced fat	Light Blue	Lite	Balance	Lite
Trim	Green	Trim	Trim	Slim
Non Fat	Light Green	Super Trim	Extra Trim	Ultra Lite
Omega 3 Enriched	Purple	Vital	-	-
Growing up Milk	Orange	-	Junior	-
Soy Milk	Red	SoyLife	-	-

99. Interviews of supermarket operators suggest that house brands and branded milk products, and the various categories of milk products, form a chain of substitutes for many consumers. In addition, on the supply-side, town milk processors might switch production between the categories of milk products in response to a change in relative prices.

100. Consequently, the Commission considers these milk products are likely to be in the same market.

Cheese

101. The proposed acquisition would result in an aggregation in respect of specialty cheese supplied to supermarkets and the foodservice (hospitality) sector. KFF imports, manufactures and wholesale supplies a range of specialty cheeses predominately under the ‘Kapiti’ brand to supermarkets and the foodservice sector. Fonterra manufactures and wholesale supplies specialty cheeses under the ‘Ferndale’, ‘Galaxy’, ‘Mainland’ and ‘Perfect Italiano’ brands.

102. The Applicant submits that the relevant product market is that for cheese, with specialty cheese constituting a segment of that market. Fonterra submits that, while the physical distinctions between block and specialty cheese might be obvious, there is a continuous chain of substitution between the products, such that they should be considered in the one market. For example, the distinction between the two segments is blurred when comparing expensive block cheeses such as ‘Weightwatchers’ with lower-priced ‘Bouton D’Or’ or ‘Galaxy’ specialty cheeses priced for everyday consumption.

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[8] *Decision 454: Mainland Products Limited / Southern Fresh Milk Company Limited*, para. 41.

103. Interviews of supermarket operators and industry participants however suggest that cheese products are differentiated, such that block cheese and specialty cheese are likely to be in separate markets.

104. Many supermarkets have three separate displays for cheese within the supermarket, indicating their different customer focus. Block cheeses (including grated cheese) are displayed in the general chiller, targeting consumers for everyday use. Fixed weight specialty cheeses (generally soft cheeses and parmesan cheese) are displayed elsewhere in the chiller. These speciality cheeses provide an easy entry point to specialty cheese products. They include feta and mozzarella cheeses for use in salads or on pizzas, parmesan for use as a garnish, and soft cheeses for special occasion snacks. Random weight specialty cheeses are displayed in a cheese bar near the delicatessen service centre, relating to a wider variety of specialty cheeses.

105. While there will be some overlap in functionality and price between specialty cheese and block cheese, in general these products are purchased for different uses, with block cheeses being more for traditional everyday use. Specialty cheese requires significantly different technical knowledge and branding relative to block cheese, suggesting they are unlikely to be close supply-side substitutes. The Commission notes that the proposed acquisition would result in an aggregation in respect of specialty cheese products.

106. Taking a conservative approach, the Commission considers that defining specialty cheese as a separate market would best assist its analysis of the competitive impacts of this acquisition.

Ice Cream

107. The proposed acquisition would result in a minor aggregation in respect to premium ice cream. Concurrent with the proposed acquisition, Foodstuffs LNI and Fonterra would agree that Fonterra would [ ]. KFF manufactures and wholesales premium ice cream under the 'Kapiti' brand and recently commenced manufacturing 'Pam's' everyday take home ice cream for Foodstuffs LNI. Fonterra manufactures and wholesales a range of novelty, scoop and everyday take home ice cream under the 'Tip Top' and 'Peters New American' brands, and contract manufactures Progressive's 'Signature' range everyday take home ice cream.

108. The Applicant submits that the relevant product market is that for:

- take home ice cream, with everyday and premium constituting segments of this market; and
- novelty and scoop ice cream.

109. The Applicant notes that the novelty and scoop ice cream market is also segmented. KFF's sales are concentrated on scoop ice cream almost exclusively to food service outlets for use as a dessert or as an accompaniment to a dessert. Fonterra's sales are focused on novelties and scoop ice cream to retailers for sale for immediate 'impulse' consumption.

110. Interested parties interviewed advised that consumers might purchase everyday ice cream for the family, but premium ice cream is generally for special occasions. The distinction between everyday and premium ice cream is:

- premium ice cream contains more fat and less air than everyday ice cream;
- premium ice cream is made from cream and higher quality ingredients; while everyday ice cream might be made from anhydrous milk fat (AMF) or milk powder;
- premium ice cream is priced significantly higher than everyday ice cream (eg $5 to $10 per litre compared to as low as $1.50 to $2.50 per litre); and
- premium ice cream is supplied in small pack sizes (generally one litre or less), while everyday ice cream is supplied in one, two and five litre containers.

111. The Applicant estimates that the current annual growth in the premium segment to be approximately [ ] percent by volume. This distinction between everyday and premium ice cream also applies for frozen novelty and scoop ice cream products.

112. The Commission received mixed views on whether these products are in the same market. Reasons for separate markets are:

- a supermarket operator advised that, when allocating limited freezer space in supermarkets, house brand ice cream might displace branded everyday ice cream products, but no thought is given to displacing premium ice cream; and
- an everyday ice cream manufacturer advised of difficulties in entering the premium ice cream segment of the market.

113. Reasons in favour of a single market are:

- on the demand-side, there is likely to be a chain of substitution such that everyday ice cream is likely to be a substitute for premium ice cream when used as an accompaniment to a hot dessert; and multi-pack frozen novelties are likely to be a substitute for take home ice cream as a dessert; and
- on the supply-side, there are low barriers to ice cream manufacturers switching between supplying take home ice cream or scoop ice cream.

114. The Commission notes that KFF primarily sells premium take home ice cream and Fonterra primarily sells everyday take home ice cream and novelty and scoop ice cream, and so the proposed acquisition represents very little aggregation in everyday take home and scoop ice cream, and a [ ] percent increase in sales in the premium sector. Therefore the adoption of a single ice cream market in the case of this specific acquisition is a more conservative approach than adopting separate product markets. If the Commission finds no substantial lessening of competition in the ice cream market, then neither would there be any issues if the alternative separate product markets were adopted.

115. Consequently, given the low barriers to supply side substitution and having regard to the features of this acquisition, the Commission considers the ice cream market as a single market which is differentiated based on quality and packaging.

Conclusion on Product Markets

116. The Commission considers that the relevant product dimensions for this acquisition are:

- raw milk;
- town milk;
- specialty cheese; and
- ice cream.

Temporal Dimension

117. Generally, the Commission views markets as operating continuously over time. Where a market is characterised by highly seasonal transactions, the Commission may define a separate time dimension for the market.

Raw Milk

118. The proposed acquisition of KFF would result in Fonterra being assigned the obligation to take raw milk under contract from KFF's suppliers. KFF suppliers all have flat line production, supplying raw milk all year round. This all year round supply is achieved through a system of rotational calving and supplemented feed. Rather than from flat line suppliers, Fonterra acquires milk all year round through a mix of seasonal (peak and shoulder seasons) supply and winter milk supply contracts. The Commission considered whether flat line supply, seasonal supply and winter milk supply are in the same temporal market.

119. The Applicant submits that, while it is quite appropriate for the Commission to acknowledge the phenomenon of winter milk, it should not do so in the context of a separate market. Fonterra notes that KFF operates in the context of a single raw milk market and, as such, it would be unusual for the Commission not also to adopt a single milk market. KFF Suppliers' Committee noted the high costs of switching between flat line supply to seasonal supply.

120. The Commission was advised that the winter milk premium paid by Fonterra has decreased over the past three years. The Commission considers that winter milk supply is necessary for town milk production. Consequently, on the demand-side, seasonal supply is unlikely to be a close substitute for winter milk supply. In contrast, on the supply-side, switching from seasonal milk supply to winter milk production is possible in some regions by altering calving times. The Commission notes that Fonterra operates its winter milk supply tenders 18 months in advance to facilitate transitioning between winter milk and seasonal milk supply. Given these forward tender arrangements, the Commission considers that an acquirer is unlikely to be able to sustain a significant price reduction to suppliers in winter relative to seasonal supply, and therefore does not consider winter milk to be a different temporal market dimension to seasonal milk.

121. The Commission understands that switching from seasonal or winter milk supply to flat line supply imposes significantly more costs than borne when switching between seasonal and winter supply. Switching to flat line production requires a minimum 18 month lead-in time to make the transition, and involves significant capital investment. However, if flat line suppliers were to attempt to raise the price demanded for their milk

supply, acquirers of flat line milk supply could switch their intake to purchase milk from a combination of seasonal and winter milk suppliers.

122. Consequently, the Commission considers that it is not necessary to define a temporal dimension to the raw milk market.

Customer/Supplier Dimension

123. The Commission also examines the extent of, and potential for, suppliers (or acquirers) to discriminate between customers (or suppliers, as relevant) within identified relevant markets.

Raw Milk

124. KFF acquires its raw milk from contracted suppliers and, in the secondary market, from Fonterra under the raw milk regulations. Fonterra acquires its raw milk from predominately shareholding suppliers, but also has the flexibility to acquire from contracted suppliers. From June 2006, Fonterra is to acquire up to 15 percent of its milk from contracted suppliers. The Commission considered whether raw milk acquired from, or supplied by, contracted suppliers and share-backed suppliers are likely to be close substitutes.

125. The main cost of switching between contracted-supply and share-backed supply is the cost of shares (and any other capital instruments of a co-operative). The KFF Suppliers' Committee estimate a cost of approximately $13.3 million to $14.5 million in total if all KFF suppliers were to become Fonterra supplying shareholders. This cost is not insignificant, but should be manageable with appropriate debt servicing facilities by lending institutions.

126. Consequently, the Commission considers that it is not necessary to define a customer/supplier dimension to the raw milk market.

Functional Dimension

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

Raw Milk

128. The Applicant submits that the functional dimension of the market for raw milk is that for the supply and acquisition. This functional dimension has not been challenged by the interested parties.

129. The Commission considered whether regulatory arrangements had caused the primary and secondary milk markets to merge, such that acquiring milk directly from farmers might be a close substitute for acquiring milk at the wholesale level from a dairy cooperative. This enquiry is relevant to determine the competitive constraint imposed by Goodman Fielder/NZDF in the raw milk market as a consequence of the proposed acquisition.

130. Goodman Fielder/NZDF is the major acquirer of milk from Fonterra in the Manawatu region and is located at Longburn in Palmerston North. Goodman Fielder/NZDF acquires approximately [ ] litres of milk from Fonterra under the raw milk regulations for delivery to Longburn. The supply contract with Fonterra is [ ].

131. An acquirer of milk in the primary market is likely to consider acquiring milk in the wholesale market to be a close substitute. KFF acquires raw milk from contracted farmers and from Fonterra under the raw milk regulations. However, there are costs to switching from the wholesale market to the primary market to acquire raw milk. These costs include managing the seasonality of milk supply and the risks associated with obligations to accept supply. In the case of this proposed acquisition, the KFF suppliers' flat line production profile and sophisticated on-farm technology has reduced these costs.

132. A conservative approach in this case would be to retain the narrower market definition relating to the primary market. Consequently, the Commission considers that the functional dimension of the market would be acquiring raw milk directly from farmers.

Town Milk, Specialty Cheese and Ice Cream

133. The Applicant submits that the functional dimension of the markets for town milk, speciality cheese and ice cream is the processing/manufacture and wholesale supply function.

134. These functional dimensions have not been challenged by the interested parties. These functional dimensions are consistent with previous Commission decisions and the Commission has adopted them in this case. In the case of specialty cheese and ice cream, the Commission notes that imports are also relevant and it adds the function of 'importing'.

Conclusion on Functional Markets

135. The Commission considers that the relevant functional dimensions to consider this acquisition are the:

- supply and acquisition of raw milk;
- processing and wholesale supply of town milk; and
- import, manufacture and wholesale supply of specialty cheese and ice cream.

Geographic Dimension

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

Raw Milk

137. The Applicant submits that the geographic dimension of the market for raw milk is the North Island.

138. The KFF Suppliers' Committee submits that a narrower geographic dimension is appropriate. The KFF Suppliers' Committee submits that the outer geographic dimension of the market can be calculated as being that point when the cost of transporting milk equals the premiums on offer for producing it. Consequently, the KFF Suppliers' Committee estimates a geographic dimension of approximately 112 kilometres radius of Palmerston North.

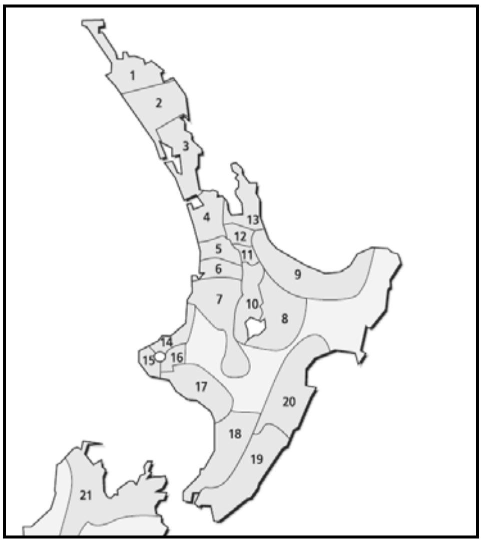
139. Open Country Cheese submits that it would not be economic for it to acquire raw milk from KFF suppliers for processing at its Waharoa plant, approximately 365 kilometres away.

140. The Commission considers that the relevant inquiry for determining the geographic dimension of the market associated with the proposed acquisition is to assess the ability of suppliers to switch from one acquirer to another in the event that the merged entity made a significant reduction in payout. In the *NewCo Draft Determination*, the Commission identified that transport costs generally restrict catchment areas to within 100 kilometres or less. In long thin catchment areas an outer limit for the transportation of milk might be 250 kilometres. In addition, winter milk may be transported greater distances given the reduced processing plants in operation over the winter period.

141. The Commission considers that it is difficult to define a precise geographic dimension for the collection of raw milk. KFF currently acquires milk from within 100 kilometres radius of its processing plant. KFF advised that, on its establishment, it acquired raw milk from Gisborne Milk, approximately 380 kilometres away, in order to meet its shortfall in requirements until it secured independent supply. Limitations on available data also make precise definition difficult.

142. Taking a conservative approach for the purposes of this acquisition, the Commission considers that the geographic dimension of the market would be the area within 100-150 kilometres of the KFF plant, which roughly equates to the Manawatu and Wairarapa wards (ward 18 and 19 outlined in Figure 1 below).

Figure 1: Fonterra's wards for milk collection in the North Island



Town Milk

143. The Applicant submits that the geographic dimension of the market for town milk is a national market. Fonterra submits that several 'Anchor' products sold nationwide now are produced only at Takanini, Auckland. Similarly, NZDF contract manufactures all of Fonterra's national 'Supashake' requirements from its Christchurch plant, and ship product nation wide. On the demand-side, supermarket chains and route service operations purchase town milk on a national level, with national distribution networks. In addition, Fonterra provided a report by CRA International indicating [ ].

144. [ ] the town milk market is a North Island market. Most of the milk processed in each island continues to be sold within that island. Generally the closer the processing plant to the area of supply, the more efficiently the milk processor can supply the milk, as the cost of transporting milk is not insignificant for milk. For example, transport costs for a chilled truck from Palmerston North to Auckland are approximately [ ] per litre. [ ].

145. The proposed acquisition relates to milk supply in the lower North Island, the major processors and acquirers of milk operate on at least an island basis. In addition, while some milk is transported across the Cook Strait, the majority is sold in the island in which it is processed. The Commission considers that the geographic market for town milk is likely to be the North Island.

Specialty Cheese

146. The Applicant submits that the geographic dimension of the market for specialty cheese is a national market. This reflects the national purchasing regimes of the major supermarkets, and the ease with which cheese can be transported long distances.

147. This geographic dimension has not been challenged by the interested parties and is consistent with previous Commission decisions. The Commission supports a national market.

Ice Cream

148. The Applicant submits that the geographic dimension of the market for ice cream is a national market. This geographic dimension has not been challenged by the interested parties and is consistent with previous Commission decisions. The Commission supports a national market.

Conclusion on Geographic Dimension

149. The Commission considers that the relevant geographic dimensions to consider in relation to this acquisition are:

- the Manawatu and Wairarapa region for raw milk;
- the North Island for town milk; and
- national markets for specialty cheese and ice cream.

Conclusion on Market Definition

150. The Commission concludes that the relevant markets are:

- the supply and acquisition of raw milk in the Manawatu and Wairarapa region (raw milk market);
- the processing and wholesale supply of town milk (excluding flavoured milks) in the North Island (town milk market);
- the national market for the import, manufacture and wholesale supply of specialty cheese; and
- the national market for the import, manufacture and wholesale supply of ice cream.

COUNTERFACTUAL AND FACTUAL

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

Counterfactual

152. The Applicant submits that the counterfactual is likely to be the status quo. This would involve Foodstuffs LNI increasing the prevalence of its house brand products through its supermarkets and the route trade.

153. Foodstuffs LNI confirmed that it would retain KFF in the counterfactual. Its strategy (in the absence of divestment) had three limbs:

- [ ];
- [ ]; and
- [ ].

Factual

154. In the factual, Fonterra would acquire KFF and UML and add the range of brands acquired to its current portfolio. Fonterra would also be assigned the obligation to take raw milk under contract from KFF's suppliers for the remaining terms of these contracts. At the expiry, the KFF suppliers would have three options:

- apply to supply Fonterra either as a share-backed or contracted supplier;
- supply another independent processor or set up a new processing plant; or
- exit the dairy industry.

155. For the purposes of the analysis, the worst case competition impact would arise if all KFF suppliers supplied Fonterra, and consequently, the Commission assumes this outcome in the factual.

156. Concurrent with the acquisition, Fonterra would enter into arrangements with Foodstuffs LNI for the manufacture and wholesale supply of house brand milk and cream for [ ]. In addition, Fonterra would [ ]. The Commission considers that the long term supply agreement is distinct from the acquisition for which clearance is sought.[9]

COMPETITION ANALYSIS

The Market for the Supply and Acquisition of Raw Milk in the Manawatu and Wairarapa Region

Existing Competition

157. Existing competition occurs between those businesses in the market that already supply the product, and those that could readily do so by adjusting their product mix (near competitors). Supply-side substitution by near competitors arises either from redeployment of existing capacity, or from expansion involving minimal investment, in both cases involving a delay of no more than one year.

158. An examination of concentration in a market can provide a useful indication of the competitive constraints that market participants might place upon each other, providing that there is not significant product differentiation. Moreover, the increase in seller concentration caused by a reduction in the number of competitors in a market by an acquisition is an indicator of the extent to which competition in the market might be lessened.

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

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

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

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

[9] The terms of the agreement are simply matters to which the Commission can give such weight as it considers appropriate in considering the proposal.

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

162. The Commission recognises that concentration is only one of a number of factors to be considered in the assessment of competition in a market. In order to understand the impact of the acquisition on competition, and having identified the level of concentration in a market, the Commission considers the behaviour of the businesses in the market. Specifically, the Commission seeks to understand the dynamics of the competition that would exist between the remaining firms in the market, compared to what would exist in the absence of the acquisition.

Market Concentration and Analysis

163. KFF and Fonterra are the only acquirers of raw milk direct from farmers in the Manawatu and Wairarapa region.

164. Table 2 outlines the impact of the proposed acquisition based on estimates of market shares for raw milk for the Manawatu and Wairarapa region for the 2004/05 season.

Table 2: Estimated Shares of Raw Milk Market for Manawatu and Wairarapa

Acquirer	**Volume litres (000s)**	**Market Share (%)**
Fonterra	[ ]	[ ]%
KFF	[ ]	[ ]%
Total post-acquisition	[ ]	[ ]%

Note: The quantity attributed to KFF excludes raw milk acquired from Fonterra under the raw milk regulations.

165. The market is highly concentrated and the proposed acquisition is outside the Commission's safe harbours.

166. The Applicant submits that the proposed acquisition would have a de minimis effect on competition in the market. The Applicant cites the DIRA and Fonterra's co-operative structure as constraining Fonterra's market power in the raw milk market.

167. The KFF Suppliers' Committee submits that the proposed acquisition has the likely effect of lessening competition based on two key factors.

- The proposal reduces the number of acquirers of raw milk from two to one. Goodman Fielder/NZDF's long-term supply contract with Fonterra excludes it from entering the primary raw milk market and it is not seen as a potential acquirer.
- KFF suppliers would incur a reduction in payout for the supply of their milk of approximately [ ] percent from the loss of premiums currently paid by KFF. In addition, the KFF suppliers would be required to expend $13.3 to $14.5 million to acquire Fonterra shares.

168. In addition, the KFF Suppliers Committee submits that:

> The arguments advanced by Fonterra that the assessment of this application can be made on the basis of other competitive constraints (e.g. constraints provided under the Dairy Industry

> Restructuring Act 2001("DIRA"), next best alternative uses of land and Fonterra's co-operative structure) are not sound. The substantial lessening of competition test under section 47 of the Commerce Act 1986 ("the Act") is a comparative test. The factual (the merger proposal) must be compared with the most likely counterfactual (which in this case is the status quo). These additional arguments advanced by Fonterra may be characterised as merely addressing competition within the factual. They do not provide an answer to the likely loss of competition when comparing the factual with the counterfactual.[10]

169. The Commission considers that the DIRA and Fonterra's co-operative structure constrain Fonterra's market power to some extent in the raw milk market. However, the ability of the DIRA and Fonterra's cooperative structure to act as constraints on Fonterra is largely unchanged in the factual and counterfactual. The DIRA places obligations on Fonterra to enable farmers to exit or reduce supply to the co-operative and thereby ensures Fonterra is subject to the threat of competition. However, the competitive disciplines imposed by potential competition are not equivalent to that imposed by actual competition. The impact of the proposed acquisition would be to remove a small but existing competitor for the acquisition of raw milk and this is the focus of the Commission's analysis.

170. The Commission considers that the constraint imposed by existing competition in the raw milk market generally arises through two mechanisms:

- the ability of suppliers to switch between acquirers in response to changes in price or other terms of supply; and
- benchmarking of prices offered by acquirers informs suppliers for their contractual negotiations with their own acquirers.

171. In the counterfactual, KFF would provide an alternative for some farmers to switch in part or in full from Fonterra. However, the competitive constraint imposed by this limited ability to switch is small due to KFF's relative size.

172. In the factual, KFF would no longer exist as an alternative acquirer of raw milk and existing KFF suppliers are assumed to switch to supply Fonterra. Those suppliers may apply to supply Fonterra as supplying shareholders or tender to supply as contract suppliers, including winter milk suppliers.

173. As a consequence of the acquisition, these KFF suppliers may incur a reduction in the price that they receive for their milk, although the Commission had difficulty in determining the extent of this reduction given the difference in methods for calculating payouts between Fonterra and KFF. However, this reduction in payout relates to a small proportion of suppliers in the market as a whole.

174. The Commission considers that KFF provided a limited competitive constraint in the counterfactual and consequently its removal is unlikely to result in a significant enhancement of Fonterra's market power in the factual.

175. Consequently, the Commission considers that, whilst the proposed acquisition will reduce the number of acquirers from two to one, this is unlikely to result in a substantial lessening of competition.

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[10] KFF Suppliers' Committee submission, dated 10 February 2006, paragraph 2.7.

Conclusion

176. The Commission concludes that the proposed acquisition is unlikely to substantially lessen competition in the market for the supply and acquisition of raw milk in the Manawatu and Wairarapa region.

The North Island Market for Processing and Wholesale Supply of Town Milk

Existing Competition

Market Concentration

177. The town milk market in the North Island is characterised by two large processors, Fonterra and Goodman Fielder/NZDF, and a number of smaller regional processors particularly in the upper North Island. KFF is the third largest processor of town milk, with its sales being concentrated in the lower North Island. KFF manufactures both 'Farmgate' and 'Pam's' house brand milk for Foodstuffs LNI. Pam's milk is over [ ] percent of Foodstuffs LNI's milk sales, with the remainder largely being of 'Meadow Fresh' milk. Foodstuffs LNI has approximately [ ] percent of supermarket sales in the lower North Island.

178. On the demand side, [ ] percent of milk is sold through supermarkets, with the remainder sold through the route trade (including to oil companies) and foodservice. Supermarket house brands make up about [ ] percent of total sales, and [ ] percent of supermarket sales. Foodstuffs (Auckland) house brand milk is manufactured by Fonterra. Progressive Enterprises house brand milk is mainly manufactured by Fonterra, with a small portion in the upper North Island manufactured by Fresha Valley. Progressive Enterprises' house brand contract is currently being tendered for renewal in May 2006.

179. The Applicant submits that the manufacture and wholesale supply of house brands should not be included in the manufacturers' market shares, given the short-term nature of these contracts. The Commission has on a number of occasions considered the treatment of house brand or third party agency contracts in assessing market concentration.[11] In these previous decisions, the Commission aggregated house brand volumes with brands' volumes to determine town milk market volumes. However, if these contracts were relatively short-term and contestable, this was taken into account in the competition analysis, for which market shares are only a starting point. This approach enables a full discussion of the extent of competition for the contracts.

180. Table 3 outlines the impact of the proposed acquisition based on estimated existing market shares and a number of assumptions. Approximately [ ] percent of town milk is sold through the route trade and foodservice, for which there is limited data. Fonterra provided estimates of sales through these channels based on factory estimates with assumptions projected from supermarket sales.

[11] *Decision562: Fonterra Co-operative Group Limited and New Zealand Dairy Foods Limited (November 2005), Decision 487: Burns Philp & Company Limited and Goodman Fielder Limited (February 2003).*

181. The Commission notes that data for 12 months prior to the proposed acquisition might not be a good indication of forward market shares:

- In July 2005, Foodstuffs LNI implemented its strategy for preferential stocking of house brands, which increased house brand milk sales to over [ ] percent of sales. This strategy resulted in 'Anchor' milk almost being removed from Foodstuffs LNI's stores. Some form of this strategy is expected to continue into the future under the counterfactual and factual. On request, Fonterra amended the data used in the table based on projections of sales after the Foodstuffs LNI's strategy was implemented.
- [ ]. Table 3 is based on assumptions that Fonterra and Fresha Valley continue to share this contract in similar proportions to the current contract.

Table 3: Estimated Shares of Town Milk Market

Firm	Brands	Volume (litres)	Market Share
Fonterra	Anchor	[ ]	[ ]%
	House brands	[ ]	[ ]%
Pre-acquisition		**[ ]**	**[ ]%**
KFF	Kapiti	[ ]	[ ]%
	House brands	[ ]	[ ]%
Post-acquisition		**[ ]**	**[ ]%**
NZDF/Goodman Fielder		[ ]	[ ]%
Gisborne Milk		[ ]	[ ]%
Independent Milk Processors		[ ]	[ ]%
Fresha Valley		[ ]	[ ]%
Top Milk		[ ]	[ ]%
Green Valley		[ ]	[ ]%
Ridge (A2)		[ ]	[ ]%
Taranaki Fresh		[ ]	[ ]%
Total		**[ ]**	**100.0%**

182. Table 3 shows that Fonterra's market share is likely to increase from [ ] percent to [ ] percent as a result of the acquisition. Post-acquisition, Fonterra would contract manufacture Foodstuffs LNI's house brand milk. This resulting level of market concentration is outside the Commission's safe harbours.

183. There would also be an increase in concentration in the town milk market in some distribution channels and geographic regions. In the factual, Fonterra would:

- manufacture and supply approximately [ ] percent of town milk to supermarkets in the North Island (up from [ ] percent); and
- manufacture and supply approximately [ ] percent of town milk to the lower North Island (including route and foodservice) (up from [ ] percent)).

Views of the Parties

184. The Applicant submits that:

- Goodman Fielder/NZDF would remain a strong competitor for branded milk and its rights to access raw milk are protected under the DIRA; and
- a variety of other existing competitors provide a competitive constraint, particularly in their local regions, and they generally have surplus capacity to expand in response to changes in price.

185. Interested parties interviewed raised a number of issues regarding the impact of the proposed acquisition on existing competition.

- Most interested parties consider that KFF provides an important competitive constraint in the town milk market. Following Foodstuffs LNI's acquisition of KFF, the wholesale price of town milk fell and this is attributed to realisation of the threat of vertical integration by the supermarkets.
- Views are mixed on the competitive constraint imposed by Goodman Fielder/NZDF. The location of Goodman Fielder/NZDF's processing plant in Longburn means that it incurs higher transport costs of approximately [ ] cents per litre to compete in the upper North Island. [ ].
- The other smaller competitors are considered to lack economies of scope and scale to constrain Fonterra. This is particularly important for sales to supermarkets, which require security of supply and scale in distribution.
- The proposed acquisition would lessen competition for house brand contracts, as Fonterra would have incentives to reduce sales of house brand milk in favour of its branded milk, [ ]. House brand milk is generally sold at lower prices.
- KFF provided competitive pressure through providing a negotiating counterpoint or benchmark which informed acquirers in dealing with Fonterra. [ ].

Commission Analysis

186. The Commission considers that in the counterfactual, Foodstuffs LNI would continue its strategy of preferential stocking of its house brand milk to the exclusion of other branded milks. In addition, Foodstuffs LNI would seek to expand its sales of house brand milk into the route trade within the lower North Island.

187. Consequently, the Commission considers that there are three direct impacts of the proposed acquisition of KFF on existing competition:

- it removes an independent competitor in the route trade in the lower North Island;
- it potentially removes an independent benchmark of wholesale prices that informed other acquirers of town milk in order to leverage better prices from other suppliers; and

- [ ], but it does not change the size of the contestable portion of the market to Fonterra's competitors, as Foodstuffs LNI would continue to acquire all of its house brand town milk from its wholly-owned subsidiary, KFF, in the counterfactual.

188. The Commission considers that the competitive position in the upper North Island is largely unchanged, as KFF did not operate in this region.

189. Given these assumptions, it is possible to consider the ability of existing competition to constrain Fonterra post-acquisition.

190. The Commission considers that Goodman Fielder/NZDF would remain a strong competitor for its branded milk post-acquisition. Goodman Fielder/NZDF is the sole other national supplier of town milk. Goodman Fielder/NZDF currently has [ ] percent market share in the North Island and its 'Meadow Fresh' brand is particularly strong in the route trade.

191. Goodman Fielder/NZDF has secure raw milk supply arrangements protected by the raw milk regulations and [ ] to improve economies of scale. It also has an extensive distribution network, following the dairy brand swap with Fonterra in August 2005, which reduces any locational disadvantages. Goodman Fielder/NZDF is also located in Palmerston North and is therefore well placed to fill any competitive void that might arise from the removal of KFF.

192. Other smaller processors might lack economies of scale to compete island-wide, but they provide a competitive constraint within their regions where they have established a home base for their brands. These smaller processors are also particularly strong in the route trade in their regions. Fresha Valley, Gisborne Milk, Taranaki Fresh, Top Milk, Independent Milk Processors, and Green Valley together supply approximately [ ] percent of milk sold in supermarkets in the North Island, but about [ ] percent of milk sold in the market as a whole (when the route trade is included).

193. These independent processors generally have capacity to expand production of town milk (for example, Gisborne Milk currently sells its surplus milk to Fonterra). The hurdles to expansion into sales to supermarkets are the need for critical mass to make distribution viable and being able to guarantee security of supply. However, the Commission considers that supermarket operators could facilitate expansion by these competitors in the event that Fonterra sought to exercise market power post-acquisition. For example, Fresha Valley supplies Progressive Enterprises' house brand town milk to 31 stores in the upper North Island.

194. The Commission considers that the proposed acquisition of KFF removes an independent benchmark for wholesale prices of town milk that might have informed acquirers to enable them to leverage discounts from suppliers. However, this benchmark was relatively weak as it could only be inferred from Foodstuffs LNI's retail price. Foodstuffs LNI would continue to have incentives to maintain a competitive retail price. In addition, in KFF's absence, the smaller independent processors would continue to provide a benchmark for wholesale prices for independent supply of town milk. This benchmark could be used as leverage by acquirers who are generally intolerant of regional price discrepancies in basics such as milk.

195. In the case of house brand milk, the number of participants competing for contested house brand contracts is largely unchanged by the proposed acquisition. KFF exclusively supplied Foodstuffs LNI's house brand and [ ].

196. The main change is that Fonterra would have [ ] to manufacture and supply Foodstuffs LNI's house brand town milk. This arrangement would enable Fonterra to maintain a base level of sales and economies of scale in processing and distribution in the lower North Island. However, Fonterra is not prevented from competing for Progressive Enterprises' house brand contracts and, [ ], the Commission considers that Fonterra would still have incentives to supply house brand products at competitive prices to maintain volumes.

197. Goodman Fielder/NZDF is a possible alternative supplier [ ].

<u>Conclusion on Existing Competition</u>

198. The proposed acquisition results in the amalgamation of the first and third largest wholesale suppliers of town milk in the North Island. However, the Commission considers that Goodman Fielder/NZDF would remain a strong competitor for its branded milk on an island-wide basis. There are also a number of independent smaller competitors that provide an important constraint in the geographical regions in which they are based and which generally have capacity to expand. The proposed acquisition does not change the number of suppliers competing for house brand contracts. Consequently, the Commission considers that existing competition would continue to impose some constraints on Fonterra post-acquisition.

Potential Competition

199. An acquisition is unlikely to result in a substantial lessening of competition in a market if the businesses in that market continue to be subject to real constraints from the threat of market entry.

200. The Commission's focus is on whether businesses would be able to enter the market and thereafter expand should they have the incentives to do so, and the extent of any barriers they might encounter should they try. Where barriers to entry in a market are clearly low, it may be unnecessary for the Commission to identify specific businesses that might enter. In other markets, where barriers are higher, the Commission might seek to identify possible new entrants as a way of testing the assessed entry barriers.

<u>Conditions of Entry</u>

201. The Applicant submits that barriers to entry to the town milk market are low. Raw milk may be acquired from Fonterra under the raw milk regulations or directly from farmers (as facilitated by the DIRA). The costs of establishing a full processing plant are not significant. Consumers are not overly brand conscious and the colour coding of milk caps assists consumers to recognise milk types. Distribution networks through third party distributors might be easily established, particularly in the regional route trade.

202. Open Country Cheese submits that in its experience, barriers to entry for the acquisition of raw milk are not low:

> While the legal entry barriers may have been intended by the legislators to be low, there are many factors that are relevant. Barriers to entry include the complex realities of persuading farmers accustomed to the Fonterra system to switch to a new processor. (…) before they will commit their milk to an alternative processor they want to see then establish their bona fides as a processor (…).
>
> Fonterra's behaviour has in the practical sense frustrated the effective operation of the entry provisions of DIRA.[12]

203. The Commission has previously looked at the conditions for entry to this market.[13] The major constraints on entry related to the need for a distribution network and the critical mass required to make entry economic. Supermarket operators interviewed confirmed that these costs of entry were still relevant.

204. KFF advises that the cost of entry to be an acquirer in the raw milk market is approximately $12 million for a processing plant with a capacity of 100,000 litres per day and a blow moulding plant to manufacture bottles. Establishment of the plant and securing milk supply contracts would take approximately 12 months lead-time. Economies of scale in processing raw milk mean that it is desirable that entry is of a sufficient size.

205. Entry of this size would require secure access to supplies of raw milk. The raw milk regulations require Fonterra to supply up to 400 million litres to independent processors. As at 15 December 2005, Fonterra declared that it had contractual obligations to supply 408,732,000 litres and that it was likely to supply this amount. The proposed acquisition would result in milk (equal to approximately [ ] million litres per annum) supplied to KFF under the raw milk regulations to be available to other independent processors.

206. The Commission considers that there is some uncertainty about the ability to secure longer term access to raw milk under the raw milk regulations. Fonterra has reported that the 400 million litres required to be supplied is being met in each year, and no independent processor (other than Goodman Fielder/NZDF) is guaranteed supply from one year to the next.

207. The DIRA facilitates independent processors acquiring milk directly from farmers through obligations on Fonterra to reduce switching costs for its supplying shareholders. The switching costs are reduced by:

- the 'no discrimination' rule, which provides for farmers to receive the full capital value of their investment in Fonterra when reducing supply or exiting Fonterra;
- obligations on Fonterra to accept complying notices to reduce supply or exit Fonterra and to ensure timely payment for surrendered shares in the form of cash or capital notes;
- the '20 percent rule' enabling shareholding suppliers to supply up to 20 percent of their milk to another acquirer, subject to conditions;

[12] Open Country Cheese submission, dated 17 January 2006, paragraphs 15-16.
[13] *Decision 428: Mainland Products Limited and Southern Fresh Milk Company Limited* (18 May 2001).

- the ‘no foreclosure rule’ ensures that, within a 160 kilometre radius of any point, at least 33 percent of contracts to supply milk expire at the end of any season; and
- obligations on Fonterra to sell farm vats on request at fair value.

208. Despite the reservations expressed by Open Country Cheese, there is some evidence that these measures are working in practice. For example, the establishment of Synlait and the recent announcements by Landcorp for eight of its farms to switch to supply Open Country Cheese indicate some willingness by suppliers to switch away from Fonterra. Fonterra submits that, to its knowledge, [ ].

209. Distribution of town milk is specialised requiring an ability to supply retail chains seven days a week, sometimes several times a day. The product is bulky, low value, leaks, and requires management of crate returns. The supermarket operators interviewed said that, despite upgrading their central warehousing facilities, they had no plans to invest in distribution of milk to their stores. Consequently, distribution is likely to remain a constraint on entry on an island-wide scale and subject to entering into third party distribution arrangements. However, these costs are not considered to be prohibitive for entry on a smaller scale in particular geographic regions, particularly in the route trade.

210. As noted in the discussion on existing competition, although on a small scale, market entry has occurred in the town milk market. Whilst milk available under the raw milk regulations may no longer be available to all who wish to purchase it, an increasing number of producers are sourcing raw milk directly from farmers, as evidenced by Synlait and other food processors such as Open Country Cheese.

211. Consequently, the Commission considers that the conditions of entry are such that potential entrants could continue to impose some constraints on Fonterra post-acquisition.

<u>Potential Entrants</u>

212. The Applicant submits that three classes of potential competitor could enter the market:

- an international player (like San Miguel through National Foods), or an existing domestic competitor operating in near markets (like Open Country Cheese);
- competing co-operatives, or dairy farmers exiting Fonterra, could vertically integrate; or
- Progressive Enterprises or Foodstuffs (Auckland) could vertically integrate and replicate the Foodstuffs LNI/KFF model.

213. [ ]. Dairy farmers interviewed were unaware of approaches by a new entrant to support a major entrant in the town milk market in the North Island.

214. The Commission considers that entry on a scale necessary to constrain Fonterra post-acquisition on an island-wide basis is unlikely within the Commission’s timeframe. However, localised entry by dairy farmers vertically integrating into town milk

processing is possible and this could impose some constraint on Fonterra within certain regions.

Conclusion on Potential Competition

215. The major constraints on entry to the town milk market relate to the need for a distribution network and the critical mass required to make entry economic. The raw milk regulations could assist new entrants to gain a foothold in the markets for milk and milk products (however once the 400 million litre ceiling reached raw milk supply may not be guaranteed). The DIRA facilitates securing access to supplies of raw milk directly from farmers to support entry on a scale large enough to act as a competitive constraint to Fonterra. However, any new entry would generally require a one to two year lead time.

216. The Commission could not find evidence of potential entry on an island-wide scale that might constrain Fonterra post-acquisition. However, localised entry by dairy farmers vertically integrating into town milk is possible and this would impose some localised competitive constraints.

Countervailing Power

217. A firm may be constrained by any countervailing power possessed by its customers. Buyer power is likely to be high when there is concentration of buyers and the volume of purchases of the buyers is high.

218. The supermarkets and oil companies are the major acquirers of town milk in the North Island. The Applicant's economic experts, CRA International, referred to a British study[14] outlining how supermarkets derived their power in relation to suppliers:

- as their suppliers' customer (given their market shares at the retail level, supermarkets are a necessary intermediary for suppliers);
- as their suppliers' competitor (by developing house brands either through toll manufacturing contracts or vertical integration); and
- as their suppliers' supplier (by supplying shelf and advertising space).

219. The Applicant submits that supermarkets have countervailing power as major purchasers of milk and through house brand contracts.

220. [

].

221. Supermarket sales constitute [ ] percent of town milk sales in the North Island, and this share is growing in the order of [ ] percent per annum. These sales are split between the three major supermarket operators, with the two Foodstuffs cooperatives [ ] market shares in their respective regions. Consequently, the volume of sales of each

[14] Dobson, Paul W (2005) *"Exploiting Buyer Power: Lessons from the British Grocery Trade"*, Antitrust Law Journal, 72, 529-562.

supermarket operator is significant, but the availability of alternative distribution channels might reduce their individual countervailing power.

222. For supermarkets to exercise buyer power through management of house brand contracts and allocation of shelf space requires at least one other credible alternative source of supply or the supermarket being able to leverage buyer power across the contracted suppliers' portfolio of products.

223. Goodman Fielder/NZDF is an alternative provider of branded milk on an island-wide basis. [

].

224. [

].

225. [

].

226. Accordingly, this buyer power would arise from the supermarkets having alternative suppliers to supply house brand contracts and through being able to leverage some buyer power against Fonterra across the portfolio of Fonterra's dairy products. However, this countervailing power is unlikely to be sufficient on its own to prevent Fonterra from raising prices post-acquisition.

227. The Commission considers that the major acquirers of town milk would have some countervailing power over Fonterra post-acquisition.

Coordinated Power

228. The Applicant submits that the characteristics of the town milk market provide minimal scope for collusive (express or tacit) behaviour. These structural and behavioural characteristics include:

- a high degree of competition between Goodman Fielder/NZDF and Fonterra, and other smaller competitors;
- growth is occurring in value-added products, and in this respect marketing and product differentiation are crucial;
- a number of smaller competitors with secure access to raw milk at a competitive price, that create a disproportionate downward effect on price;
- low barriers to entry and expansion;
- major supermarkets possess substantial countervailing power; and

- the asymmetry between Fonterra, Goodman Fielder/NZDF and other players, in respect of capacity, business models and other interests.

229. As outlined in the Commission's guidelines, the Commission applies certain tests to assess the likelihood of coordinated market power. This analysis is summarised in Table 4 below.

230. This analysis outlines that the market would be concentrated post-acquisition. However, the existence of smaller competitors, the rate of product innovation, the lack of history of anti-competitive coordination and the ability of supermarkets to exercise some buyer power would limit the potential for coordinated market power.

231. The Commission considers that the proposed acquisition would not increase the likelihood of co-ordinated market power at the manufacturing or wholesale levels.

Table 4: Testing for Potential for Co-ordinated Market Power

Factors Conducive to Collusion	**Presence of Factors in the Market**
High seller concentration	Yes: Post-acquisition the two main suppliers would have [ ] percent market share.
Undifferentiated product	On balance, No: there are a variety of white milk products available on the market. In the period December 03 to September 05, sales of enriched milk grew by [ ]% and reduced fat milk by [ ]%. Sales of full cream milk fell by [ ]% and standard homogenised milk by [ ]%.
Slow speed of new entry	On balance, Yes: De-novo entry would require securing sufficient supplies of raw milk, establishing processing capacity and marketing arrangements. Estimated to be 12 months minimum lead time required.
Lack of smaller competitors	No: There are a range of smaller competitors with approximately [ ] percent market share.
Acquisition of a maverick business	On balance, No.
Price inelastic market demand	Yes.
History of co-ordinated behaviour	No: Goodman Fielder/NZDF and Fonterra have a number of co-operation agreements, including relating to manufacturing of town milk in the South Island. However, there is no historical evidence of co-ordination in the wholesale supply of town milk.
Lack of countervailing power of buyers	No. Some countervailing power by supermarkets and oil companies.

Conclusion

232. In conclusion, post-acquisition, Fonterra's market share would increase from [ ] percent to [ ] percent. This would arise from the merger of the first and third largest suppliers of town milk in the North Island. The proposed acquisition would also increase concentration in parts of the North Island, particularly the wholesale supply of town milk to supermarkets and the wholesale supply of town milk in the lower North Island.

233. In the counterfactual, KFF would continue to provide a limited competitive constraint outside the lower North Island.

234. In the factual, there are a number of constraints that would continue to operate on Fonterra. In particular:

- Goodman Fielder/NZDF would continue to exist as an alternative supplier of branded town milk on an island-wide basis;
- the existence of smaller competitors, with the capacity to expand, facilitates competition at the regional level;
- the potential for new entry, particularly at the regional level; and
- some countervailing power by supermarkets and oil companies.

235. Consequently, the increased concentration that would result from the proposed acquisition are concentrated in a portion of the market.

236. The Commission considers that the competitive constraint imposed by Goodman Fielder/NZDF, in combination with the other three factors, would constrain Fonterra post-acquisition. In comparing the factual and the counterfactual, there is unlikely to be a material increase in the ability of Fonterra to exercise market power post-acquisition.

237. Consequently, the Commission considers that there is unlikely to be a substantial lessening of competition in the town milk market.

The National Market for the Import, Manufacture and Wholesale Supply of Specialty Cheese

Existing Competition

238. The speciality cheese market is characterised by two tiers, those manufacturers competing on a national basis, and a number of smaller niche manufacturers competing in geographical regions.

239. The major manufacturers at the national level are Fonterra and Goodman Fielder/NZDF, but other participants include KFF, Waimata, Whitestone Cheese, and Delmaine. At the regional level, there are over 100 specialty cheese producers including Gibbston Valley Cheese, Kingsmeade, Matatoki Farm Cheese, Neudorf Dairy, and Zany Zeus.

240. The Euromonitor[15] describes the specialty cheese market as being 'vibrant and dynamic', with a large number of brands and considerable product innovation. However, the boutique producers of specialty cheese sell their products mainly at retail outlets attached to their manufacturing plants, and in specialty food shops and tourist outlets, rather than through supermarkets. Sales into supermarkets require sufficient economies of scale to support distribution and marketing, in some cases including in-store packaging and stocking.

241. Table 5 outlines the likely impact of the proposed acquisition on market shares in the specialty cheese market. The data used in this table was provided by the Applicant. It is based on supermarket scanner data through the chiller plus Fonterra estimates of sales

[15] Euromonitor Report, *Packaged Food in New Zealand,* April 2005.

through the supermarket cheese bar and in the route and foodservice trade. It was necessary to use estimates as supermarket scanner data is not available for supermarket cheese bar sales and there is no systematic collection of data on route trade and foodservice sales.

242. The data indicates that [ ] percent of specialty cheese sales by value are through supermarkets, with the majority of these sales through the chiller (being the fixed weight specialty cheeses). KFF sales of speciality cheese are [ ] split between the random weight cheese bar in the supermarkets and the foodservice channel. KFF does not sell its specialty cheese in the route trade. Fonterra sells its specialty cheese through supermarkets and the route trade. With the exception of ‘Ferndale’, Fonterra’s brands tend to occupy a different product space from those of KFF.

243. Table 5 shows that the likely effect of the proposed acquisition is to increase Fonterra’s market share from [ ] to [ ] percent of sales by value. In particular, it would expand Fonterra’s sales into the foodservice channel.

Table 5: Estimate of National Specialty Cheese Sales by Brand by Distribution Channel for 2005 (by value)										
Brand / Manufacturer	**Chiller Sales ($)**	**Share of Chiller Sales**	**Cheese Bar Sales ($)**	**Share of Cheese Bar Sales**	**Total KA Sales ($)**	**Share of KA Sales**	**Route / Foodservice Sales ($)**	**Share of Route / FS Sales**	**Total Sales ($)**	**Share of Total Sales**
Mainland	[ ]	[ ]%	[ ]	[ ]	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Galaxy	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Ferndale	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Perfect Italiano	[ ]	[ ]%	[ ]	[ ]	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Fonterra	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**
Kapiti	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Post - acquisition	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**
Aakronia	[ ]	[ ]%	[ ]	[ ]	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Anchor	[ ]	[ ]%	[ ]	[ ]	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Bouton D’Or	[ ]	[ ]%	[ ]	[ ]	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Ornelle	[ ]	[ ]%	[ ]	[ ]	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Puhoi	[ ]	[ ]	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Royal Tasman	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Total GF/NZDF	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**	**[ ]**	**[ ]%**
Delmaine	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Waimata	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Imported	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Barry’s Bay	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Whitestone	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Other	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%	[ ]	[ ]%
Total	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**

Views of the Parties

244. The Applicant submits that:

- Goodman Fielder/NZDF would remain a strong competitor;
- there are numerous small niche manufacturers who compete strongly at the premium segment of the specialty cheese market; and
- imports of specialty cheese impose a competitive constraint, particularly in the foodservice sector.

245. Interested parties interviewed were generally unconcerned with the proposed acquisition and considered that it would not increase Fonterra's market power. Generally, parties thought the acquisition might have three effects:

- improve distribution of 'Kapiti' cheeses through Fonterra's extensive distribution network;
- result in rationalisation of some brands with 'Kapiti' and 'Ferndale' being similarly positioned; and

provide opportunities for smaller niche manufacturers to expand into foodservice at the premium end of the specialty cheese market.

Commission Analysis

246. Supermarket sales of specialty cheese (by volume) over the period December 1999 to September 2005 have grown at an average annual rate of [ ] percent. This growth has been particularly strong in soft cheeses. Consumers are increasingly trading up to higher quality cheeses as a result of demographic factors (such as declining family sizes, aging consumers, and immigration) leading to demands for smaller volumes and healthier, more diverse, alternatives.

247. The proposed acquisition would result in a merger between the first and third largest producers of specialty cheese. It would enable Fonterra to expand its foodservice sales and consolidate its position in supermarket sales. However, the Commission considers that a range of factors would constrain Fonterra's market power post-acquisition. These include:

- Goodman Fielder/NZDF would remain a strong competitor with approximately [ ] percent market share. 'Puhoi Valley' is the leading specialty cheese brand based on supermarket scanner data. Goodman Fielder/NZDF has secure access to raw milk and has considerable distribution assets in order to compete in the route and foodservice trade.
- There is considerable product innovation occurring with specialty cheese. The Euromonitor outlines new soft cheese products which have been released with international flavours crafted for New Zealand tastes, including adding dried fruits, herbs, and pepper. Similarly, lower fat soft cheeses, such as feta, have undergone extensive product development. The rate of product innovation means that any newly launched specialty cheese product could be superseded by newer products;
- A price increase by Fonterra would facilitate expansion by the smaller specialty cheese producers already operating at the national level. [

]. Supermarket operators could also list the smaller boutique producers' products in supermarkets in their local areas to facilitate their expansion. Similar to wine, regional variations in specialty cheese products are increasingly valued in the market. However, significant expansion might require these producers to review their arrangements for supply of raw milk and seek direct supply in order to significantly expand production, particularly once Fonterra reaches the ceiling on its regulatory obligation to supply up to 400 million litres to independent processors under the raw milk regulations.

- Supermarkets could establish and/or expand their range of house brand specialty cheeses. [ ] is manufacturing five varieties of specialty cheese for Progressive Enterprises in the 'Signature' range. House brand products typically facilitate price competition.
- Imports are also viable for specialty cheese and these constitute approximately [ ] percent of the market. However, imports generally are sold at a different price point to domestic specialty cheeses. Major importers of cheese include KFF, Hutchinsons (NZ) Limited and Eurodell Limited. Certain restaurateurs and specialty stores also import specialty cheese directly. If Fonterra discontinued this line of its business or sought to raise prices post-acquisition, these other importers would be able to expand in response.

248. Consequently, the Commission considers that existing competition would impose a competitive constraint on Fonterra post-acquisition. However, consideration will also be given to the likely constraint imposed by potential competition.

Potential Competition

249. The Applicant submits that a variety of other potential competitors could enter the market, including:

- international manufacturers from Australia and Europe could wholesale supply specialty cheese in New Zealand;
- entry by supermarkets with house brands, as has recently occurred with Progressive Enterprises; or
- de novo entry by a new or near competitor.

250. The Applicant also provides a submission from CRA International referring to studies outlining that market growth is conducive to entry.[16]

251. Specialty cheese is a relatively high value product, able to be stored for long periods, and is therefore suitable for importing. The Commission considers that supermarket operators are unlikely to tolerate major price discrepancies for specialty cheese on either side of the Tasman. Consequently, the threat of imports by Australian manufacturers, such as National Foods, would be likely to constrain Fonterra from significantly raising prices post-acquisition.

[16] Siegfried, J and L Evans (1994), "*Empirical Studies of Entry and Exit: A Survey of the Evidence*", Review of Industrial Organization, 9(2), 121-155.

252. The costs of new entry to process specialty cheese depend on the scale of entry. Requirements for greenfields entry include access to supplies of raw milk, acquiring cheese processing facilities, developing cheese manufacturing expertise, obtaining food safety compliance certification, and establishing distribution arrangements.

253. Fonterra estimates that the cost of entry at the boutique level is approximately $2.5 to $5 million, and entry on a medium to large scale would cost approximately $15 to $20 million. This order of costs was confirmed by an industry participant.

254. The Commission notes that there has been steady entry to this market on a small boutique scale in recent years. This entry is likely to continue, although processors might increasingly need to establish independent supplies of raw milk once Fonterra has reached the ceiling on its regulatory obligation to supply up to 400 million litres under the raw milk regulations. This localised competition would impose some constraints on Fonterra post-acquisition.

255. Consequently, the Commission considers that the threat of imports and the potential for entry by boutique processors at the regional level would impose some competition constraints on Fonterra post-acquisition.

Countervailing Power

256. The Applicant submits that supermarkets would continue to exercise countervailing market power over Fonterra post-acquisition due to the availability of alternative suppliers and the ability to establish house brand products (which have been successfully introduced in Australian supermarkets).

257. The Commission considers that the availability of alternative suppliers, such as Goodman Fielder/NZDF, and the threat of imports, particularly from Australian manufacturers, would give supermarkets some countervailing power. Supermarkets would also be able to facilitate entry or expansion by existing or potential competitors through allocating shelf space and promotional spots.

Coordinated Power

258. The Applicant submits that there is minimal scope for coordinated conduct in the specialty cheese market due to:

- low seller concentration and sellers of varying sizes;
- large variety of different cheese types;
- ease and speed of new entry; and
- countervailing power of supermarkets as the major purchasers of cheese.

259. The Commission considers that the specialty cheese market is differentiated, with a large number of smaller competitors, and is subject to the threat of imports. There is no history of coordination in this market. Consequently, the Commission considers that coordinated market power is unlikely to occur post-acquisition.

Conclusion

260. In conclusion, post-acquisition, Fonterra's market share would increase from [ ] percent to [ ] percent. This would arise from the merger of the first and third largest suppliers of specialty cheese.

261. The Commission considers that there are a number of constraints that would continue to operate on Fonterra. In particular:

- Goodman Fielder/NZDF would continue to exist as a major competitor for specialty cheese products;
- there are a large number of smaller competitors at the national and regional level and, with a growing market, further entry is likely;
- there is a high level of product innovation, meaning that any new specialty cheese product would be constantly under threat of being supplanted by newer products;
- existing or potential imports impose some constraints on Fonterra's ability to raise prices; and
- supermarkets would have some countervailing power.

262. The existing competition posed by Goodman Fielder and smaller competitors would likely constrain Fonterra. This is supplemented by the additional constraints posed by potential competition in the form of new product development and imports, as well as the countervailing power of supermarkets. Consequently, the Commission considers that the proposed acquisition is unlikely to substantially lessen competition in the specialty cheese market.

The National Market for the Import, Manufacture and Wholesale Supply of Ice Cream

Existing Competition

<u>Market Concentration</u>

263. The ice cream market in New Zealand consists of Fonterra as the major participant, with a number of smaller processors, including KFF, Kiwi Ice Cream, Emerald Foods, Talleys, Deep South, Rush Munro's, Gourmet Ice Cream Co, as well as Unilever (Streets) who import ice cream from Australia.

264. On the demand side, [ ] percent of ice cream in New Zealand sold is everyday and premium ice cream, and [ ] per cent is novelty and scoop. House brands make up just over [ ] percent of total everyday take home ice cream sales, and [ ] percent of total ice cream sales.

265. As noted in paragraph 114 above, the Commission considers the ice cream market as a single, but differentiated product market, including novelty and scoop ice cream, everyday take home and premium take home.

266. Fonterra is the largest processor of ice cream, manufacturing the 'Tip Top' and 'Peters New American' brands. 'Tip Top' is an 'everyday' brand, and accounts for [ ] percent of novelty and scoop ice cream and [ ] percent of everyday take home ice cream.

KFF's ice cream is considered to be a premium brand, and KFF's sales account for [ ] percent of premium take home ice cream sold.

267. Emerald Foods and Talley's both supply branded and house branded ice cream to retailers. Emerald Foods manufactures 'Pam's' house brand (two litre) ice cream in the upper North Island and South Island, and the 'Signature' range house brand ice cream. Since January 2006, KFF produces 'Pam's' ice cream products for Foodstuffs LNI in the lower North Island.

268. Table 6 estimates the impact of the proposed acquisition based on estimated existing market shares. As the data received by the Commission does not breakdown the sales of house brand ice cream by manufacturer, the Commission has attributed all house brand sales to Fonterra, resulting in an overestimation of Fonterra's market share. The Commission believes this cautious approach is more appropriate than underestimating its market share.

Table 6: Estimated Market Shares of Ice Cream Market

Manufacturer	Novelty and scoop		Everyday take home		Premium take home		Total all ice cream	
	$ m	%	$ m	%	$ m	%	$ m	%
Fonterra (Tip Top)	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Housebrands	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Pre acquisition	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**
Kapiti	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Post acquisition	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**	**[ ]**
Kiwi Ice Cream	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Emerald Foods	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Talleys	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Deep South	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Rush Munro's	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Gourmet Ice Cream Co	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Unilever	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Others	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Total	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**	**[ ]**	**100%**

269. Table 6 shows that the proposed acquisition would increase Fonterra's share for novelty and scoop ice cream by [ ] percent to [ ] percent, and by [ ] percent to [ ] percent for premium take home ice cream. Fonterra's total ice cream market share is likely to increase from [ ] percent to [ ] percent as a result of the acquisition. As noted above, the exact market share figure could be less as some house brand manufacture is carried out by Fonterra's competitors.

Views of the Parties

270. The Applicant submits that:

Take home market

- The aggregation resulting from the acquisition will be insignificant, and simply extends Fonterra's ice cream range into the super premium segment.
- Emerald Foods would retain a high share of the premium segment with sales of its 'Killinchy Gold' and 'Mövenpick' brands.
- Supermarkets themselves would provide a competitive constraint by changing suppliers for their house brand contracts.

Novelty and scoop market

- As the aggregation is only [ ] percent in this segment, no impact on the competitive dynamics of the market would be felt.
- Demand for super premium ice cream is driven by non-price attributes such as new flavours, rather than price. The merged entity would continue to face considerable competition from a range of competitors.
- Supply-side substitution possibilities at the customer dimension means that producers can switch channels towards food service outlets and thereby constrain the merged entity.

Imports

- Emerald Foods currently imports some 'Mövenpick' ice cream directly from Switzerland on a seasonal basis to provide new flavours for the New Zealand market.
- Almost [ ] percent of the ice cream supplied at the wholesale level in New Zealand is produced in Australia.

271. Interested parties interviewed raised a number of issues regarding the impact of the proposed acquisition on existing competition.

- A concern was voiced that with Fonterra forming a close partnership with Foodstuffs (and thus Toops, Gilmours and Trents), the number of potential distributors available to competitors would effectively be reduced from 4 to 3.
- The growth of house brands has resulted in constraints on access to freezer space in supermarkets, particularly in the everyday take home ice cream segment. Consequently, open contestability for the house brand manufacturing contracts is important for economies of scale. [

  ].

Commission Analysis

272. The Commission considers that the proposed acquisition would result in a small increase in aggregation in the market overall.

273. The premium segment of the ice cream market has grown over the last two years by [ ] percent, with an average annual growth rate of [ ] percent. This growth is fuelled by

product innovation and expansion by existing manufacturers. The proposed acquisition would increase Fonterra's share of the premium take home ice cream product segment, however given Emerald Foods' current strong 'Mövenpick' and 'Killinchy Gold' brands, Emerald Foods would remain a strong competitor to Fonterra in this segment post-acquisition.

274. There are also a number of smaller competitors in the ice cream market, with established brands and distribution networks. The Commission was informed by the Applicant that excess capacity currently exists in the sector. This was confirmed by other market participants. The Applicant estimates current spare capacity to be [ ] per cent of total capacity, and other parties confirm they are running below full capacity. This excess capacity ensures strong competition for house brand contracts. House brand ice cream constitutes approximately [ ] percent of everyday take home ice cream. [

].

275. Whilst Fonterra may form a close partnership with Foodstuffs (and thus Toops, Gilmours and Trents), and the number of potential distributors available to competitors may effectively be reduced from 4 to 3, the Commission understands that the NZ Distributor's Association, Crean and Goodman Fielder, as well as many smaller regional distributors, could be used by Fonterra's competitors. The Commission does not consider that an effective lessening of potential distributors in this case raises concerns.

276. Exports of ice cream products are also significant for ice cream products. If Fonterra sought to raise price post-acquisition, existing manufacturers could divert exports (primarily sold to Japan and Korea) to the domestic market.

<u>Conclusion on Existing Competition</u>

277. The Commission considers that existing competition would impose adequate constraints on Fonterra post-acquisition.

Potential Competition

278. The Applicant submits that there are a wide range of commercially viable entry or expansion options for domestic and overseas ice cream suppliers and that this is evidenced by new entry in the industry over the past five years. Access to raw materials and distribution arrangements are not major barriers. In particular, the evolution of central distribution systems by supermarkets and food service distributors means a lack of its own distribution network would not impede a new entrant.

279. The Commission considers that there are relatively low barriers to new entry for Australian ice cream manufacturers to export ice cream products to New Zealand. This would require marketing to establish brand recognition, distribution networks and access to limited supermarket freezer space. Such entry could be facilitated by supermarket operators in the event that Fonterra sought to raise prices post-acquisition.

280. Greenfield entry would require access to raw ingredients, plant, technical knowledge, and marketing and distribution arrangements. Raw ingredients are generally available, as ice cream can be manufactured from raw milk, cream, milk powders and/or anhydrous milk fat (AMF). The Applicant estimates the costs of establishing a medium

scale plant to be approximately $10 - $15 million. Evidence of new entry to the ice cream market over the last five years, suggests that these costs of entry are not significant.

Conclusion on Potential Competition

281. The Commission considers that barriers to entry and expansion may exist in the form of brand recognition and limited supermarket shelf space. However as ice cream is a growing market, the Commission does not believe that such barriers could be considered to significantly constrain competition.

Countervailing power

282. The Applicant submits that similar to the cheese market, the countervailing market power of supermarkets will significantly constrain the post-merger entity.

283. The Commission considers that the supermarkets are likely to have some countervailing power, as discussed above in terms of control of access to freezer space and management of house brands, as the majority of everyday and premium ice cream is sold through supermarkets.

Coordinated power

284. The Applicant submits that the characteristics of the ice cream market provide minimal scope for collusive (express or tacit) behaviour, for the same reasons as given with respect to the town milk market in paragraphs 228. In particular, the asymmetry between Fonterra and other players, in respect of product, market share and business models, and that the import of goods by Unilever and the supermarkets constitute a significant proportion of demand in the market, mean that collusive behaviour will not increase in the market.

285. The Commission considers the coordinated power is unlikely.

Conclusion

286. In conclusion, Fonterra's market share would increase from [ ] percent to [ ] percent as a result of the proposed acquisition. This is a conservative estimate based on all house brand production being attributed to Fonterra. Fonterra's share of wholesale supply of premium ice cream products would increase by [ ] percent to [ ] percent.

287. The Commission considers that there are a number of constraints that would continue to operate on Fonterra in the factual. In particular:

- Emerald Foods would continue to exist as a major competitor for premium ice cream;
- there are a number of smaller competitors in the ice cream market and, with a growing market, further entry is possible;
- diversion of ice cream currently exported out of New Zealand by existing competitors, and new imports both provide competitive constraints;

- there is a high level of product innovation, meaning that any newly launched specialty flavours of ice cream would be constantly under threat of being supplanted by newer products; and
- supermarkets would have some countervailing power.

288. The Commission considers that, when it considers the impact of these factors in the factual as compared to the counterfactual, there is unlikely to be a material increase in the ability of Fonterra to exercise market power post-acquisition. Consequently, the Commission considers that there is unlikely to be a substantial lessening of competition in the ice cream market.

289. The Commission considers that the proposed acquisition is unlikely to substantially lessen competition in the ice cream market.

OVERALL CONCLUSION

290. The Commission has considered the probable nature and extent of competition that would exist, subsequent to the proposed acquisition, in the following markets:
    - the supply and acquisition of raw milk in the Manawatu and Wairarapa region;
    - the processing and wholesale supply of town milk in the North Island;
    - the national market for the import, manufacture and wholesale supply of specialty cheese; and
    - the national market for the import, manufacture and wholesale supply of ice cream.

291. The Commission considers that in the counterfactual Foodstuffs LNI would retain ownership of KFF and UML and continue to grow the business.

292. In the factual, Fonterra would add the KFF brands to its current portfolio and continue to grow the business into the foodservice trade. In association with the proposed acquisition, Fonterra and Foodstuffs LNI would also enter into a number of secondary arrangements for the manufacture and wholesale supply of milk and cream products.

293. In the raw milk market, Fonterra would become the sole acquirer of raw milk direct from farmers in the Manawatu and Wairarapa region. However, due to KFF's relative size, any lessening of competition from the acquisition of KFF would be unlikely to materially impact on the market as a whole.

294. In the town milk market, Fonterra's market share would increase from [ ] percent to [ ] percent as a result of the proposed acquisition. Goodman Fielder/NZDF would remain a strong competitor for branded town milk and smaller competitors would impose a competitive constraint in their home regions. Further entry is possible, particularly at the regional level. Supermarkets and oil companies would exercise some countervailing power.

295. In the specialty cheese market, Fonterra's market share would increase from [ ] percent to [ ] percent as a result of the proposed acquisition. Goodman Fielder/NZDF would remain a strong competitor and numerous small and medium sized competitors would also impose a competitive constraint. The specialty cheese market is growing, with considerable product innovation. Market growth facilitates entry and ensures that any

benefits from differentiation can be competed away by new product development over time.

296. In the ice cream market, Fonterra's market share would increase from [ ] percent to [ ] percent as a result of the proposed acquisition. These figures include the overestimation of all housebrand production being attributed to Fonterra. Emerald Foods would continue to exist as a major competitor for premium ice cream and a number of smaller competitors would impose a competitive constraint, as would potential export diversion and new imports. Supermarkets are also considered to have some countervailing power.

297. Consequently, the Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in any of the affected markets.

DETERMINATION ON NOTICE OF CLEARANCE

298. Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by Fonterra Co-operative Group Limited, or any one of its wholly-owned subsidiaries, of 100 percent of the issued shares in Kapiti Fine Foods Limited and United Milk Limited.

Dated this 23rd February 2006

Paula Rebstock
Chair
Commerce Commission